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# Corporate Taxation: The General Franchise Tax

Jorge Martinez-Vazquez
*Georgia State University*, jorgemartinez@gsu.edu

Martin Grace
*Georgia State University*, mgrace@gsu.edu

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# TAXATION AND ECONOMIC DEVELOPMENT

## A Blueprint for Tax Reform in Ohio

ROY BAHL
*Editor*

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# 10 Corporate Taxation: The General Franchise Tax

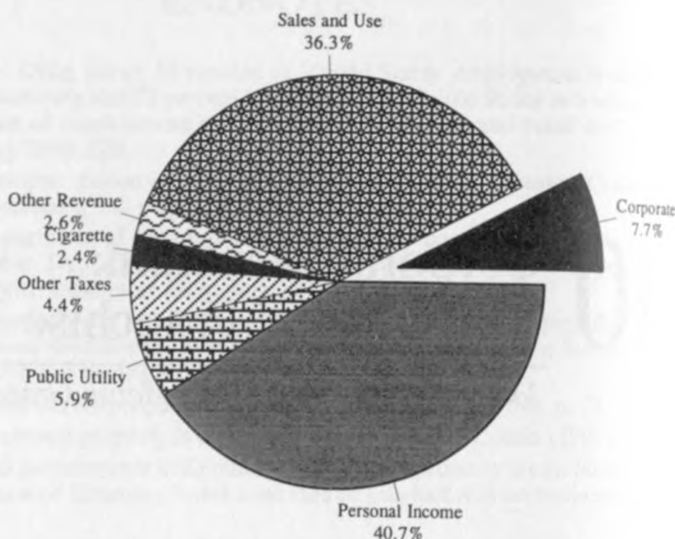
*Jorge Martinez-Vazquez and Martin Grace*[1]

## CURRENT STRUCTURE

The franchise tax is actually composed of two alternative taxes, one falling on net income and the other falling on net worth. The net worth statute dates from 1903 and has not been revised since 1936. Corporations in Ohio must compute both the tax on a net worth basis and the tax on a net income basis and pay the higher of the two. In any case the tax paid cannot be less than a minimum tax of $50. Ohio banks and other depository financial institutions pay a modified franchise tax only on a net worth basis, but at a higher tax rate. The franchise tax on financial institutions is discussed in Chapter 11 of this book. Ohio corporations pay an additional "litter tax" in two tiers, although the second tier is paid only by "litter stream" companies.

These are some of the most important features of the corporate franchise tax:

- *Relative importance*. The franchise tax is the third most important source of tax revenue in the state of Ohio. However, this tax represents a relatively small share of total general revenues. As shown in Figure 10-1, 1993 revenues from the corporate franchise tax represented 7.7 percent of total revenues. By comparison, in the same year the personal income tax raised 40.7 percent of total revenues and the sales tax raised 36.3 percent.




*Source:* Ohio Department of Taxation

*FIGURE 10-1. Ohio 1993 general revenues by type as a percentage of total general revenue.*

- *Volatility of tax revenues*. Tax liabilities from the corporate franchise tax for the last ten years are presented in Table 10-1. Several things are noticeable from this time series. First, although over the past ten years the two taxes on net worth (the general net worth franchise tax and the tax on financial institutions) have had some ups and downs, for the most part revenues have increased steadily. Some of the variability of the general net worth tax has been produced by the dual nature of the tax. In years of economic expansion more firms had higher net incomes and therefore paid the net income tax rather than the net worth tax. The time series for the net income tax reflects the volatility of its tax base (profits) over the business cycle. Revenues from the corporate net income tax have moved with the business cycle. Profits are by far the most volatile component of the state's gross income. Consequently, revenues from corporate income taxes are less reliable than those coming from other taxes, including the personal income tax, sales tax, and property tax. The instability of the net income tax has imposed a roller coaster effect on the overall collections from the franchise tax, as illustrated in Figure 10-2. The peaks and valleys in tax collections in Figure 10-2 are quite pronounced, even though they are expressed in real terms (constant 1987 prices).

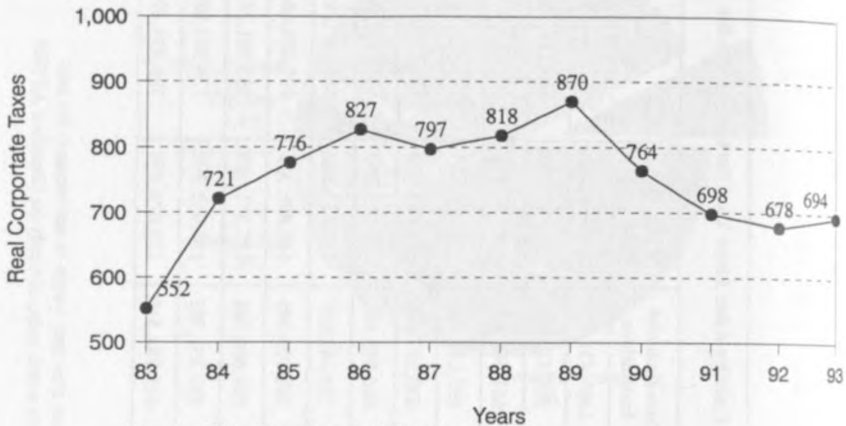
**TABLE 10-1**
**Total Corporate Franchise Tax Liability, Tax Years 1983–1993**

| Liability Before Litter Tax, Surtax and Credits* Non-Financial Institutions | | | | | Liability After Litter Tax, Surtax and Credits | | |
|---|---|---|---|---|---|---|---|
| Tax Year | Minimum ($50) Taxpayers | Net Worth Taxpayers | Net Income Taxpayers | Total | Non-financial Institutions | Financial Institutions | Total |
| 1983 | $11,404,800 | $147,735,230 | $332,041,840 | $491,181,870 | $486,431,925 | $37,405,560 | $523,837,485 |
| 1984 | 3,962,800 | 152,794,129 | 392,943,381 | 549,700,310 | 526,520,864 | 98,853,844 | 625,374,708 |
| 1985 | 3,480,493 | 144,100,946 | 522,502,099 | 670,083,538 | 661,568,822 | 98,650,431 | 760,219,253 |
| 1986 | 3,418,864 | 156,793,269 | 539,368,861 | 699,580,994 | 695,018,816 | 93,705,954 | 788,724,770 |
| 1987 | 2,783,324 | 172,179,120 | 490,115,343 | 665,077,787 | 630,587,449 | 104,670,239 | 735,257,688 |
| 1988 | 3,003,242 | 168,554,036 | 542,200,372 | 713,757,650 | 666,389,890 | 109,640,240 | 776,030,130 |
| 1989 | 2,835,850 | 163,646,944 | 598,482,693 | 764,965,487 | 722,042,029 | 130,125,260 | 852,167,289 |
| 1990 | 3,031,624 | 182,506,786 | 537,005,053 | 722,543,463 | 684,708,345 | 142,896,321 | 827,604,666 |
| 1991 | 3,614,626 | 202,190,495 | 444,733,217 | 650,538,338 | 609,690,068 | 147,271,175 | 756,961,243 |
| 1992 | 3,719,592 | 224,748,796 | 385,027,710 | 613,496,098 | 580,451,785 | 157,912,202 | 738,363,987 |
| 1993 | 2,501,161 | 228,158,717 | 401,836,889 | 632,496,767 | 615,784,545 | 173,074,954 | 788,859,499 |

*Source*: Ohio Department of Taxation.

*Only liability BEFORE litter tax, surtax and credits can be identified by type of tax base (net worth or net income) for non-financial institutions. Liability for financial institutions, which pay tax based on net worth only, can only be identified AFTER credits.

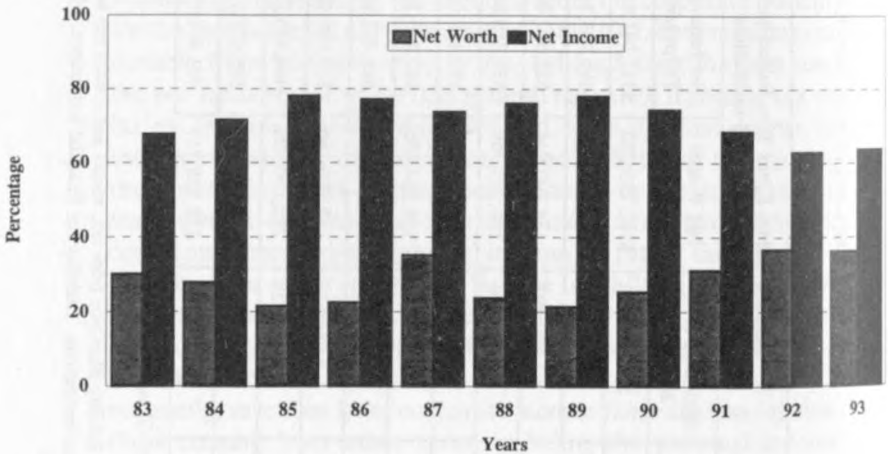
- *Shifting importance of net income and net worth taxes.* The net worth tax component of the franchise tax has played an increasing role in overall revenues since the late 1980s as documented in Figure 10-3.




*Source:* Ohio Department of Taxation.

*Note*: Deflator from Economic Report of the President except 1993; 1993 deflator estimated using *Survey of Current Business*.

*FIGURE 10-2. Real corporate franchise tax collections (1987 dollars: millions).*




*Source*: Ohio Department of Taxation.

*Note*: Totals do not add to 100% due to minimum ($50) taxpayers.

*FIGURE 10-3. Liability of N.W. taxpayers vs. N.I. taxpayers as a percentage of total corporate tax liabilities.*

- *Tax payments are concentrated from a small group of taxpayers.* Although the concentration of tax payments by a relatively small group of taxpayers is common to other taxes, corporate income taxes have traditionally been more concentrated than other taxes. Ohio's corporate franchise tax is not an exception to this rule. As shown in Figure 10-4, over 80 percent of the net worth tax in 1993 was paid by 10 percent of the taxpayers. The level of concentration was almost as high for the net income tax. The highest decile of taxpayers paid just a little under 80 percent of total net income collections (Figure 10-5).

## STRUCTURE OF THE TAX

*Nexus.* The franchise tax is levied on Ohio and non-Ohio corporations for the privilege of doing business in the state. The presumption of the general obligation to pay franchise tax in Ohio is established by doing business in

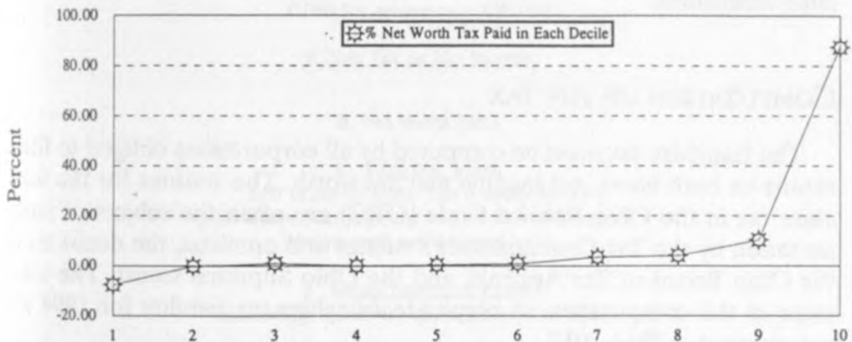



*FIGURE 10-4. Net worth tax paid 1993 by net worth deciles.*

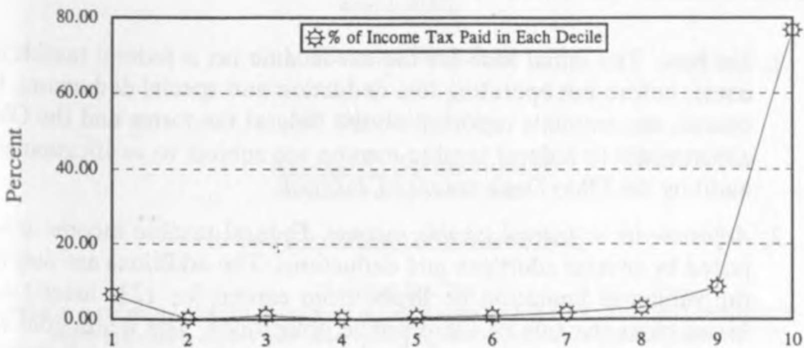



*FIGURE 10-5. Net income tax paid 1993 by net worth deciles.*

Ohio, owning capital or property in the state, or holding a charter authorizing the corporation to do business in Ohio.[2]

*Scope of the general franchise tax.* Besides all C corporations, agricultural cooperatives (Chapter 1729 corporations) and business trusts are also required to file the franchise tax. An S corporation is not subject to the franchise tax unless it functioned as a C corporation for part of the tax year. Other corporations not subject to the franchise tax include public utilities[3] (which are required to pay an excise tax on gross receipts under Chapter 5727 of the ORC), insurance companies (which pay a premium tax and are required to file annual reports with the Superintendent of Insurance), and "dealers in intangibles" (which also pay a separate tax).[4]

*Holding companies* must file the Supplemental Franchise Tax Schedules for holding companies of insurance companies, public utilities, and financial institutions, if the holding company owns at least 25 percent of the issued and outstanding shares of common stock of one or more financial institutions, or if the holding company owns at least 80 percent of the issued and outstanding shares of common stock of one or more public utilities or insurance companies.

## Computation of the Tax

The franchise tax must be computed by all corporations obliged to file a return on both bases, net income and net worth. The statutes for the franchise tax in the Ohio Revised Code (ORC) are often the subject of interpretation by the Tax Commissioner's rulings and opinions, the decisions of the Ohio Board of Tax Appeals, and the Ohio Supreme Court. The main steps in the computation of corporate franchise tax liability for 1994 are summarized in Table 10-2.

## Computation of the Net Income Tax

1. *Tax base.* The initial base for the net income tax is federal taxable income, before net operating loss deduction and special deductions. Of course, the amounts reported on the federal tax forms and the Ohio adjustments to federal taxable income are subject to verification and audit by the Ohio Department of Taxation.

2. *Adjustments to federal taxable income*. Federal taxable income is adjusted by several additions and deductions. The additions are only for the valuation limitation on losses from capital (or 1231 assets) and losses from the sale of Ohio public obligations. The deductions are more substantial but fairly standard. They include: valuation limitation

**TABLE 10-2**
**Computation of Corporation Franchise Liability for 1994**

A. Net Income Basis

1. Federal Taxable Income
*plus* additions
*minus* deductions (foreign income, dividends, U.S. interest, other)

2. Base Income
*minus* allocable income everywhere

3. Apportionable Income
*times* (income) apportionment ratio (4 factors: property, payroll, double weighted sales)

4. Apportioned Income
*plus* Ohio allocable Income
*minus* Ohio NOL
*plus* Other adjustments (related entity, transfer on corporation)

5. Ohio Taxable Income
*times* 0.051 for first $50,000 and
0.089 for income over $50,000

6. Ohio Tax on Net Income

B. Net Worth Basis

1. Total Net Worth
*Sum* of capital stock (less treasury stock)
*plus* retained earnings and additional paid-in capital
*plus* reserves and deferred taxes

2. Minus Exempted Assets
(including: goodwill, appreciation, and other)

3. Equals Net Value of Stock
*times* (net worth) apportionment ratio (2 factors: total assets and receipts)

4. Taxable Net Worth
*times* 0.00582

5. Tax on Net Worth Basis

C. Final Tax Liability

1. Franchise Tax Due (the largest of)
Net income or net worth basis

2. *plus* Tier One and Tier Two Litter Taxes

3. Total Tax Due
*minus* non-refundable credits (investment in subsidiaries, export sales, qualifying investment)
*minus* refundable credits (new jobs, qualifying investment) and advanced payments

4. Balance Due (or Overpayment)

on gains from capital (or 1231 assets), gains from the sale of Ohio public obligations, dividends received, interest from Ohio public obligations, and net interest from United States obligations.[5]

Ohio corporations are allowed to deduct net income from foreign sources. However, this deduction was amended in 1991 to limit it in some cases to a percent of the foreign source income. The rationale was that some of the operating expenses deducted by the corporation are also attributable to foreign income. In particular, ORC section 78, foreign dividend gross-up, and ORC section 951 (subpart F) are deductible in full. However, foreign dividends of affiliated corporations that do not transact or hold assets in the USA can be deducted by 85 percent, and foreign royalties can be deducted by 90 percent. Income from technical services performed in the United States for a foreign firm is not at all deductible.

3. *Allocable income.* The Ohio corporate franchise tax, as in many other states, distinguishes between allocable income and apportionable income. Allocable income is either entirely included or entirely excluded from the tax base of the corporate income tax in the state. In the case of apportionable income, part of the income is included in the base by using an apportionment formula reflecting how much of the corporation's business is transacted in the state.

   Ohio statutes make no distinction between business and nonbusiness income in the designation of allocable income. The issue of what income is allocable versus apportionable has often been the subject of appeals by taxpayers because allocated income, unlike apportioned income, enters the tax base at 100 percent.[6] The following types of income are fully allocable to the state of Ohio: net rents and royalties from real property located in the state and from tangible personal property utilized in the state, capital gains and losses from the sale of property located in the state, and dividends which are not otherwise deducted or excluded from net income.[7] Also, net patent, franchise, and copyright royalties and technical assistance fees are allocable to Ohio to the extent that the activity takes place in Ohio, and that they do not constitute the corporation's principal source of income.[8]

4. *Apportionable income and formula.* A large number of corporations with an obligation to file a corporate franchise tax return in Ohio do business in other states besides Ohio. This raises the necessity of determining what part of the corporation's net income ought to be taxed in the state of Ohio. Except for those income items that are considered directly allocable to Ohio or other states, all other income derived by the corporation is apportioned to the state of Ohio using a conventional three factor formula based on property, payroll, and sales, but

with the sales factor double-weighted. The composition of the formula is illustrated in Table 10-3.

5. *Taxable income.* In order to arrive at Ohio taxable income for the corporation, the sum of the apportioned income and allocable income within Ohio is first adjusted by the income or losses of transferor corporations and "related entity and related member" from combined reports. The second adjustment is for net operating losses.

6. *Net operating losses.* In the calculation of the net income tax, corporations are allowed to take a deduction for net operating losses (NOLS) realized in past periods. NOLS are allocated and apportioned, inside and outside Ohio, for the year in which the NOLS have occurred in the same manner that net income would have been allocated and apportioned. NOLS incurred in or after 1982 can be carried forward for 15 consecutive years, starting the year after the NOL occurred.[9] There is no carry back provision.

**TABLE 10-3**
**Net Income Apportionment Formula**

$$\text{Ohio Apportioned Net Income} = \text{Total Net Corporation Apportionable Income} \times \frac{\text{Property} + \text{Payroll} + \text{Sales} + \text{Sales Factors}}{4^{*}}$$

**Reduced by number of factors with a denominator of zero.*

The factors are computed as follows:

$$\text{Property Factor}^{*} = \frac{\text{Average cost of owned or rented real and tangible personal property used in business in Ohio}}{\text{Average cost of such property used everywhere}}$$

$$\text{Payroll Factor}^{**} = \frac{\text{Total compensation paid in Ohio}}{\text{Total compensation paid everywhere}}$$

$$\text{Sales Factor}^{***} = \frac{\text{Sales in Ohio}}{\text{Sales everywhere}}$$

**Excludes cost of pollution control, coal conversion, solid waste energy conversion, thermal efficiency improvement, energy conversion facilities, property that generates rental income, property in a qualified facility in an enterprise zone, and property used exclusively for qualified research in Ohio.*

***Excludes compensation to certain employees at a qualified facility in an enterprise zone, and compensation to employees engaged in qualified research in Ohio.*

****For sales of tangible personal property, sales inside and outside of Ohio are determined by the final destination of the property sold; other sales are sitused according to where the income-producing activity takes place. Sales derived from allocable income are not included in this factor.*

One peculiarity of the dual nature of the Ohio franchise tax is that the carry forward of losses is of no benefit in the computation of the alternative net worth tax that corporations may have to pay even in those years in which they have made positive net income.

## Computation of the Net Worth Tax

1. *Tax base.* The tax base for the net worth tax is computed as the total book value of the corporation's capital, surplus, retained earnings, and reserves. The value of the corporation's issued and outstanding shares of stock for the purposes of the net worth tax is based on the book value kept according to generally accepted accounting principles.[10]
2. *Exempted assets.*. Certain assets are exempt from the base of the net worth, including "goodwill," appreciation, land used in agriculture, research facilities, and pollution-and-energy-saving assets after certification by the Tax Commissioner. Goodwill is the cost in excess of fair value of the net assets acquired.[11] The list of currently exempt assets is in Box 10-1.
3. *Net worth apportionment formula.* Many of the corporations liable for the net worth tax in Ohio are also doing business in other states besides Ohio. The share of the corporation's net worth subject to tax in Ohio is determined through the application of an apportionment formula which is different from the apportionment formula used for net income tax purposes. The apportionment formula for net worth is based on two single weighted factors; property and "business done" in Ohio. This formula is illustrated in Table 10-4.

## Other Taxes

There are two litter taxes levied with the franchise tax. These taxes were scheduled to expire in 1993 but have been extended through 1995. It is quite possible that the state legislature will prolong their lives beyond 1995.

All corporations except "litter stream corporations", financial institutions, family farm corporations and those paying the minimum tax of $50, pay the "tier one litter tax." The tax has a cap of $5,000[12] and it is computed as the larger of the following two bases:

a. Net income basis: the first $50,000 of Ohio taxable income is taxed at a rate of 0.11 percent and for taxable income above $50,000 the rate is 0.22 percent.

b. Net worth basis: Net worth taxable value at a rate of 0.014 percent.

**BOX 10-1**
**Assets Exempt from The Net Worth Tax**

Certain valuation reserves;

Taxes due and payable;

Goodwill, appreciation, and abandoned property;

Specified investments in public utilities, insurance companies, and financial institutions in which the taxpayer has ownership interests as required by statute (investments and business attributed to these companies are also eliminated in determining the property and business fractions for apportioning net worth);

Certified Ohio pollution control facilities;

Certain facilities designed to convert coal into other fuels or to desulphurize coal (assets excluded for 30 years);

Certified Ohio civil defense structures;

Certified Ohio energy conversion, thermal efficiency improvement, and solid waste energy conversion facilities;

Voting stock and participation certificates of production credit associations;

Land in Ohio devoted exclusively to agricultural use;

Property within Ohio used exclusively for qualified research;

Qualified improvements to property located in an enterprise zone.

(ORC 5709.25, 5709.35, 5709.50, 5709.65, 5733.05, and 5915.29)
Reproduced from Department of Taxation Annual Report.

**TABLE 10-4**
**Net Worth Tax Base Formula**

$$\text{Ohio Taxable Value} = \left[\begin{array}{c}\text{Total Net Worth}\\ \text{minus}\\ \text{Exempted Assets}\end{array}\right] \times \frac{\text{Property + Business done factors}}{2}$$

The factors are computed as follows:

$$\text{Property Factor} = \frac{\text{Book Depreciated Value of Ohio Assets}^{*}}{\text{Book Value of Total Assets}}$$

$$\text{Business Factor} = \frac{\text{Ohio Business done}^{*}}{\text{Total Business done}^{**}}$$

*Excludes value of pollution control, coal conversion, solid waste energy conversion, thermal efficiency improvement and energy conversion facilities, goodwill, appreciation, abandoned property, qualified property in an enterprise zone, and property used exclusively for qualified research.*

***Business done for the sale of tangible personal property is determined by the final destination of the goods. For other types of sales business done is determined according to the situs of the sales.*

The "tier two litter tax" applies only to those corporations that manufacture or sell litter stream products. These are defined to include all types of alcoholic beverages, soft drinks, packaging and containers, cigarettes and other tobacco products, matches, candy and gum.

The "tier two litter tax" is also computed on the larger of the two alternative bases of net income and net worth. The rates are double those of the "tier one litter tax". The only exception is for the first $50,000 of net income, to which the rate of 0.11 percent is applied. The "tier two litter tax" is capped at $10,000.

## CREDITS

First, there is a credit for investment in qualified subsidiaries.[13] The objective of this credit is to address the double taxation of net worth at the parent and subsidiary levels. The credit is for investment in qualified subsidiaries when the parent company owns more than 50 percent of the capital stock of the subsidiary and when during the fiscal year both parent and subsidiary paid the franchise tax on a net worth basis. The credit equals the lesser of the following:

- The tax charged on the corporation's net worth represented by investments in its subsidiaries.

- The amount by which the corporation's net worth tax exceeds its computed (but not paid) net income tax.
- The amount by which the net worth tax of its subsidiaries exceeds the computed (but not paid) net income tax.
- The credit for investment in qualified subsidiaries is being phased in over a period of six years starting in 1990, according to the following schedule:

| Tax Year | Percentage |
|---|---|
| 1990 | 25 |
| 1991 | 50 |
| 1992 | 50 |
| 1993 | 50 |
| 1994 | 75 |
| 1995 | 100 |

Second, there is a credit for qualifying new investment, which has the objective of reducing the double taxation of real assets under the franchise and property taxes. Corporations may claim a credit against the franchise tax liability for the difference between the property tax paid on certain qualifying property and the tax that would have been paid had this property been listed at a lower rate set forth in ORC section 5733.061 (B). The credit applies to equipment and machinery for manufacturing or refining acquired after 1978 and not previously owned and credited by other taxpayers. This credit is not refundable, but when the credit exceeds the tax liability it can be carried forward for three years provided that the property has not been sold.[14]

Third, there is an export sales credit. This applies to corporations that increase their export sales at the same rate they increase their Ohio property and/or payroll. The credit can be claimed through the year 2005 and is computed on the basis of a formula incorporating the incremental changes in export sales and property and payroll factors.

Fourth, there is a "new jobs credit" which is refundable and calculated as the amount of Ohio income tax that the employer withheld from its employees times the percentage agreed with the Tax Credit Authority. Rehired or laid-off workers called back to work in a new facility or in the production of new goods or services qualify for the new jobs credit. This new credit is administered by the Tax Credit Authority and the Ohio Department of Development.

Fifth, there is a credit for qualified non-retail corporations locating in "enterprise zones." This credit is equal to the amount reimbursed to specified employees for the cost of day care services (up to a maximum of $300

per child) plus the amount reimbursed to specified employees for training costs (up to a maximum of $1,000 per employee).

*Other tax benefits.* In addition to the tax credits discussed above, corporations are eligible for several other tax benefits. Corporations that invest and create new jobs in certified enterprise zones can receive several tax benefits from the franchise tax, including an employee training credit, a day care credit, exclusion of qualifying property and payroll factors for the apportionment of the net income tax, and the exemption of qualifying property from the base of the net worth tax. Furthermore, the net book value of property within Ohio used exclusively for qualified research activities is excluded from the numerators of the apportionment factors for the net income and net worth taxes. This property is also treated as exempt in the computation of the net worth tax base.

*Combined income reporting.* At present, the majority of corporations file a separate entity tax return. However, taxpayer corporations have the option of using a combined report for the apportionment of their incomes to the state.[15] Combined reports apply only to the net income portion of the franchise tax. No similar option exists for the net worth tax.

More specifically, any corporation subject to the franchise tax that directly or indirectly controls over 50 percent of the voting stock of other corporation(s) subject to the franchise tax in Ohio may elect to combine incomes for the purpose of apportioning income taxes.[16] There is no obligation to include all the eligible corporations in the combined report, and related subsidiaries may elect to file a combined report without the inclusion of the parent corporation. If related entities are excluded from the combined report, the Commissioner requires an explanation for the exclusion.[17] Once combined income filing is selected by a group of corporations, they cannot opt out without written permission of the Tax Commissioner.[18]

Finally, the Commissioner may require combined income reporting for a group of interrelated corporations if it is felt that a combined report is necessary to properly reflect income and tax liability. Often such rulings have been appealed.

## Distribution of Liabilities

The distribution for 1993 of net worth and net income tax payments among corporations grouped by level of net worth and by economic sector is presented in Tables 10-5 and 10-6, respectively. In 1993 there were 107,824 filers, of which 84,391 or 78.3 percent were net worth taxpayers, and 23,433 or 21.7 percent were net income taxpayers. The distribution of taxpayers between the two bases contrasts with the distribution of revenues. The net worth tax yielded $228 million or 36.2 percent of total franchise tax revenues, while the net income component yielded $402 million or 63.8 percent

## TABLE 10-5
## Reported Tax Liability by Tax Base and Net Worth, 1993

| Net Worth | Tax Liability before Litter Tax and Credits | | | | | |
|---|---|---|---|---|---|---|
| | Net Worth Payers | Number of Filers | Net Income Payers | Number of Filers | Total Liability | Number of Filers |
| $< 0 | $1,062,274 | 20,646 | $27,576,223 | 1,799 | $28,638,497 | 22,445 |
| 0 - 1 | 3,457,697 | 8,885 | 3,766,570 | 549 | 7,224,267 | 9,434 |
| 2 - 200,000 | 10,877,777 | 35,275 | 21,371,425 | 12,226 | 32,249,202 | 47,501 |
| 200,001 - 500,000 | 11,191,797 | 7,164 | 14,698,029 | 3,001 | 25,889,826 | 10,165 |
| 500,001 - 2,500,000 | 24,690,981 | 6,178 | 37,390,834 | 2,695 | 62,081,815 | 8,873 |
| 2,500,001 - 5,000,000 | 8,623,498 | 1,409 | 19,049,265 | 742 | 27,672,763 | 2,151 |
| 5,000,001 - 20,000,000 | 20,714,086 | 2,189 | 48,876,795 | 1,134 | 69,590,881 | 3,323 |
| 20,000,001 - 100,000,000 | 36,719,759 | 1,612 | 67,416,587 | 852 | 104,136,346 | 2,464 |
| 100,000,001 - 250,000,000 | 22,950,564 | 534 | 39,480,517 | 238 | 62,431,081 | 772 |
| 250,000,001 - 500,000,000 | 20,978,333 | 231 | 29,403,482 | 93 | 50,381,815 | 324 |
| 500,000,001 - 750,000,000 | 12,415,001 | 83 | 14,669,812 | 39 | 27,084,813 | 122 |
| 750,000,001 - 1,000,000,000 | 5,447,423 | 51 | 6,142,703 | 13 | 11,590,126 | 64 |
| > 1,000,000,000 | 48,880,774 | 134 | 72,188,481 | 52 | 121,069,255 | 186 |
| TOTAL | $228,009,964 | 84,391 | $402,030,723 | 23,433 | $630,040,687 | 107,824 |

| Net Worth | Litter Taxes, Credits, and Total Reported Liability | | | | |
|---|---|---|---|---|---|
| | Tier 1 * Litter Tax | Tier 2 * Litter Tax | New Investment Credit | Subsidiary & Other Credits | Total Liability |
| $< 0 | $304,121 | $24,927 | $6,002,070 | $144,623 | $22,820,852 |
| 0 - 1 | 66,541 | 748 | 103,825 | 11,064 | 7,176,667 |
| 2 - 200,000 | 601,314 | 17,452 | 331,145 | 93,381 | 32,443,442 |
| 200,001 - 500,000 | 606,341 | 16,298 | 687,464 | 53,085 | 25,771,916 |
| 500,001 - 2,500,000 | 1,390,911 | 34,720 | 1,623,866 | 191,556 | 61,692,024 |
| 2,500,001 - 5,000,000 | 629,889 | 13,784 | 1,195,312 | 131,125 | 26,989,999 |
| 5,000,001 - 20,000,000 | 1,400,574 | 50,968 | 2,135,724 | 776,761 | 68,129,938 |
| 20,000,001 - 100,000,000 | 1,676,883 | 56,917 | 3,547,254 | 1,167,769 | 101,155,123 |
| 100,000,001 - 250,000,000 | 818,486 | 35,961 | 3,790,020 | 698,033 | 58,797,475 |
| 250,000,001 - 500,000,000 | 487,287 | 12,599 | 3,118,471 | 924,131 | 46,839,099 |
| 500,000,001 - 750,000,000 | 237,755 | 16,821 | 1,096,816 | 454,446 | 25,788,127 |
| 750,000,001 - 1,000,000,000 | 138,212 | 7,205 | 283,147 | 219,369 | 11,233,027 |
| > 1,000,000,000 | 536,361 | 35,652 | 7,017,896 | 2,487,910 | 112,135,462 |
| TOTAL | $8,894,675 | $324,052 | $30,933,010 | $7,353,253 | $600,973,151 |

* Tier 1 Litter Tax is paid by all corporations. Tier 2 Litter Tax is paid only by "litter stream" corporations.

of total revenues. Litter taxes raised $9.2 million in 1993. Total credits allowed against the franchise tax in 1993 amounted to $38.3 million, of which $30.9 million corresponded to the new investment tax credit.

The distribution of tax liabilities among different firm sizes and economic groups is better visualized in percentage terms. This is shown in Tables 10-

## TABLE 10-6
## Reported Tax Liability by Tax Base and Industry, 1993

| Industry | Tax Liability before Litter Tax and Credits | | | | | |
|---|---|---|---|---|---|---|
| | Net Worth Payers | Number of Filers | Net Income Payers | Number of Filers | Total Liability | Number of Filers |
| Agriculture, Forestry | $1,216,809 | 1,146 | $1,669,607 | 380 | $2,886,416 | 1,526 |
| Mining | 8,857,777 | 1,014 | 3,637,913 | 173 | 12,495,690 | 1,187 |
| Construction | 7,271,866 | 7,483 | 14,951,878 | 2,165 | 22,223,744 | 9,648 |
| Manufacturing | 84,341,330 | 10,431 | 204,172,971 | 4,025 | 288,514,301 | 14,456 |
| Utilities | 21,912,296 | 3,369 | 28,796,966 | 1,019 | 50,709,262 | 4,388 |
| Wholesale | 17,754,276 | 6,446 | 32,419,816 | 2,318 | 50,174,092 | 8,764 |
| Retail | 20,527,571 | 11,125 | 46,673,693 | 3,391 | 67,201,264 | 14,516 |
| Finance, Insurance, & Real Estate | 31,698,024 | 9,824 | 23,424,360 | 2,470 | 55,122,384 | 12,294 |
| Services | 22,951,030 | 23,498 | 37,946,724 | 5,787 | 60,897,754 | 29,285 |
| Not Classified | 11,478,985 | 10,055 | 8,336,795 | 1,705 | 19,815,780 | 11,760 |
| TOTAL | $228,009,964 | 84,391 | $402,030,723 | 23,433 | $630,040,687 | 107,824 |

| Industry | Litter Taxes, Credits, and Total Reported Liability | | | | |
|---|---|---|---|---|---|
| | Tier 1 * Litter Tax | Tier 2 * Litter Tax | New Investment Credit | Subsidiary & Other Credits | Total Liability |
| Agriculture, Forestry | $52,418 | $336 | $8,021 | $1,246 | $2,929,903 |
| Mining | 183,965 | 860 | 643,064 | 105,441 | 11,932,010 |
| Construction | 464,970 | 5,864 | 82,770 | 50,758 | 22,561,050 |
| Manufacturing | 3,678,054 | 129,536 | 27,366,195 | 3,747,747 | 261,207,949 |
| Utilities | 463,486 | 267 | 90,612 | 679,397 | 50,403,007 |
| Wholesale | 913,495 | 54,012 | 621,463 | 560,919 | 49,959,215 |
| Retail | 943,665 | 106,152 | 282,134 | 177,755 | 67,791,192 |
| Finance, Insurance, & Real Estate | 820,690 | 7,683 | 175,027 | 1,257,108 | 54,518,623 |
| Services | 1,135,244 | 13,317 | 131,323 | 563,403 | 61,351,590 |
| Not Classified | 238,688 | 6,025 | 1,532,401 | 209,479 | 18,318,612 |
| TOTAL | $8,894,675 | $324,052 | $30,933,010 | $7,353,253 | $600,973,151 |

* Tier 1 Litter Tax is paid by all corporations. Tier 2 Litter Tax is paid only by "litter stream" corporations.

7 and 10-8. Smaller firms with a net worth under $500,000 represented 73.6 percent of all taxpayers, but paid only 10.8 percent of all tax liabilities. Firms with net assets over $1 billion represented only 0.17 percent of the total number of filers, but they accounted for 19.22 percent of all liabilities. Credits also tend to be concentrated at the top. Firms with assets over $1 billion claimed 22.7 percent of new investment tax credits and 33.8 percent of all other tax credits. In terms of economic sectors, the manufacturing sector is the largest taxpayer, being responsible for 45.8 percent of total tax liabilities even though this sector represents only 13.4 percent of the total number of filers.

## TABLE 10-7
## Reported Tax Liability by Tax Base and Net Worth by Percentage of Total, 1993

| Net Worth | Tax Liability before Litter Tax and Credits | | | | | |
|---|---|---|---|---|---|---|
| | Net Worth Payers | Number of Filers | Net Income Payers | Number of Filers | Total Liability | Number of Filers |
| $< 0 | 0.47% | 24.46% | 6.86% | 7.68% | 4.55% | 20.82% |
| 0 - 1 | 1.52 | 10.53 | 0.94 | 2.34 | 1.15 | 8.75 |
| 2 - 200,000 | 4.77 | 41.80 | 5.32 | 52.17 | 5.12 | 44.05 |
| 200,001 - 500,000 | 4.91 | 8.49 | 3.66 | 12.81 | 4.11 | 9.43 |
| 500,001 - 2,500,000 | 10.83 | 7.32 | 9.30 | 11.50 | 9.85 | 8.23 |
| 2,500,001 - 5,000,000 | 3.78 | 1.67 | 4.74 | 3.17 | 4.39 | 1.99 |
| 5,000,001 - 20,000,000 | 9.08 | 2.59 | 12.16 | 4.84 | 11.05 | 3.08 |
| 20,000,001 - 100,000,000 | 16.10 | 1.91 | 16.77 | 3.64 | 16.53 | 2.29 |
| 100,000,001 - 250,000,000 | 10.07 | 0.63 | 9.82 | 1.02 | 9.91 | 0.72 |
| 250,000,001 - 500,000,000 | 9.20 | 0.27 | 7.31 | 0.40 | 8.00 | 0.30 |
| 500,000,001 - 750,000,000 | 5.44 | 0.10 | 3.65 | 0.17 | 4.30 | 0.11 |
| 750,000,001 - 1,000,000,000 | 2.39 | 0.06 | 1.53 | 0.06 | 1.84 | 0.06 |
| > 1,000,000,000 | 21.44 | 0.16 | 17.96 | 0.22 | 19.22 | 0.17 |
| TOTAL | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

| Net Worth | Litter Taxes, Credits, and Total Reported Liability | | | | |
|---|---|---|---|---|---|
| | Tier 1 * Litter Tax | Tier 2 * Litter Tax | New Investment Credit | Subsidiary & Other Credits | Total Liability |
| $ < 0 | 3.42% | 7.69% | 19.40% | 1.97% | 3.80% |
| 0 - 1 | 0.75 | 0.23 | 0.34 | 0.15 | 1.19 |
| 2 - 200,000 | 6.76 | 5.39 | 1.07 | 1.27 | 5.40 |
| 200,001 - 500,000 | 6.82 | 5.03 | 2.22 | .72 | 4.29 |
| 500,001 - 2,500,000 | 15.64 | 10.71 | 5.25 | 2.61 | 10.27 |
| 2,500,001 - 5,000,000 | 7.08 | 4.25 | 3.86 | 1.78 | 4.49 |
| 5,000,001 - 20,000,000 | 15.75 | 15.73 | 6.90 | 10.56 | 11.34 |
| 20,000,001 - 100,000,000 | 18.85 | 17.56 | 11.47 | 15.88 | 16.83 |
| 100,000,001 - 250,000,000 | 9.20 | 11.10 | 12.25 | 9.49 | 9.78 |
| 250,000,001 - 500,000,000 | 5.48 | 3.89 | 10.08 | 12.57 | 7.79 |
| 500,000,001 - 750,000,000 | 2.67 | 5.19 | 3.55 | 6.18 | 4.29 |
| 750,000,001 - 1,000,000,000 | 1.55 | 2.22 | 0.92 | 2.98 | 1.87 |
| > 1,000,000,000 | 6.03 | 11.00 | 22.69 | 33.83 | 18.66 |
| TOTAL | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

* Tier 1 Litter Tax is paid by all corporations. Tier 2 Litter Tax is paid only by "litter stream" corporations.

**TABLE 10-8**
**Reported Tax Liability by Tax Base and Industry by Percentage of Total, 1993**

| Industry | Tax Liability before Litter Tax and Credits | | | | | |
|---|---|---|---|---|---|---|
| | Net Worth Payers | Number of Filers | Net Income Payers | Number of Filers | Total Liability | Number of Filers |
| Agriculture, Forestry | 0.53% | 1.36% | 0.42% | 1.62% | 0.46% | 1.42% |
| Mining | 3.88 | 1.20 | 0.90 | 0.74 | 1.98 | 10 |
| Construction | 3.19 | 8.87 | 3.72 | 9.24 | 3.53 | 8.95 |
| Manufacturing | 36.99 | 12.36 | 50.79 | 17.18 | 45.79 | 13.41 |
| Utilities | 9.61 | 3.99 | 7.16 | 4.35 | 8.05 | 4.07 |
| Wholesale | 7.79 | 7.64 | 8.06 | 9.89 | 7.96 | 8.13 |
| Retail | 9.00 | 13.18 | 11.61 | 14.47 | 10.67 | 13.46 |
| Finance, Insurance, & Real Estate | 13.90 | 11.64 | 5.83 | 10.54 | 8.75 | 11.40 |
| Services | 10.07 | 27.84 | 9.44 | 24.70 | 9.67 | 27.16 |
| Not Classified | 5.03 | 11.91 | 2.07 | 7.28 | 3.15 | 10.91 |
| TOTAL | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

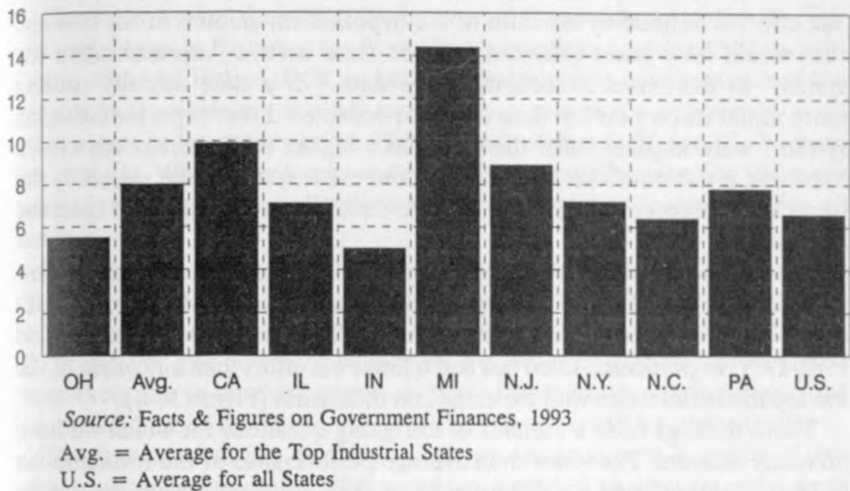
| Industry | Litter Taxes, Credits, and Total Reported Liability | | | | |
|---|---|---|---|---|---|
| | Tier 1 * Litter Tax | Tier 2 * Litter Tax | New Investment Credit | Subsidiary & Other Credits | Total Liability |
| Agriculture, Forestry | 0.59% | 0.10% | 0.03% | 0.02% | 0.49% |
| Mining | 2.07 | 0.27 | 2.08 | 1.43 | 1.99 |
| Construction | 5.23 | 1.81 | 0.27 | 0.69 | 3.75 |
| Manufacturing | 41.35 | 39.97 | 88.47 | 50.97 | 43.46 |
| Utilities | 5.21 | 0.08 | 0.29 | 9.24 | 8.39 |
| Wholesale | 10.27 | 16.67 | 2.01 | 7.63 | 8.31 |
| Retail | 10.61 | 32.76 | 0.91 | 2.42 | 11.28 |
| Finance, Insurance, & Real Estate | 9.23 | 2.37 | 0.57 | 17.10 | 9.07 |
| Services | 12.76 | 4.11 | 0.42 | 7.66 | 10.21 |
| Not Classified | 2.68 | 1.86 | 4.95 | 2.85 | 3.05 |
| TOTAL | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

* Tier 1 Litter Tax is paid by all corporations. Tier 2 Litter Tax is paid only by "litter stream" corporations.

# COMPARISON WITH OTHER STATES

## Revenue Performance

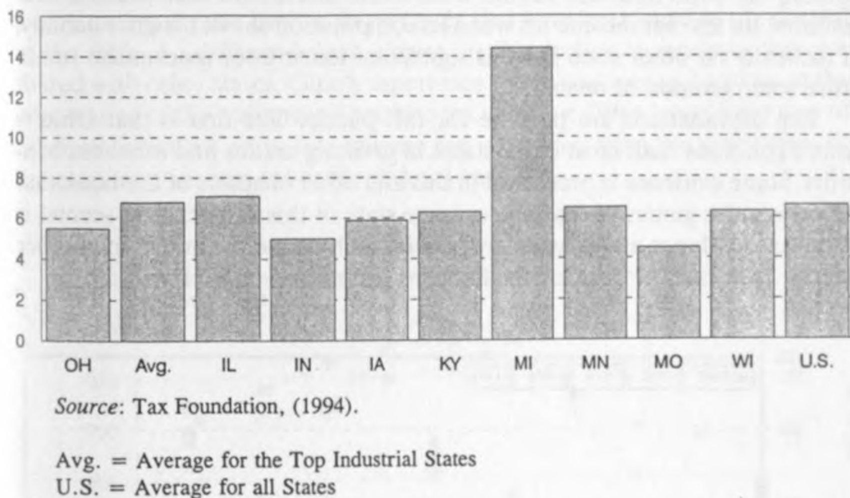
*Average reliance on the tax.* By comparison to other states, Ohio's use of the corporate income tax is below average. This is shown with data for 1991 in Figure 10-6 where Ohio's corporate tax collections as a percent of total tax revenue are compared to those of the eight top industrial states and to the entire United States' average. The comparison with states in the Midwest Region gives similar results (Figure 10-7). In 1991 Ohio was rely-




*Source:* Facts & Figures on Government Finances, 1993

Avg. = Average for the Top Industrial States
U.S. = Average for all States

*FIGURE 10-6. 1991 Corporate tax collections as a percentage of total tax revenue: top industrial states.*




*Source*: Tax Foundation, (1994).

Avg. = Average for the Top Industrial States
U.S. = Average for all States

*FIGURE 10-7. 1991 corporate tax collections as a percentage of total revenue: Midwest region.*

ing less on corporate franchise taxes than all other states in the two groups except for Indiana and Missouri.

A different way to compare the performance of Ohio's franchise tax vis-a-vis the average performance for other states is to examine its relative performance or tax effort. The Advisory Commission on Intergovernmental Relations (ACIR) conducts periodic studies of the tax effort of the states.[19]

Tax effort is defined by the ratio of the hypothetical amount of tax revenue that would have been collected had the state used a "representative tax system" to the actual collections in the state.[20] If a state actually collects more under its own tax law than would be collected if the "representative tax system" were in place, then the state has a higher than average tax effort. Similarly, if the state's actual tax collections are less than those raised by the hypothetical representative tax, then the state's tax effort is lower than the average.

Using this approach to examine Ohio's corporate franchise tax performance, we find that Ohio has made a lower tax effort on the corporate income—net worth tax than the average state in the United States in the period 1982-1991. In particular, Ohio has had a lower tax effort than any other of the ten top industrial states with the exception of Indiana (Figure 10-8).

These findings raise a number of intriguing questions for which we have no ready answers. The lower than average performance of the franchise tax in Ohio is unexpected for several reasons. The corporate franchise net income tax in Ohio has, as we see below, a base similar to that in most other states, and the tax rate for nominal net income is among the highest. In addition, the Ohio franchise tax has a net worth alternative base which is substituted for the net income tax when its computation shows a higher liability. Practically no other state has this significant lower floor mechanism to ensure some amount of revenue.

Two explanations are possible for this puzzle. The first is that Ohio is more generous than most other states in granting credits and other tax benefits. Some evidence is presented in this and other chapters of the book that Ohio is more generous than the average state in this respect. The second is that tax avoidance and evasion are considerably worse in Ohio than in other states. However, no data are available to pursue this conjecture.

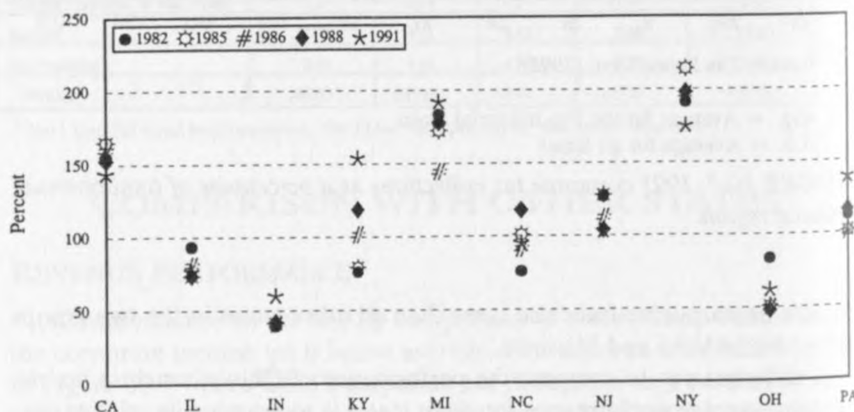
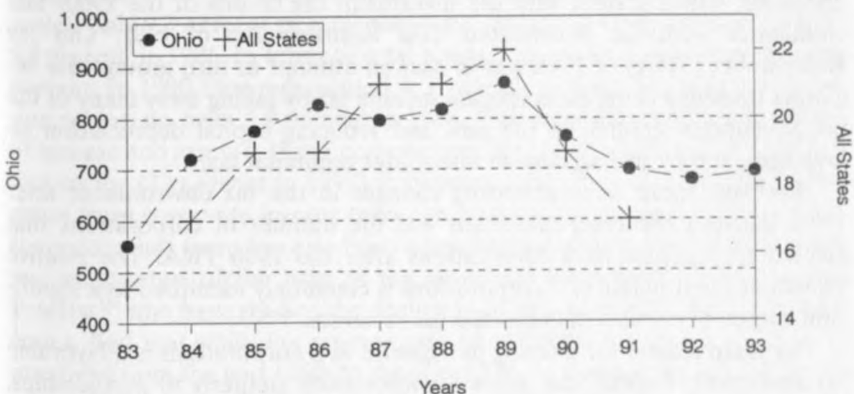



*FIGURE 10-8. Relative tax effort for the corporate franchise tax.*

*The trend toward decreasing importance of the corporate income tax.* The ups and downs in the revenues from Ohio's franchise tax from 1983 to 1993 (Table 10-1 and Figure 10-2), and the general decrease in importance of the corporate franchise tax in total tax revenues, mirror the experience of all other states in the same period. This is clearly shown in Figure 10- 9, where the real (at 1987 prices) corporate franchise tax collections for Ohio are compared to the total collections from the corporate income tax for all states.[21]

This pattern of similar behavior in Ohio and the United States is also shown in Figure 10-10 which tracks the percent change from year to year for both series. However, these two figures also suggest a less pronounced profile in the ups and downs of collections for Ohio than for all states. This is most likely due to the dual nature of Ohio's franchise tax, which makes firms pay the highest of the net income tax and the net worth tax components.

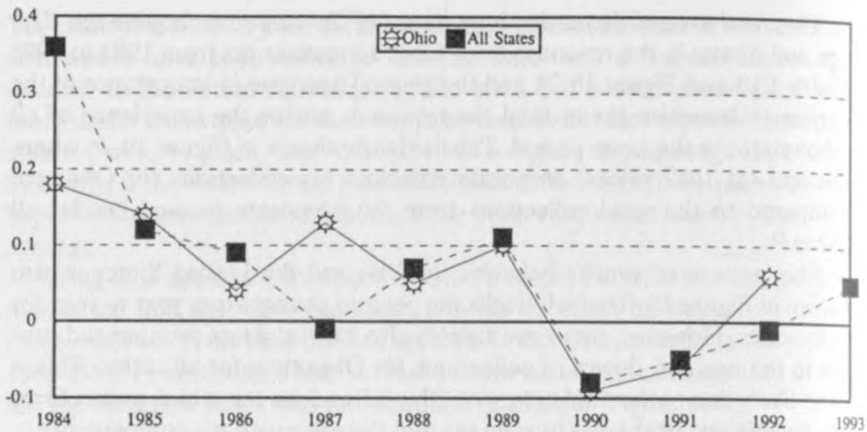
The franchise tax has declined in relative importance as a source of revenue over the last ten years. This trend has persisted whether revenues from the net worth tax on financial institutions are included or excluded from the total (Table 10-9). What are the explanations for the declining importance of Ohio's franchise tax in total revenues? To answer this we will need to examine causes for the decline in revenues that have been outside the control of the state, or, differently put, causes for the decline in revenues that are shared with other states. Ohio's experience with a continuing decrease in the importance of the corporate franchise tax does not differ much from that of other states with a corporate income tax, or indeed from the experience of the corporate income tax at the federal level.




*Source*: Ohio Department of Taxation.

*Note*: Deflator from Economic Report of the President.

*FIGURE 10-9. Real corporate franchise tax collections for Ohio vs. all states (1987 dollars: Ohio in Millions, Total for all states in billions).*




*Source:* Ohio Department of Taxation Facts and Tax Foundation, (1994)

*FIGURE 10-10. Percent change in actual corporate tax revenues (Ohio vs. total for all states).*

At the federal level, collections from the corporate income tax have been declining since the 1960s, when the corporate income tax represented as much as one-fifth of total federal tax revenues. Since the mid-1980s and during the 1990s, corporate income tax collections have represented approximately one-tenth of total federal tax revenues. A part of this decline is associated with policy changes granting more favorable tax treatment to corporations, which started with the investment tax credits of the 1960s and culminated with the Accelerated Cost Recovery Act of 1981. The Tax Reform Act (TRA) of 1986 was in part an attempt to turn around the declining revenues from the corporate income tax by taking away many of the tax advantages granted in the past and reducing capital depreciation allowances, and by introducing an alternative minimum tax.

However, there were offsetting changes in the tax environment after 1986. Perhaps the most important was the number of corporations that elected to organize as S corporations after the 1986 TRA. The relative growth in the number of S corporations is commonly identified as a significant source of erosion in corporate tax revenues.

The main reason for electing to organize as S corporations is a favorable tax treatment. Federal law treats S corporations similarly to partnerships. Many states, including Ohio, do the same. The profits (or losses) of S corporations are passed through to shareholders, and taxes are paid only at the personal level. In contrast, profits from C corporations are taxed once at the company level and taxed again as dividend income or as capital gains at the individual level.[22] The growth in importance of S corporations is dramatized

**TABLE 10-9**
**Corporate Franchise Tax Liability as a Percentage of State Tax Revenue**

| Tax Year | Liability After Litter Tax, Surtax and Credits | |
|---|---|---|
| | Excluding Financial Institutions | Total |
| 1983 | 8.4912 | 9.1441 |
| 1984 | 7.9320 | 9.4213 |
| 1985 | 9.0797 | 10.4366 |
| 1986 | 9.1934 | 10.4329 |
| 1987 | 7.7637 | 9.0524 |
| 1988 | 7.7565 | 9.0327 |
| 1989 | 8.2534 | 9.7408 |
| 1990 | 7.5291 | 9.1004 |
| 1991 | 6.6936 | 8.3104 |
| 1992 | 6.1629 | 7.8395 |
| 1993 | 6.1454 | 7.8726 |

*Source*: Ohio Department of Taxation.

by the fact that in 1986 they represented 21 percent of all corporations and by 1990 they represented 48 percent. The largest increase happened just after TRA 1986 was enacted. However, these numbers may exaggerate the importance of S corporations. In terms of net income S corporations represented only 9.3 percent of total corporate income in 1990; this was up from 5.9 percent in 1986. In terms of total assets, S corporations are even less important. In 1990 they represented 4. 1 percent of total assets in the corporate sector, up from 1.8 percent in 1986. One reason for this smaller share of income and assets is that S corporations tend to be smaller and in the service sector (32 percent in 1990).[23] However, not all of the decrease in revenues from corporate income taxes can be traced to changes in tax policies. It appears that there has also been a persistent downward trend in the relative importance of the base of the corporate income tax. Auerbach and Poterba,[24] who have studied the decline in federal corporate income tax revenues, find that while the average rate of corporate taxation had fallen by one-third from the mid 1960s to the mid 1980s, in the same period corporate profitability had declined by a factor of two. While it has been relatively easy to disentangle the causes behind lower average corporate tax rates, to date there is no clear understanding of why corporate profitability has decreased by so much. The profit rate has trended downward since the 1960s and dropped most sharply in the 1980s.[25] Many observers associate this sharp

decrease with the oil crisis that hit at about the same time. The taxable income of many corporations has also decreased through leverage buy-outs and other means for relying more heavily on debt financing. In more recent years the rate of profitability has turned around, but it has not reached the levels of the 1960s or 1970s.

## How Different is Ohio's Franchise Tax?

*Nexus.* The legal definition and the administrative enforcement of nexus in Ohio are broad by national standards. The state of Ohio is more likely to consider that nexus exists as a result of non-universal business activities, such as the use of a company car for a salesperson or the listing of the company in the phone book in another state. Of the seven non-universal activities used by state tax administrations to determine nexus listed in Table 10-10, Ohio is the only state that uses all of them. In particular, Ohio is one of only four states that considers the presence of a salesperson who only takes orders as evidence of business nexus.[26] Ohio's Department of Taxation maintains several permanent offices in other states which help enforce the state's franchise tax.

*Apportionment formulas.* Ohio uses a three factor, double-weight sales formula for the apportionment of net income. The more common apportionment formula is a three-factor formula with sales, payroll, and property having the same weights.[27] However, ten other states besides Ohio use the double-weighted sales factor formula. The formulas used in a selected sample of states are surveyed in Table 10-11. The accompanying Table 10-12 summarizes the nature of the modified formulas of all the states not using the straight three factor equally weighted formula. Besides the double weighting of the sales factor, almost every other modification of the formula also involves some other weighting of the sales factor. Three states (Iowa, Texas, and Nebraska) use a single-factor sales formula.

Ohio conforms with the practice of many other states by eliminating a factor if its denominator is zero but leaving the factor in the formula if the numerator is zero (See Table 10-11). Ohio also allows corporations, under some particular circumstances, to use separate accounting rather than the apportionment formula as a method of apportioning income to the state.[28] As seen in the interstate comparisons in Table 10-11 separate accounting as an apportionment method is often completely excluded.

*Throwback rule.* Ohio does not use a "throwback" rule for the computation of the sales factor of the apportionment formula for the net income tax. Thus, when corporations doing business in Ohio make sales in states without a corporate income tax, those (untaxed) sales enter the denominator of the formula (hence some sales are not apportioned to any state). The problem with this approach is that it opens an avenue for tax avoidance by "transferring" sales to the no-tax state. The use of the "throwback" rule would make

**TABLE 10-10**
**Non-Universal Activities Used to Determine Nexus**

| State | Licensing Intangible Rights | Licensing of Software | Company Listed in Phonebook | Company Car for Salesperson | Salesperson Sets up Promotional Items | Salesperson Takes Orders Only | Inventory Inspection by Salesperson |
|---|---|---|---|---|---|---|---|
| Ohio | X | X | X | X | X | X | X |
| Illinois | X | X | X | | X | | X |
| Indiana | X | N/R | | | X | | |
| Iowa | X | | | | X | | X |
| Kentucky | X | X | | | | | X |
| Michigan | | N/R | | | X | | X |
| Minnesota | X | X | | | X | | X |
| Missouri | X | N/R | X | X | X | | X |
| Wisconsin | | | | | | | |
| California | X | N/R | | | X | | X |
| Colorado | | | | | | | |
| Florida | X | X | X | | | | |
| Georgia | | | | X | X | X | X |
| New Jersey | X | N/R | | X | X | | X |
| New York | X | X | X | X | | | |
| North Carolina | | N/R | | | | | |
| Pennsylvania | X | | | | | | |
| Total of All Other States | 20 | 12 | 4 | 6 | 16 | 2 | 17 |
| Total of All States Using Activity | 32 | 18 | 9 | 11 | 26 | 4 | 27 |

*Source:* 1993 Multistate Corporate Tax Guide

X - These items create nexus.
N/R - No report from this state.

such sales part of the numerator of the sales factor for Ohio purposes. Table 10-13 surveys the use of the "throwback" rule in a selected group of states.

*Tax base.* Ohio couples the state franchise net income tax with federal taxable income before the net operating loss deduction and special deductions.[29] About half of the states choose to couple their corporate income tax bases with federal taxable income, before special deductions; the other half couple with federal taxable income after special deductions. See Table 10-14 for a sample of state practices. Nevertheless, Ohio allows an adjustment deduction from taxable income for dividends received and also allows a reduction for net operating losses in Ohio.

Ohio allows interest from United States Government securities as a deduction from taxable income. However, some states do tax this interest income, as shown in Table 10-15. But in order to tax interest from federal securities these states must also tax interest from their own state securities. This non-discriminatory clause makes the option of taxing federal income

## TABLE 10-11
## General Formula Apportionment

| State | Does State Follow UDITPA? | Generally Used Factors | | | Are the Factors Weighted Equally? | Does State Allow Separate Accounting? | Does State Eliminate Factor if: | |
|---|---|---|---|---|---|---|---|---|
| | | Sales | Property | Payroll | | | Denominator is Zero? | Numerator is Zero? |
| Ohio | No | X | X | X | No* | Yes* | Yes | No |
| Illinois | Yes* | X | X | X | No* | Yes* | Yes | No |
| Indiana | No | X | X | X | Yes | Yes* | Yes | No |
| Iowa | No | X | — | — | N/A | Yes* | N/A | N/A |
| Kentucky | Yes* | X | X | X | No* | No | Yes | No |
| Michigan | Yes* | X | X | X | No* | Yes* | Yes | No |
| Minnesota | No* | X | X | X | No* | No | Yes | No |
| Missouri | Yes* | X | X | X | Yes | Yes* | Yes | No |
| Wisconsin | Yes* | X | X | X | No* | Yes* | Yes | No |
| California | Yes* | X | X | X | Yes* | Yes* | Yes* | No |
| Colorado | Yes* | X* | — | X | Yes | Yes* | No | No |
| Florida | No* | X | X | X | No* | No | Yes | No |
| Georgia | No* | X | X | X | Yes | Yes* | Yes | No |
| New Jersey | No | X | X | X | Yes | No | Yes | No |
| New York | No | X | X | X | No* | No* | Yes | No* |
| North Carolina | Yes* | X | X | X | No* | No | Yes | No |
| Pennsylvania | Yes* | X | X | X | Yes | Yes* | Yes | No |

*Source*: 1993 Multistate Corporate Tax Guide.

* More qualifications apply.

less attractive; nevertheless, it is an option that should be considered. The option is especially important if, as discussed in the next chapter, banks and other financial institutions are brought under the general regime of the corporate franchise tax. One of the main problems of doing so is that banks and other financial institutions tend to have abnormally low net incomes when interest from federal securities is exempt.

*Tax rates.* Only the tax rates for the net income tax are comparable to those used in other states, since Ohio is one of few states with a substantial (uncapped) net worth tax and the only one in which the net worth tax is paid when the liability is larger than under the net income tax. In terms of the net income tax, Ohio's rates are in the upper range of the spectrum. By comparison to a selected group of 16 other states shown in Table 10-16, only four states have higher rates for corporate net incomes than Ohio. The highest rate is charged by Pennsylvania, 12.25 percent. Iowa has a progressive schedule reaching a marginal rate of 12 percent for net incomes above $250,000. Closer to Ohio's rate are Minnesota, with a rate of 9.8 percent, and New York, with a rate of 9 percent.

**TABLE 10-12**
**States with Modified Apportionment Formulas**

| State | Alternative Formula | Effective Date |
|---|---|---|
| Ohio | Double-weighted sales factor formula. | 1983 |
| Colorado | By election, a corporation may use either the two-factor formula (sales and property) or the equally weighted three-factor formula. | - |
| Connecticut | Double-weighted sales factor formula. | 1981 |
| Florida | Double-weighted sales factor formula. | 1983 |
| Illinois | Double-weighted sales factor formula. | 1987 |
| Iowa | Single factor sales formula. | - |
| Kansas | By election, a corporation may use either the equally weighted three-factor formula or two-factor formula of property and sales (if payroll exceeds average of such factors by 200%). | 1988 |
| Kentucky | Double-weighted sales factor formula. | 1986 |
| Massachusetts | Double-weighted sales factor formula. | 1978 |
| Minnesota | Sales weighted 70% and property and payroll weighted 15%each. | 1987 |
| Mississippi | Manufacturing-retailer uses sales, plus average of property-payroll (denominator is two) formula. Manufacturer-wholesaler uses equally weighted three-factor formula. Single-factor sales formula for retailing, renting, servicing and merchandising. | 1988 |
| Missouri | By election, a corporation may use either the equally weighted three-factor formula or the single-factor sales formula.[1] | - |
| Nebraska | Single-factor sales formuala. | 1992 |
| New Hampshire | (1.5 sales + 1 property + payroll) ÷3 | |
| New York | Double-weighted sales factor formula. | 1976 |
| North Carolina | Double-weighted sales factor formula. | 1989 |
| Oregon | Double-weighted sales factor formula. | 1991 |
| Texas | Single-factor sales formula. | 1989 |
| West Virginia | Double-weighted sales factor formula. | 1986 |
| Wisconsin | Double-weighted sales factor formula. | 1974 |

*Source*: Updated from J. Coalson, "State and Local Corporate Tax Roundup," *Corporate Taxation*, Vol. 3, No. 1., May/June, 1992.

[1]Alternative formula is calculated as: $\frac{\text{Missouri sales + all other sales}}{\text{All sales}}$ times Net income

[2]Effective date is 1992, with pre-1992 five year phase-in.
*Source:* Updated from J. Coalson, "State and Local Corporate Tax Roundup," *Corporate Taxation*, Vol. 3, No. 1., May/June, 1992.

*Minimum Tax.* Several states use an Alternative Minimum Tax (AMT) together with the regular corporate income tax (Table 10-17). In the selected sample of states only New Jersey uses a fixed amount for a minimum tax. Other states using a fixed amount minimum tax and not shown in Table 10-17 are Massachusetts with a flat tax of $456, Connecticut ($250), Vermont ( $150), and Utah ($100). Several states in the selected sample do impose a

**TABLE 10-13**
**Throwback Rules**

| State | Does State's Throwback Rule Apply to Sales? |
|---|---|
| Ohio | NO |
| Illinois | YES. If corporation is not taxable in state where property had its situs or was used. |
| Indiana | YES |
| Iowa | NO |
| Kentucky | NO |
| Michigan | YES |
| Minnesota | NO |
| Missouri | YES |
| Wisconsin | YES |
| California | YES |
| Colorado | YES. State where goods were shipped from. |
| Florida | NO |
| Georgia | NO |
| New Jersey | NO |
| New York | NO |
| North Carolina | NO |
| Pennsylvania | NO |

*Source*: 1993 Multistate Corporate Tax Guide.

minimum tax similar to the federal AMT. This is to ensure that corporations do not take "excessive" deductions based on tax preferences. Corporations need to compute the ordinary corporate income tax and the AMT simultaneously. The latter has a wider base but at a lower rate. Corporations are required to pay the larger of the two. The states of Iowa, New York, California, and Florida all have such a tax. However, none of these states uses the computation of the federal AMT to implement its AMT.

*NOL carry forwards and carry backs.* As we have seen in the previous section, Ohio allows the carry forward of net operating losses under the net income tax for 15 years and no carry back of losses is allowed. The carry forward provision is almost universal in other states with a corporate income tax, and an allowance of 15 years is the norm. Pennsylvania is the exception, having eliminated the carry forward provision in 1994. About half of the states sampled in Table 10-18 allow the carry back of losses for three years. The use of the carry back provision offers a more favorable treatment to business but at the same time tends to create more instability in state revenue collections.

## TABLE 10-14
## Conformity to Federal Rules

| State | Does State Computation of Taxable Net Income Start with a Figure from Federal Form 1120? |
|---|---|
| Ohio | Yes. Starts with taxable income BEFORE special deductions. |
| Illinois | Yes. Starts with taxable income AFTER special deductions. |
| Indiana | Yes. Starts with taxable income AFTER special deductions. |
| Iowa | Yes. Starts with taxable income AFTER special deductions and BEFORE NOL. |
| Kentucky | No. |
| Michigan | Yes. Starts with taxable income AFTER special deductions. |
| Minnesota | Yes. Starts with taxable income BEFORE special deductions. |
| Missouri | Yes. Starts with taxable income AFTER special deductions. |
| Wisconsin | Yes. Starts with taxable income BEFORE special deductions and NOL. |
| California | Yes. Starts with taxable income BEFORE special deductions. |
| Colorado | Yes. Starts with taxable income AFTER special deductions. |
| Florida | Yes. Starts with taxable income AFTER special deductions. |
| Georgia | Yes. Starts with taxable income AFTER special deductions. |
| New Jersey | Yes. Starts with taxable income BEFORE special deductions and NOL on single-entity basis and NOL's. |
| New York | Yes. Starts with taxable income BEFORE special deductions. |
| North Carolina | Yes. Starts with taxable income BEFORE special deductions. |
| Pennsylvania | Yes. Starts with taxable income BEFORE special deductions. |

*Source*: 1993 Multistate Corporate Tax Guide.

*Miscellaneous taxes.* Ohio is not unique in adding minor miscellaneous taxes to the corporate franchise tax. New Jersey, as Ohio, has litter control taxes. However, most of the miscellaneous taxes in other states are in the nature of small franchise taxes on capital stock or net worth (Table 10-19).

*Tax incentives.* Ohio offers a number of incentives with the franchise tax, including credits and exemptions, some of which are associated with setting up business in an enterprise zone. Ohio is not out of line with many other states which offer similar incentives. Most offer incentives for enterprise zones. However, Ohio is among the smaller group of states that use the franchise tax rather than sales and income taxes in their incentive programs. Ohio is also the only state that reports using exemptions of assets as a form of tax incentive to business activity.

*Combined income reporting for unitary businesses.* Ohio allows combined income reporting for a unitary group of corporations as long as the corporations are all Ohio taxpayers and other conditions are met. There is con-

**TABLE 10-15**
**Treatment of Federal Obligations (Dividends and Interest)**

| State | U.S. Treasury Bills & Notes |
|---|---|
| Ohio | |
| Illinois | |
| Indiana | |
| Iowa | |
| Kentucky | |
| Michigan | (No corporate income tax, single business tax only) |
| Minnesota | X |
| Missouri | |
| Wisconsin | X |
| California | X (franchise only) |
| Colorado | |
| Florida | X |
| Georgia | |
| New Jersey | X |
| New York | X |
| North Carolina | |
| Pennsylvania | The deduction for interest income from U.S. obligations is reduced by the interest incurred in carrying the securities and the expenses incurred in the production of such income. |

*Source*: 1993 Multistate Corporate Tax Guide.

X: Interest income from U.S. Government securities is taxable.

siderable diversity among the states on this issue (Table 10-20). While some other states besides Ohio make it optional for the taxpayers to use combined reporting and/or the Department of Taxation to require it, there are many more states that either require combined income reporting or disallow it entirely.

## MAIN ISSUES AND PROBLEMS

### THE NET WORTH PORTION OF THE TAX

How common is the net worth tax or business assets taxes? An alternative business tax falling on assets or net worth is not all uncommon. In fact,

**TABLE 10-16**
**Tax Rates**

| State | Tax Rate |
|---|---|
| Ohio | Greater of ($0 - 50,000 = 5.1%; > $50,000 = 8.9%) or (5.82 Mills multiplied by net worth; a surtax of .11% on the first $50,000 and .22% over $50T of net income or .0014 of net worth). |
| Illinois | 4.0% Corporate Rate<br>+ 20.0% Surcharge until 1993 (10% after)<br>+ 2.5% Personal Property Tax<br>= 7.3% before 1993 |
| Indiana | 3.4% of AGI + 4.5% supplemental net income tax |
| Iowa | $0-25,000 = 6%<br>25,001-100,000 = 8%<br>100,001-250,000 = 10%<br>> 250,000 = 12% |
| Kentucky | $0-25,000 = 4%<br>25,001-50,000 = 5%<br>50,001-100,000 = 6%<br>100,001-200,000 = 7%<br>> 200,000 = 8% |
| Michigan | 2.35% single business tax |
| Minnesota | 9.8% |
| Missouri | $0-100,000 = 5.0%<br>100,001 - 335,000 = 6.0%<br>> 335,000 = 6.5% |
| Wisconsin | 7.9% + 5.0% recycling tax until 4/1/99<br>(Minimum recycling tax = $25; Maximum = $9,800) |
| California | 9.3%, banks and financial institutions = 10.668% |
| Colorado | $0-50,000 = 5%; > $ 50,000 = 5.1% |
| Florida | 5.5% |
| Georgia | 6.0% |
| New Jersey | 9.0% + .375% surcharge which is reviewed annually |
| New York | 9.0%; 8.0% graduated rate for small businesses<br>+ 10.0% surtax in 1993 |
| North Carolina | 7.75% plus surtaxes (1991 = 4%, 1992 = 3%) (1993 = 2%, 1994 = 1%) |
| Pennsylvania | 12.25% |

*Source*: 1993 Multistate Corporate Tax Guide.

Ohio is the only state that requires the tax payer to pay the higher of the two taxes.[30] Several states have a tax on net worth, some of these taxes are capped and work as minimum taxes rather than as alternatives to the net income tax. Others such as Pennsylvania have extremely high net worth tax rates.[31]

**TABLE 10-17**
**Alternative Minimum Tax**

| State | Does State Impose a Minimum Tax? | Is State-Imposed AMT Similar to Federal AMT? | What is State's AMT Rate? |
|---|---|---|---|
| Ohio | Yes | No | $50 |
| Illinois | No | N/A | N/A |
| Indiana | No | N/A | N/A |
| Iowa | Yes | Yes | 7.2% |
| Kentucky | No | N/A | N/A |
| Michigan | No | N/A | N/A |
| Minnesota | Yes | Yes, With Modifications | 5.8% |
| Missouri | No | N/A | N/A |
| Wisconsin | No | N/A | N/A |
| California | Yes | Yes | 7% |
| Colorado | No | N/A | N/A |
| Florida | Yes | No | 3.3% |
| Georgia | No | N/A | N/A |
| New Jersey | Yes, Flat fee: $25 domestic, $50 foreign | No | N/A |
| New York | Yes | Yes | 5% |
| North Carolina | No | N/A | N/A |
| Pennsylvania | No | N/A | N/A |

*Source*: 1993 Multistate Corporate Tax Guide.

There are a number of ways to look at the net worth tax and compare across states. First, one could examine the percentage of corporate taxes raised through the net worth tax. By including the financial services tax as part of the net worth tax, Ohio raises almost 50.1 percent of its corporate tax revenues from the net worth tax (Table 10-1). No other state raises as much as a proportion to total corporate tax revenues. However, other states such as Pennsylvania taxes its corporations heavily through a 12.25 percent net worth tax. This is a much higher rate than Ohio's and potentially much more burdensome.

**TABLE 10-18**
**Net Operating Loss Carry Forwards and Carry Backs**

| State | Carry Backs Allowed? | Carry Forwards Allowed? | No. of Years Carry Backs Allowed | No. of Years Carry Forwards Allowed |
|---|---|---|---|---|
| Ohio | No | Yes (Ohio loss only) | N/A | 15 |
| Illinois | Yes | Yes | 3 | 15 |
| Indiana | Yes | Yes | 3 | 15 |
| Iowa | Yes | Yes | 3 | 15 |
| Kentucky | Yes | Yes | 3 | 15 |
| Michigan | No. NOL is termed "business loss." | Yes. NOL is termed "business loss" | N/A | 10 |
| Minnesota | No | Yes | N/A | 15 |
| Missouri | Yes | Yes | 3 | 15 |
| Wisconsin | No | Yes | N/A | 15 |
| California | No | Yes | N/A | 15 |
| Colorado | No | Yes | N/A | 15 |
| Florida | No | Yes | N/A | 15 |
| Georgia | Yes | Yes | 3 | 15 |
| New Jersey | No | Yes | N/A | 7 |
| New York | Yes, limited to first $10T of loss for each year. | Yes, SAF, except limited to first $10T of loss. | 3 | 15 |
| North Carolina | No | Yes, net *economic* loss. | N/A | 5 |
| Pennsylvania | None allowed after the 1991 tax year. | | | |

*Source*: 1993 Multistate Corporate Tax Guide.

Alternative taxes on assets or net worth have become more popular around the world over the last decade, but still are far from common.[32] Some European countries have such a tax. Germany levies a net assets tax with a rate between 0.6 and 0.75 percent, and this tax is not allowed as a deduction or a credit from the regular corporate income tax. Austria has a net asset tax with a rate of 1.35 percent, but this tax is allowed as a deduction from the regular corporate income tax. Norway uses a 0.3 percent tax on net assets, and no deduction is allowed from the corporate income tax.

Business taxes on assets have become particularly popular in Latin America.[33] Mexico implemented an alternative asset tax five years ago and since then many other countries in Latin America such as Argentina and Venezuela, have introduced some form of business asset tax. However, in Latin America this type of tax is actually used as an administrative measure for controlling evasion when the tax administration apparatus cannot make the corporate income tax work properly.[34] For this reason, asset taxes are al-

**TABLE 10-19**
**Miscellaneous Taxes on Business Activities**

| State | Name of Tax | Tax Base | Tax Rate Schedule |
|---|---|---|---|
| Ohio | Two tier litter tax | | |
| Illinois | Various | N/R | N/R |
| Indiana | Gross Income Tax | All gross receipts of a taxpayer with special exemptions and/or deductions | Varies |
| Iowa | N/A | | |
| Kentucky | Corporation License Tax | Capital employed | .21% |
| Michigan | N/A | | |
| Minnesota | N/A | | |
| Missouri | N/A | | |
| Wisconsin | N/R | N/R | N/R |
| California | N/A | | |
| Colorado | N/A | | |
| Florida | Intangibles Tax | Stocks, bonds, value of receivables on 1/1 | 1.5 mills. |
| Georgia | Net Worth Tax | Net Worth | $10 Minimum to $5,000 on net worth in excess of $22 million |
| New Jersey | Litter Control Tax | N/R | N/R |
| | Gross Income Tax Withholding | N/R | N/R |
| | Spill Compensation Tax | N/R | N/R |
| New York | Fixed Dollar Minimum | Predetermined dollar amounts, based on gross payroll | Varies |
| | Capital | Allocated business and investment capital | 1.78 mills per $1 of allocated capital; .9 mills per $1 allocated subsidiary capital |
| | Organization Tax | Authorized and issued capital stock | .05 of 1% of par value; 5 cents per share of no par stock |
| North Carolina | Franchise Tax | Capital stock, surplus, and undivided profits | $1.50 per $1,000 |
| Pennsylvania | Capital Stock/Franchise Tax | Fixed formula variation of capital stock | 13 mills |

*Source*: 1993 Multistate Corporate Tax Guide.

most always used as alternative minimum taxes creditable against the regular corporate income tax and often can be carried forward as a credit for several years.[35]

*Advantages of a net worth or business assets tax.* The most important advantage of the net worth tax is that it has provided the state with a more stable source of revenues over the years. The data in Table 10-21 show

# TABLE 10-20
## Unitary Business

| State | Treatment of Unitary Business Combinations | Does Unitary Business Include Worldwide Activities? | Is a Water's-Edge Unitary Method Available? |
|---|---|---|---|
| Ohio | Optional only if the unitary members are Ohio taxpayers. | No | Yes, upon arrival. |
| Alabama | Not Allowed | N/A | N/A |
| Alaska | Required | Yes, until 1-92 for non-oil cos. | Yes, After 1-92. |
| Arizona | Required | No | No |
| Arkansas | Not Allowed | N/A | N/A |
| California | Required | Yes | Yes |
| Colorado | Required | No | Yes |
| Connecticut | Allows taxpayer to petition for an alternative allocation method. | N/A | N/A |
| Delaware | Not Allowed | N/A | N/A |
| Florida | Not Allowed | N/A | N/A |
| Georgia | Optional. State can force Unitary. Taxpayer cannot elect to apply it. | No | No |
| Hawaii | Required. State's option only. | No | Yes |
| Idaho | Required | Yes | Yes |
| Illinois | Required | No (Yes before 1982) | No (Water's-Edge after 1982) |
| Indiana | Optional for state and taxpayer. | Yes (Taxpayer's option) | Yes |
| Iowa | Not Allowed | N/A | N/A |
| Kansas | Required | No | No |
| Kentucky | Optional for state and taxpayer | No | Yes (All applications of unitary treatment) |
| Louisiana | Not Allowed | N/A | N/A |
| Maine | Required | No | No |
| Maryland | Not Allowed | N/A | N/A |
| Massachusetts | Not Allowed | No | No |
| Michigan | Not Allowed (but state can force) | No | No |
| Minnesota | Required | No | No |
| Mississippi | Not Allowed (but state can force) | No | No |
| Missouri | Not Allowed | N/A | N/A |
| Montana | Required | Yes | Yes (3-year renewable period) |
| Nebraska | Required | No | No |
| Nevada | No corporate tax | | |
| New Hampshire | Required | No. (Dividends from foreign unitary affiliates are taxed after a foreign factor relief.) | No. (Water's-Edge is required.) |

continued

**TABLE 10-20 (continued)**
**Unitary Business**

| State | Treatment of Unitary Business Combinations | Does Unitary Business Include Worldwide Activities? | Is a Water's-Edge Unitary Method Available? |
|---|---|---|---|
| New Jersey | Not Allowed | N/A | N/A |
| New Mexico | Optional for taxpayer. State cannot force. | No | No |
| New York | Optional for state and taxpayer. | Yes. Alien corporations not included. | No |
| North Carolina | Not Allowed | N/A | N/A |
| North Dakota | Required. Commissioner may require or permit unitary treatment. | Yes | Yes |
| Oklahoma | Optional for state | No | Yes |
| Oregon | Required | No | No. Required by state. |
| Pennsylvania | Not Allowed | N/A | N/A |
| Rhode Island | N/A | N/A | N/A |
| South Carolina | Not Allowed | N/A | N/A |
| South Dakota | No corporate tax | | |
| Tennessee | Optional for state | No | Yes |
| Texas | Not Allowed | N/A | N/A |
| Utah | Required | If taxpayer elects. | Yes |
| Vermont | Required. Note that unitary reporting for Vermont is NOT combined reporting. | No | No |
| Virginia | Not Allowed | N/A | N/A |
| Washington | No corporate Tax | | |
| West Virginia | Taxpayer may request or state may force. | No | Yes, after formal request by taxpayer. |
| Wisconsin | Not Allowed. All corporations are taxed as separate entities. | N/A | N/A |
| Wyoming | No corporate tax | | |
| D.C. | Not Allowed | N/A | N/A |

*Source*: 1993 Multistate Corporate Tax Guide.

liabilities for the corporate franchise tax from 1988 to 1993, together with what the tax liability would have been had there been no net worth tax component in the present franchise tax. Of course, without adjustment of rates, revenues from the franchise tax would have been lower. But what is more important, revenues would have been less stable. The rate of change (positive or negative) from period to period is often twice as much for the franchise tax without the net worth tax as for the franchise tax with the net worth tax. The higher relative instability in the franchise tax without its net worth component is reflected in a coefficient of variation for this series that is double the size of the coefficient of variation for the series including the net

**TABLE 10-21**
**Corporate Franchise Tax Liability With and Without Net Worth Tax Component, 1988–1993**

| Tax Year | Total with Net Worth | Percent Change over Previous Year | Total without Net Worth: Net Income Basis Only | Percent Change over Previous Year |
|---|---|---|---|---|
| 1988 | $719,430,413 | --- | $586,959,047 | --- |
| 1989 | 771,130,137 | 7.2 | 645,077,393 | 9.9 |
| 1990 | 728,156,622 | -5.6 | 585,163,816 | -9.3 |
| 1991 | 650,538,338 | -10.7 | 461,164,160 | -21.2 |
| 1992 | 613,496,098 | -5.7 | 429,994,616 | -6.8 |
| 1993 | 630,040,000 | 2.7 | 422,805,000 | -1.7 |
| Coefficient of Variation* | 0.083 | --- | 0.166 | --- |

*Sources:* Ohio Department of Taxation, *Annual Report* and our own computation.

*Computed on the ratio of the standard deviation to the mean value in the series.

worth tax. Thus, recent data confirm the intuition that the net worth component of the franchise tax adds stability to overall tax revenue collections.

Are there any other positive side benefits of the net worth tax? The other main advantage of taxes on net worth or assets is, as we have seen, as an administrative measure to control tax evasion and aggressive avoidance. Several other arguments have been used in defense of these taxes, but none is strong or completely convincing.

In the case of a closed economy with little mobility of capital, an asset tax tends to have the same effect as a land tax. It gives an incentive to owners of capital to put capital to its most productive use. One can hardly afford owning capital that is not being used to its full potential. But this argument hardly applies to Ohio or any other state because the economy is fully open and capital is mobile. In an open economy with capital mobility, the tax on net worth will encourage the exit of capital from the state or retard the entry of new capital. To the extent that Ohio taxes capital more heavily than other states (in a combination of property, net worth, and corporate income taxes), then state residents (either as consumers, workers, or owners of land) will tend to pay for the heavier capital taxation. Their payment may take the form of higher prices, lower wages, and lower prices of land or other fixed inputs.

Some economists have supported the idea of a tax on fixed assets because all marginal profits become tax exempt and economic activity is thus encouraged. But this does not apply to the Ohio franchise tax because higher marginal profits will eventually trigger the net income tax. Also important in the long run is the fact that capital assets are not fixed and; consequently, a net worth tax is not free of distortions. On the administrative side, asset

taxes reduce the ability of interstate and international companies to do tax planning or transfer pricing schemes to reduce their tax liabilities.

Finally, an additional benefit of a net worth tax is its (potential) simplicity. This is a main reason why the tax has become more popular in developing economies. Tax administration in developing countries tends to be weaker, with limited capabilities to audit, for example, sophisticated tax companies. Taxing net worth is attractive because the tax base is easier to recognize by tax auditors and revenue collectors. As an economy develops, presumably the tax administration, itself, becomes more sophisticated and is better able to administer and audit income taxes, including those of larger multinational corporations.

*Disadvantages of a net worth tax.* The major problem with Ohio's corporate franchise tax is its net worth component. The unpopularity of the net worth tax among taxpayer corporations, as we will see, is not surprising. The net worth component has caused more litigation problems than any other aspect of the franchise tax. The most important criticisms and shortcomings of the net worth tax are examined in the following paragraphs.

The list of criticisms and shortcomings of the net worth tax is a long one. First, taxpayers feel that the net worth tax is unfair because it puts an additional burden on those companies that have had a bad year, with low income or net losses. The tax comes at a time when enterprises are least able to afford it, and thus it increases their financial risk. This may be particularly damaging to new companies, which often have several years of losses.[35] In 1993, $158 million was paid in net worth taxes (out of a total of $228 million) by corporations with zero or negative net incomes.

Second, the tax is horizontally inequitable because it depends on the structure of the business. Some business sectors may require more (or fewer) capitalization for technological reasons and consequently more (or less) risk and maturation periods for profit-making. In this sense, the net worth tax can be viewed as discriminatory—favoring enterprises that are lightly capitalized, such as those in the service sector, and penalizing enterprises more heavily capitalized, such as those in the manufacturing sector. Both types of companies would pay the net income tax in years of good performance, but in a recession those sectors that are more heavily capitalized may pay a much higher net worth tax.

Third, the net worth tax discriminates against companies with headquarters in Ohio. This arises from the fact that the property factor of the apportionment formula for the net worth tax situses to Ohio intangible assets such as bank deposits, investments in other businesses, and securities that the corporation owns outside Ohio. This penalty is more serious for the parent or holding companies domiciled in Ohio and for those who own most of their assets in intangibles. Discrimination against Ohio companies also arises from the inclusion in the "business done" factor of the net worth

formula of receipts from intangible assets which are sitused to Ohio (and only for Ohio companies), regardless of where they may actually be used.

Fourth, the net worth tax is a source of double taxation. This arises first because the net worth tax falls on the same assets as are taxed by the property tax. The issue of double taxation of property has become more acute with the repeal in 1993 of the credit against the franchise tax for property taxes paid. That credit, it has been argued, helped equalize property tax burdens for companies located in different local jurisdictions across Ohio.[37] A second issue of double taxation arises when both parent company and subsidiaries located in Ohio have to pay the net worth tax. However, this form of double taxation is being partially addressed with the new credit for investment in qualified subsidiaries.

Fifth, the net worth tax makes taxpayer compliance much harder and costlier. Both tax bases under the franchise tax, net income and net worth, must be fully computed every year despite the fact that only one will be used. The computation of the net worth tax is especially cumbersome because it requires the situsing of every component in the balance sheet based on complex rules which in some instances go back at least half a century.[38]

Sixth, the net worth tax distorts the method of financing and it encourages thin capitalization. Corporations that add to their real assets by borrowing from a bank or issuing debt will not experience an increase in their net worth tax base. However, those corporations that purchase the same real assets financing them with new equity issues will experience an increase in the tax base by the entire amount of the investment. Thus, the marginal effective rate of taxation on the same asset goes from zero, if financed with debt, to a positive rate of taxation if the asset is not exempt. The effective marginal rate of taxation on any asset also depends on other provisions in the law, ranging from tax credits to depreciation rules.[39]

Seventh, the net worth tax may discourage investment in Ohio if the combination of the net income tax and net worth taxes imposes a tax burden on capital invested in Ohio that exceeds the average tax burden imposed on capital in all other states. A common view of the incidence of the corporate income tax is that the *average* burden imposed by corporate taxes may be paid by all capital owners across the nation. However, taxing capital investment more heavily than the average state will drive or keep investment out of this higher tax state as long as the after tax rate of return to capital is higher in other states. Because of the lower capital investment in the state, the tax burden of higher corporate taxes in reality is shifted to other factors of production in the state that are less mobile, such as labor and land.[40]

This tendency of the net worth tax to drive or keep out corporate investment in Ohio will be more pronounced in the more heavily capitalized sectors, such as manufacturing. Manufacturing has been the backbone of Ohio's economy, although it has suffered a considerable decline in recent

times. The question is to what extent the net worth tax has been a significant contributing factor to this decline.

## Apportionment Formulas

There are several important differences between the apportionment formulas for net income and net worth. The first and most obvious one is that net income is apportioned according to three factors (payroll, property, and sales, with the latter double-weighted), while net worth is apportioned according to two factors (property and sales). Less obvious but just as important is the fact that the definitions of the property and sales factors differ significantly in the two formulas.

The property factor in the net worth formula includes all types of assets: tangibles and intangibles. In contrast, the property factor in the net income formula includes only real and tangible personal property, including leasehold improvements and the value of rented property. The inclusion of intangibles in the net worth formula has created problems for situsing the property and has given corporations an incentive to establish their legal domiciles outside of Ohio.

The "business done" factor in the net worth formula is also a wider concept than the receipts from sales used in the net income formula. The business done factor includes not only sales of tangible property and revenue from services but also rents and royalties, dividends and interest, patent copyrights, and in some cases the sale of assets.[41] Dividends, interest, royalties, and other intangible income are treated as allocable income under the net income tax and, therefore, do not enter the net income apportionment formula.

The differences in the two formulas highlight some contradictions in the philosophy underlying the two components of Ohio's franchise tax. Under the net income base, a larger part of the tax is shifted to taxpayers outside Ohio by the fact that the sales factor is double weighted. The exclusion of allocable income from the sales factor also has the same effect, since its inclusion would increase the numerator of the factor more than the denominator. The exclusion of intangible property in the property factor of the net income tax also favors Ohio companies, since most of the intangible property would be sitused in Ohio.

Under the net worth tax, the computation of the two factor formula shifts the tax burden more towards Ohio corporations. This is because income from intangible assets is included in the business factor and intangible assets are included in the property factor. As a consequence, Ohio companies experience an increase in both factors vis-a-vis non-Ohio companies, since most intangible property and income have an Ohio situs.

As discussed above, Ohio statutes do not address the issue of what to do with the factors in the net income apportionment formula when part of the corporation's business takes place in a state that has no corporate income tax. By not adjusting the formula to these circumstances corporations actually obtain a lower tax. Some states have adopted adjustments in the formula by following a "throwback" rule, which assigns to the factor numerator of the taxing state the activity carried out in the states without a corporation tax, or a "throw out" rule, which eliminates from both the numerator and the denominator of the factor the activities carried out in the noncorporate tax states.

## Reporting: Separate Entity Versus Combined Income Reporting

Most economists would agree that combined income reporting is the only sensible way to go about apportioning income to a state for any corporation that is part of a unitary or related business operating in that state or several states.[42]

The present approach of giving the option to file with combined income reporting when some minimum requirements are met almost certainly guarantees that the only groups of corporations filing combined reports are those that can reduce their tax liability by doing so. Other corporations that use intercorporate transactions within and out of the state for tax planning purposes are not expected, of course, to file combined income reports.

The Tax Commissioner can require combined income reporting for a group of interrelated corporations. In practice this has been a complex and litigious process. In addition, the statutes also limit the initiative of the Commissioner in this respect. For example, since 1992 interest payments between related members, or charges for the use of intangible property, cannot be considered sufficient grounds for requiring combined income reporting.[43]

Thus, the important issue here is how much income tax is avoided in Ohio because the majority of the corporations file as separate entities. Separate entity reporting leaves open many potential loopholes for tax avoidance. These range from the most apparent and well-known, such as the use of out-of-state passive investment companies (better known as Delaware holding companies), to the more sophisticated (and harder to detect) transfer pricing schemes.

Some of these problems have been addressed with recent legislation in Ohio. The reform of the franchise tax law in 1991 ( "Budget Bill" Am. Sub. H. 298) had two main objectives. The first was to make Ohio corporations take over certain gains recognized by "non taxpayer" (for Ohio purposes) related entities. The second was to deny Ohio corporations deductions for

interest and other intangible expenses (such as charges for the use of intangible property, royalties, patents, copyright fees and licensing fees) paid to "related entities" which for the most part are passive investment companies ("Delaware holding companies 11).[44]

There are other significant forms of intra-unitary transactions that the 1991 reform did not address. These include the use of affiliated non-Ohio companies to hold assets generating investment income, the overstatement of costs and understatement of revenues through transfer pricing, and changes in location to avoid the situsing of assets to Ohio. To be fair, there is no law that can be comprehensive enough to deal with all these issues. But being able to take care of all these issues is the fundamental advantage of combined income reporting.

## Minimum Tax

The minimum tax of $50 in Ohio may be too low. It has not been changed for many years despite inflation. In fact, the actual amount of $50 may now be under what it actually costs the Department of Taxation to process a tax return.

## Taxing Interest From Federal and Ohio Securities

At present Ohio exempts interest from both federal government and State of Ohio securities. This conforms with the practice of many other states. In order to tax federal interest income it would be necessary to tax Ohio interest income. There are some states that do this. The attraction of this option is that it would facilitate the coverage of financial institutions under the general franchise tax. Banks and other financial institutions earn a good portion of their income from holding federal government securities in their portfolios.

## Allocation Versus Apportionment Of Income

Is there a good rationale for keeping the distinction between allocable and apportionable income? Should this distinction be reformed, or even abandoned? Actually there are at least twelve states that do not distinguish between allocable and apportionable income. These are known as "full apportionment states."[45] Many other states, including Ohio, distinguish between allocable and apportionable income. Most often what is apportionable and what is allocable income depends on whether the income is defined as business or non-business income, respectively. Business income

is generally defined as that earned during the regular course of business.[46]The presumption for the distinction lies in the fact that some income is not earned by the application of factors of production but simply by the corporate entity itself, and these should be sitused where the corporation is domiciled. For example, dividend income from shares of other companies is considered to be earned by the corporation in a way that is different from the income derived from production and sale of goods and services. Many of the distinctions, such as royalties and technical service fees as passive income, have little economic justification. Ohio is among the few states that make no distinction between business and non-business income but instead allocate certain types of income.

As in other areas of corporate state taxation, the potential for double taxation of certain types of income increases, because the same income may be considered apportionable in one state and allocable in a different state.

The clear incentive for "headquarters" states is to classify income as allocable, because 100 percent of it is taxed in the state. The disadvantage is that a very aggressive position on allocable income may cause some corporations to choose a different state for domicile. States with relatively few or important company headquarters may have revenue advantages with the "full apportionment" approach.

## The Use of Corporate Limited Partnerships as a Way to Avoid the Franchise Tax

Partnerships, and in particular corporate partnerships, have been used for some time as a vehicle for tax planning. Multistate corporations may take advantage of different regulations to structure transactions across states boundaries to minimize taxes. One fundamental issue that arises with corporate partners that have no direct business activities in a state is whether or not the corporate partner has tax nexus in the state because of its interest in the partnership doing business in the state. Most states, including Ohio, consider the corporate partner to have nexus in the 46 state.[47] Fewer states treat the partner's distributive share as income from an intangible asset, and they source the income to the situs of the asset, i.e., to the state where the corporate partner has its domicile. The revenue implications of choosing between the two regimes will differ from state to state, depending on the number and importance of out-of-state corporate partners and state domiciled corporations entering partnerships outside the state.

An increasing loophole has appeared in recent times, with non-Ohio corporations taking a limited partnership interest, directly or indirectly through wholly owned non-Ohio subsidiaries in an Ohio partnership. As opposed to the case of a general partnership interest in which the non Ohio corporation or its subsidiaries are declared to have nexus in Ohio, limited partners are

treated as individual stockholders and through multi layering of subsidiaries may avoid income taxes entirely.

Ohio has recently adopted legislation recognizing the new business form of "limited liability company. " In practice, this business form is taxed as a partnership that has only limited partners. The important issue here is that this new development could be used for tax avoidance schemes similar to those now being used with limited partnerships.

There are no easy solutions to the problem created by the use of limited partnerships by out-of-state corporations to escape the franchise tax in Ohio. Probably the simplest solution would be to change the law so that corporate limited partners can be ruled to have nexus in Ohio and, therefore, be subject to the corporate franchise tax. However, this approach may face many legal hurdles. A second solution, currently being studied by the Department of Taxation, is to use a withholding system in which the flow-through entity is treated as a taxable entity, and the upstream corporations are credited for taxes already paid. A third solution is for the state of Ohio to adopt mandatory combined income reporting. Relying on discretionary rulings by the Tax Commissioner to require combined income reporting would be very likely too time consuming and, given the past history of similar rulings, ineffective.

## Municipal Income Taxes

About 500 local jurisdictions in Ohio levy individual and business income taxes. These taxes represent a significant source of revenue for local governments. One important issue is that this system of local taxation imposes heavy compliance costs on businesses because almost every jurisdiction has a different tax, with variations in the tax base, filing dates, and other administrative procedures. In the extreme case, an Ohio company would have to file close to 500 different taxes with complex administrative and appeal procedures.[48]

## Membership in UDITPA

There would be several benefits derived from joining the Multistate Tax Compact (MTC) and subscribing to the Uniform Division of Income for Tax Purposes Act. Many other states do follow UDITPA, although often with some modifications. A selected sample of states that do follow UDITPA is shown in Table 10-11. Among the most important benefits of joining the MTC are easy tax coordination with many other states that have joined the Tax Compact, use of the multistate audits of some corporations undertaken by the Tax Compact, and access to the interpretative rulings for difficult-to-

tax economic sectors. On the other hand, Ohio has in its own way adopted many of the rules in UDITPA, and joining would not be cost free. The move might be regarded as anti-business, and the state would have to change important aspects of the franchise tax to adapt to UDITPA.

# REFORM OPTIONS AND IMPLICATIONS

## Reforming the Net Worth Tax

One major reform option is to *repeal the net worth component* of the franchise tax. The new corporate franchise tax would be based exclusively on the present corporate profit or net income.

The overall impact of this change is shown in columns 2 and 3 of Table 10-22. The overall franchise tax liabilities for 1993 would have decreased from $630 million to $434 million, approximately a 31 percent decline. The elimination of the net worth tax would not affect those corporations that were already paying the net income tax, because this was the higher of either the net worth tax or the net income tax. The corporations that would benefit from the reform are those corporations that were paying the net worth tax. However, some of these corporations that had positive net income would now pay the net income tax. This "residual" net income tax would have amounted to approximately $32 million, and this is included in the total net income tax in column 3 of Table 10-22 of $434 million. The simple repeal of the net worth tax basis produces winners by all asset sizes and in all economic sectors, although winners are concentrated among the largest companies by net worth size.

The repeal of the net worth tax may be accompanied by several additional reforms. A central consideration of the complementary reforms is whether the entire package is to be made revenue-neutral. That is, do the new taxes make up for the losses in revenues represented by the elimination of the net worth tax? Or should no attempt be made to fully recover the lost revenues with the corporate franchise tax, leaving this task perhaps to other elements of the tax structure?

*Revenue-neutral reform options.* There are, of course, many possibilities that can be devised within the corporate income tax to make up for the revenue losses caused by the repeal of the net worth component. They range from the introduction of a new separate tax on assets to changes in the base and rate of the net income tax. Combinations of several or all of these options could also be used instead of one simple option.

Here we consider three basic options: (i) the introduction of a new net worth tax that differs from the old tax in base, rate, and apportionment formula; (ii) the introduction of a new asset tax, and (iii) an increase in the rate of the net income tax. Changes in the structure of the present net income

## TABLE 10-22
## Reforming the Franchise Tax: Eliminating Old Net Worth Tax, Revenue Neutral Option 1

**Net Worth Tax Using Reduced Base and Income Tax Combined**
**Revised Tax Rate = 0.138%**

| Net Worth | Base Corporate Tax | Income Tax | Reduced Base Net Worth Tax | Calculated Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Less than 1 | $35,862,764 | $32,484,779 | $1,586,750 | $34,071,529 | 0% | 2% | 98% |
| Over 1 - 200,000 | 32,249,202 | 22,648,858 | 78,480 | 22,727,338 | 12% | 4% | 84% |
| 200,001 - 500,000 | 25,889,826 | 17,056,832 | 114,562 | 17,171,395 | 71% | 26% | 3% |
| 500,001 - 2,500,000 | 62,081,815 | 41,957,122 | 991,836 | 42,948,958 | 37% | 61% | 2% |
| 2,500,001 - 5,000,000 | 27,672,764 | 20,612,339 | 1,667,925 | 22,280,264 | 24% | 76% | 0% |
| 5,000,001 - 20,000,000 | 69,590,881 | 51,720,568 | 5,902,115 | 57,622,683 | 20% | 80% | 0% |
| 20,000,001 - 100,000,000 | 104,136,346 | 71,945,004 | 35,356,683 | 107,301,687 | 63% | 36% | 1% |
| 100,000,001 - 250,000,000 | 62,431,082 | 43,731,704 | 26,183,638 | 69,915,342 | 31% | 44% | 25% |
| 250,000,001 - 500,000,000 | 50,38,1815 | 32,558,519 | 29,098,608 | 61,657,127 | 40% | 60% | 0% |
| 500,000, 001 - 750,000,000 | 27,084,813 | 15,493,821 | 34,332,427 | 49,826,248 | 18% | 80% | 2% |
| 750,000,001 - 1,000,000,000 | 11,590,126 | 6,955,357 | 39,439,230 | 46,394,587 | 43% | 57% | 0% |
| Over 1 Billion | 121,069,256 | 76,910,625 | 21,507,447 | 98,418,072 | 42% | 58% | 0% |
| Grand Total | $630,040,690 | $434,075,528 | $196,259,702 | $630,335,230 | 17% | 19% | 0.65 |

| Economic Sectors | Base Corporate Tax | Income Tax | Reduced Base Net Worth Tax | Calculated Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Agriculture, Forestry, and Fishing | $2,886,417 | $1,822,435 | $49,663 | $1,872,098 | 0% | 100% | 0% |
| Mining | 12,495,690 | 4,519,910 | 2,081,746 | 6,601,656 | 73% | 19% | 7% |
| Construction | 22,223,744 | 16,288,119 | 1,731,008 | 18,019,127 | 52% | 42% | 5% |
| Manufacturing | 288,514,301 | 215,100,251 | 84,620,539 | 299,720,790 | 42% | 48% | 10% |
| Transportation | 50,709,262 | 30,443,411 | 5,230,586 | 35,673,997 | 66% | 24% | 11% |
| Wholesale Trade | 50,174,092 | 36,713,264 | 13,474,041 | 50,187,305 | 30% | 32% | 38% |
| Retail Trade | 67,201,264 | 52,503,273 | 6,217,814 | 58,721,087 | 44% | 49% | 7% |
| Finance, Insurance, and Real Estate | 55,122,385 | 26,130,085 | 71,486,014 | 97,616,100 | 33% | 61% | 7% |
| Services | 60,897,755 | 40,282,818 | 8,252,912 | 48,535,730 | 18% | 14% | 69% |
| Unclassified | 19,815,780 | 10,271,961 | 3,115,379 | 13,387,340 | 0% | 3% | 97% |
| Grand Total | $630,040,689 | $434,075,528 | $196,259,702 | $630,335,230 | 17% | 19% | 65% |

tax, such as changes in credits or adjustments to taxable income, would not by themselves make up for the revenue gap produced by the repeal of the net worth tax. More importantly, changes in the structure of the net income tax should be considered in terms of their impact on horizontal equity, economic development, and other objectives rather than in terms of their impact on revenue.

(i) *New net worth tax.* The new net worth tax would be paid by all corporations, including those paying the net income tax. It would be structured in a way that eliminates the main problems now existing with the net worth basis of the franchise tax. The tax base would comprise the corporation's equity account (capital stock net of treasury stock, additional paid-in capital, and retained earnings) and the apportionment ratio would be the three-factor double-weighted sales formula currently used for the net income tax.

The most important change in the tax base of this new net worth tax vis-a-vis the current net worth tax would be the elimination of reserves and deferred taxes. These changes could be justified to the extent that both deferred taxes and reserves are set to offset future liabilities, and in that sense they should not be considered as part of the corporation's net worth. However, this is a debatable point.

In particular, some reserves are set against future contingent liabilities which may never materialize. The level of reserves a corporation sets aside differs by type of business and other characteristics including management style. Even though most businesses have limits on how much they can put into reserves and for how long they will be able to hold idle reserves, it is clear that their exclusion from the net worth tax base is an opportunity for tax avoidance and a source of uneven tax treatment among otherwise similar firms. The data in Table 10-23 show the ratio of reserves and deferred taxes to total net worth by size of firm (measured by net worth) and by economic sector, based on sample data from 1,377 corporation returns for 1993. These sample data show wide variations in the ratio, ranging from close to zero to 10 percent. On the other hand, the inclusion of reserves can lead to the unequal treatment of corporations with equal "long term" net worth.

The inclusion or exclusion of reserves in the tax base will simply translate into a lower or higher tax rate that will need to be applied to attain the revenue target. We used a sample of tax returns to simulate the new net worth as if it had been in effect in 1993.[49] These simulations are presented in the fourth column of Table 10-22. Besides the reduced base for the new net worth tax and the same apportionment formula as for the net income tax, we assume a tax rate of 0.138 percent for the new tax. This rate is dictated by the condition of revenue neutrality for the entire reform option: elimination of the current net worth tax, universal application of the net income tax, and introduction of the new net worth tax with overall revenue neutrality. Table 10-22 is constructed to include the overall or combined tax burden of a universal net income tax and the new net worth tax by asset size and economic sector in the fifth column.

The rate structure of the new net worth tax could be chosen to have different profiles, including other flat rates which will not allow revenue neutrality for the entire package. With revenue neutrality, as simulated in Table 10-22, 19 percent of the corporations would be losers, i.e., would pay a higher combined net income and new net worth tax. The clear net losers are those corporations now paying net income tax which would also have to pay the new net worth tax. Some corporations now paying the net worth tax may also be losers if they have enough positive net income. The simulations show that 17 percent of the corporations would be winners: they would be paying a lower combined tax than under the present franchise tax. The winners would be corporations with low or negative net incomes that are now paying

**TABLE 10-23**
**Ratio of Deferred Taxes and Reserves to Total Net Worth, by Economic Sector and Net Worth Size**

| Economic Sectors | |
|---|---|
| Agriculture, Forestry, and Fishing | 0.0129 |
| Mining | 0.0755 |
| Construction | 0.0166 |
| Manufacturing | 0.0491 |
| Transportation | 0.0981 |
| Wholesale Trade | 0.0281 |
| Retail Trade | 0.083 |
| Finance, Insurance, and Real Estate | 0.0907 |
| Services | 0.0122 |
| Unclassified | 0.0251 |

| Net Worth ($) | |
|---|---|
| 1 | 0.0268 |
| 200,000 | 0.0002 |
| 500,000 | 0.1073 |
| 2,500,000 | 0.0255 |
| 5,000,000 | 0.022 |
| 20,000,000 | 0.0397 |
| 100,000,000 | 0.077 |
| 250,000,000 | 0.0477 |
| 500,000,000 | 0.0802 |
| 750,000,000 | 0.0832 |
| 1,000,000,000 | 0.0446 |
| Over 1 billion | 0.0825 |

*Source:* Based on sample data from 1,377 franchise tax returns.

the net worth tax at a 0.582 percent rate rather than the 0.138 percent rate used in the simulations for the new net worth tax.

Although the majority of corporations, 65 percent, would not be affected by the changes in the net worth tax, the vast majority of these companies are those with net worth between $0 and $200,000.

The winners and losers by size of net worth and by economic sector, as shown in the last three columns of Table 10-22, are quite evenly distributed. Average-size firms in terms of net worth and those in the mining and transport sectors are the more likely winners.

This revenue-neutral simulation allows us to focus on the other important goals of reform. Despite the fact that they produce equal revenues, the universal net income tax combined with a new net worth tax would be generally preferable to the present net worth tax because it would be more horizontally equitable and produce less economic distortion, such as penalization of new enterprises and penalization of corporations domiciled in Ohio. However, the new net worth tax still would discriminate among companies depending on how much of their assets were financed with debt and how much were financed with equity. The next set of revenue-neutral simulations would address this issue.

(ii) *New total assets tax.* An alternative to the new net worth tax is a tax on total (nonexempt) assets. The advantage of the assets tax, vis-a-vis a net worth tax, is that the formula does not discriminate among types of financing; and, therefore, it does not induce thin capitalization. The simulations in Table 10-24 are based again on the premise that the new total assets tax will

**TABLE 10-24**
**Reforming the Franchise Tax: Eliminating Old Net Worth Tax, Revenue Neutral Option 2**

**Gross Assets Tax and Income Tax Combined**
**Net Assets Tax Rate = 0.0562%**

| Net Worth | Base Corporate Tax | Income Tax | Total Asset Tax | Calculated Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Less than 1 | $35,862,764 | $32,484,779 | $2,985,589 | $35,470,368 | 0 | 0.04 | 0.96 |
| Over 1 - 200,000 | 35,862,764 | 22,648,858 | 107,702 | 22,756,560 | 0.14 | 0.06 | 0.8 |
| 200,001 - 500,000 | 25,889,826 | 17,056,832 | 250,079 | 17,306,912 | 0.62 | 0.18 | 0.2 |
| 500,001 - 2,500,000 | 62,081,815 | 41,957,122 | 818,900 | 42,776,021 | 0.42 | 0.39 | 0.19 |
| 2,500,001 - 5,000,000 | 27,672,764 | 20,612,339 | 1,206,501 | 21,818,840 | 0.24 | 0.59 | 0.18 |
| 5,000,001 - 20,000,000 | 69,590,881 | 51,720,568 | 4,434,451 | 56,155,019 | 0.2 | 0.72 | 0.08 |
| 20,000,001 - 100,000,000 | 104,136,346 | 71,945,004 | 63,873,004 | 135,818,009 | 0.59 | 0.4 | 0.01 |
| 100,000,001 - 250,000,000 | 62,431,082 | 43,731,704 | 24,813,989 | 68,545,693 | 0.38 | 0.38 | 0.25 |
| 250,000,001 - 500,000,000 | 50,381,815 | 32,558,519 | 26,021,706 | 58,580,225 | 0.4 | 0.6 | 0 |
| 500,000, 001 - 750,000,000 | 27,084,813 | 15,493,821 | 26,294,948 | 41,788,769 | 0.53 | 0.46 | 0.02 |
| 750,000,001 - 1,000,000,000 | 11,590,126 | 6,955,357 | 28,661,292 | 35,616,649 | 0.43 | 0.57 | 0 |
| Over 1 Billion | 121,069,256 | 76,910,625 | 17,288,963 | 94,199,588 | 0.56 | 0.44 | 0 |
| Grand Total | $630,040,690 | $434,075,528 | $196,757,125 | $630,832,653 | 0.18 | 0.18 | 0.65 |

| Economic Sectors | Base Corporate Tax | Income Tax | Total Asset Tax | Calculated Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Agriculture, Forestry and Fishing | $2,886,417 | $1,822,435 | $45,102 | $1,867,537 | 0 | 0.6 | 0.4 |
| Mining | 12,495,690 | 4,519,910 | 2,548,231 | 7,068,141 | 0.57 | 0.31 | 0.12 |
| Construction | 22,223,744 | 16,288,119 | 1,238,843 | 17,526,962 | 0.52 | 0.28 | 0.2 |
| Manufacturing | 288,514,301 | 215,100,251 | 67,156,507 | 282,256,758 | 0.45 | 0.44 | 0.11 |
| Transportation | 50,709,262 | 3,044,341 | 4,528,256 | 34,971,668 | 0.66 | 0.27 | 0.07 |
| Wholesale Trade | 50,174,092 | 36,713,264 | 18,838,865 | 55,552,129 | 0.32 | 0.46 | 0.21 |
| Retail Trade | 67,201,264 | 52,503,273 | 6,744,377 | 59,247,650 | 0.44 | 0.37 | 0.19 |
| Finance, Insurance, and Real Estate | 55,122,385 | 26,130,085 | 83,525,498 | 109,655,583 | 0.33 | 0.57 | 0.11 |
| Services | 60,897,755 | 40,282,818 | 9,987,571 | 50,270,389 | 0.17 | 0.13 | 0.69 |
| Unclassified | 19,815,780 | 10,271,961 | 2,143,876 | 12,415,837 | 0.01 | 0.02 | 0.97 |
| Grand Total | $630,040,689 | $434,075,528 | $196,757,125 | $630,823,653 | 0.18 | 0.18 | 0.65 |

have to generate enough revenue to cover the revenue gap produced by the elimination of the present net worth tax. Revenue neutrality would have required a tax rate on total assets of 0.056 percent in 1993. The simulations in Table 10-24 are performed using the apportionment ratio from the net income tax.

The distribution by size of net worth and economic sector of the total assets tax is presented in the fourth column of Table 10-24. The combined burden of the universal net income tax and the new total assets tax is presented in the fifth column. Overall, the distribution of the combined burden by size of net worth and economic sector is quite similar to that in the previous simulation with the "new net worth tax." The percentages of corporations that are winners and losers are almost identical in the aggregate. However, there are more significant differences by net worth size and economic sector of the corporations. These differences between the two sets of simulations highlight the relative arbitrariness of either tax base, as the ratio of net worth to total assets is likely to differ from corporation to corporation for multiple reasons.

Either tax, the new net worth or the total assets tax, still presents the problems of all asset taxes discussed in Section 3 of this chapter. They impose a significant burden on enterprises when they may be least able to afford it, and in particular they penalize new enterprises which tend to go through several years of losses. Either of these taxes may be more acceptable or justifiable at lower levels as a way to charge corporations for the use of public services at the state level.[50] This possibility is further discussed below.

(iii) *Raising the rate of the net income tax.* An alternative way to cover the revenue gap produced by the elimination of the net worth tax is to raise the rate of the net income tax. This simulation is presented in Table 10-25. Based on 1993 tax returns, revenue neutrality would have required an increase in the rate of 3.86 percentage points for net incomes above $50,000. The new tax rate for net incomes over $50,000 would have been 12.76 percent, by comparison to the current rate of 8.9 percent. This would have made Ohio the state with the highest corporate income tax rate. At present, the highest rate is Pennsylvania's 12.25 percent. The simulations assume that the current rate of 5.1 percent for net incomes below $50,000 stays the same. The intended effect in the distribution of tax burdens is a more skewed distribution, since now only those companies with positive net incomes would pay tax. However, companies that now are paying the net worth tax will not necessarily be large winners from this change. There are quite a few corporations paying the net worth tax at the present time that do have positive net incomes, and these companies would have to pay the new net income tax at a considerably higher rate.

*Non-revenue-neutral reform options.* As we have seen in the second section, some states have along with the corporate net income tax a corporate

## TABLE 10-25
## Reforming the Franchise Tax: Eliminating Old Net Worth Tax, Revenue Neutral Option 3

**Levy Additional Income tax on Net Income over $50,000**
**New Tax Rate = 3.86%**

| Net Worth ($) | Base Corporate Tax | Income Tax | Additional Income Tax | Calculated Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Less than 1 | $35,862,764 | $32,484,779 | $12,653,125 | $45,137,904 | 0% | 1% | 99% |
| Over 1 - 200,000 | 32,249,202 | 22,648,858 | 1,080,760 | 23,729,619 | 14% | 1% | 86% |
| 200,001 - 500,000 | 25,889,826 | 17,056,832 | 993,127 | 18,049,960 | 71% | 13% | 16% |
| 500,001 - 2,500,000 | 62,081,815 | 41,957,122 | 11,892,096 | 53,849,217 | 42% | 58% | 1% |
| 2,500,001 - 5,000,000 | 27,672,764 | 20,612,339 | 11,041,390 | 31,653,729 | 24% | 76% | 0% |
| 5,000,001 - 20,000,000 | 69,590,881 | 51,720,568 | 24,143,682 | 75,864,250 | 24% | 76% | 0% |
| 20,000,001 - 100,000,000 | 104,136,346 | 71,945,004 | 39,450,860 | 111,395,864 | 74% | 25% | 1% |
| 100,000,001 - 250,000,000 | 62,431,082 | 43,731,704 | 22,449,196 | 66,180,900 | 44% | 31% | 25% |
| 250,000,001 - 500,000,000 | 50,381,815 | 32,558,519 | ·18,573,129 | 51,131,647 | 45% | 16% | 38% |
| 500,000,001 - 750,000,000 | 27,084,813 | 15,493,821 | 13,282,754 | 28,776,575 | 19% | 80% | 2% |
| 750,000,001 - 1,000,000,000 | 11,590,126 | 6,955,357 | 4,460,811 | 11,416,168 | 56% | 44% | 0% |
| Over 1 Billion | 121,069,256 | 76,910,625 | 35,909,783 | 112,820,407 | 43% | 57% | 0% |
| Grand Total | $630,040,690 | $434,075,528 | $195,930,712 | $630,006,240 | 20% | 13% | 67% |

| Economic Sectors | Base Corporate Tax | Income Tax | Additional Income Tax | Calculated Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Agriculture, Forestry, and Fishing | $2,886,417 | $1,822,435 | $532,426 | $2,354,861 | 0% | 60% | 40% |
| Mining | 12,495,690 | 4,519,910 | 2,079,680 | 6,599,590 | 73% | 20% | 7% |
| Construction | 22,223,744 | 16,288,119 | 7,215,950 | 23,504,070 | 52% | 36% | 11% |
| Manufacturing | 288,514,301 | 215,100,251 | 111,162,795 | 326,263,046 | 51% | 40% | 9% |
| Transportation | 50,709,262 | 30,443,411 | 9,651,634 | 40,095,046 | 66% | 25% | 9% |
| Wholesale Trade | 50,174,092 | 36,713,264 | 13,743,347 | 50,456,611 | 40% | 22% | 38% |
| Retail Trade | 67,201,264 | 52,503,273 | 21,148,548 | 73,651,821 | 44% | 51% | 5% |
| Finance, Insurance, and Real Estate | 55,122,385 | 26,130,085 | 10,205,405 | 36,335,490 | 43% | 23% | 34% |
| Services | 60,897,755 | 40,282,818 | 16,672,171 | 56,954,990 | 20% | 12% | 69% |
| Unclassified | 19,815,780 | 10,271,961 | 3,518,754 | 13,790,715 | 1% | 1% | 99% |
| Grand Total | $630,040,689 | $434,075,528 | $195,930,712 | $630,006,240 | 20% | 13% | 67% |

franchise tax based on net worth or assets, which is capped at some maximum payment. In addition, these taxes may have a flat rate or a graduated rate. This form of taxation has been conventionally justified as a minimum payment for the privilege of doing business in the state or as a minimum contribution for the use of services provided by the state, regardless of the profitability of the corporation. The final form such a tax may take is varied. One such schedule, which has been suggested by the business community, is presented in Table 10-26.[51] It presents a graduated system of tax payments starting at $250 for those corporations with net worth (net capital stock plus additional paid-in capital plus retained earnings) below $10,000; it adds $500 more in payment for net worth between $10,000 and $50,000, and so on; and it is capped with a payment of $25,000 for net worth of over $100 million.[52] Note that this option would change the minimum tax payment of the franchise, currently at $50 to $250.

One important implication of using this form of declining schedule as opposed to a flat tax rate, for example, is that it tends to be regressive. This is clear from inspection of Table 10-26. At the mean value of the first bracket the marginal and average rates represented by the payment for the bracket are 5 percent. The corresponding payment for the next-to-last bracket represents a marginal rate of 0.04 percent and an average rate of 0.14 percent, both evaluated at the mean value of the bracket.

Table 10-27 shows the results of a simulation using the schedule shown in Table 10-26 and assumes the current net worth tax base, apportionment formula. The simulations show that revenue from this tax will decrease slightly from $630 million to $576 million. The losers will be concentrated in the lower net worth categories. In terms of industry classification, all industries have a high proportion of losses if this type of tax is imposed.

A different option is simply to reduce the net worth tax base, by defining the base as made up of net capital stock, paid in capital, and retained earnings. Several rate simulations were run on this base. First we set the net worth tax rate at 0.1 percent. This yielded a loss of tax revenue of approximately $54 million, approximately 6 percent of corporate tax revenue. With a net worth tax rate of 0.075 percent, revenue loss increased to $89 million, or for 14 percent of current tax revenues, with a rate of 0.05 percent, rev-

**TABLE 10-26**
**Tax "Rate" Schedule for the New Net Worth Tax Proposed by the Private Sector**

| Net Worth ($) | Tax ($) |
|---|---|
| 0 -10,000 | 250 |
| 10,001- 50,000 | 500 |
| 50,001 - 100,000 | 1,000 |
| 100,001 - 250,000 | 2,500 |
| 250,001 - 500,000 | 5,000 |
| 500,001 - 750,000 | 7,500 |
| 750,001 - 1,000,000 | 10,000 |
| 1,000,001 - 10, 000,000 | 15,000 |
| 10,000,001 - 100,000,000 | 20,000 |
| Over 100,000,000 | 25,000 |

**TABLE 10-27**
**Reforming the Franchise Tax: Replacing Net Worth Tax with Capped Net Worth Tax, Non-Revenue Neutral Option 4**

Net Worth Tax Using Fixed Tax Liability for Each Level of Net Worth

| Net Worth | Base Corporate Tax | Income Tax | Reduced Base Net Worth Tax | Calculated CorporateTax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Less than 1 | $35,862,764 | $32,484,779 | $2,369,110 | $34,853,889 | 0% | 100% | 0% |
| Over 1 - 200,000 | 32,249,202 | 22,648,858 | 1,984,243 | 24,633,101 | 0% | 100% | 0% |
| 200,001 - 500,000 | 25,889,826 | 17,056,832 | 1,486,114 | 18,542,946 | 0% | 100% | 0% |
| 500,001 - 2,500,000 | 62,081,815 | 41,957,122 | 8,750,593 | 50,707,715 | 0% | 100% | 0% |
| 2,500,001 - 5,000,000 | 27,672,764 | 20,612,339 | 6,484,011 | 27,096,350 | 24% | 76% | 0% |
| 5,000,001 - 20,000,000 | 69,590,881 | 51,720,568 | 12,673,574 | 64,394,142 | 15% | 85% | 0% |
| 20,000,001 - 100,000,000 | 104,136,346 | 71,945,004 | 48,808,100 | 120,753,104 | 25% | 75% | 0% |
| 100,000,001 - 250,000,000 | 62,431,082 | 43,731,704 | 25,239,431 | 68,971,135 | 16% | 84% | 0% |
| 250,000,001 - 500,000,000 | 50,381,815 | 32,558,519 | 15,551,377 | 48,109,895 | 40% | 60% | 0% |
| 500,000,001 - 750,000,000 | 27,084,813 | 15,493,821 | 6,771,767 | 22,265,588 | 7% | 93% | 0% |
| 750,000,001 - 1,000,000,000 | 11,590,126 | 6,955,357 | 5,975,200 | 12,930,557 | 44% | 56% | 0% |
| Over 1 Billion | 121,069,256 | 76,910,625 | 6,161,162 | 83,071,787 | 30% | 70% | 0% |
| Grand Total | $630,040,690 | $434,075,528 | $142,254,682 | $576,330,210 | 7% | 93% | 0% |

| Economic Sectors | Base Corporate Tax | Income Tax | Reduced Base Net Worth Tax | Calculated Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|---|---|
| Agriculture, Forestry and Fishing | $2,886,417 | $1,822,435 | $102,685 | $1,925,119 | 0% | 100% | 0% |
| Mining | 12,495,690 | 4,519,910 | 2,205,200 | 6,725,109 | 24% | 76% | 0% |
| Construction | 22,223,744 | 16,288,119 | 5,138,173 | 21,426,293 | 8% | 92% | 0% |
| Manufacturing | 288,514,301 | 215,100,251 | 68,865,033 | 283,965,284 | 23% | 77% | 0% |
| Transportation | 50,709,262 | 30,443,411 | 6,383,597 | 36,827,008 | 7% | 93% | 0% |
| Wholesale Trade | 50,174,092 | 36,713,264 | 13,783,118 | 50,496,382 | 13% | 87% | 0% |
| Retail Trade | 67,201,264 | 52,503,273 | 7,704,923 | 60,208,196 | 11% | 89% | 0% |
| Finance, Insurance, and Real Estate | 55,122,385 | 26,130,085 | 17,188,001 | 43,318,086 | 20% | 80% | 0% |
| Services | 60,897,755 | 40,282,818 | 16,547,712 | 56,830,531 | 3% | 97% | 0% |
| Unclassified | 19,815,780 | 10,271,961 | 4,336,240 | 14,608,201 | 0% | 100% | 0% |
| Grand Total | $630,040,689 | $434,075,528 | $142,254,682 | $576,330,209 | 7% | 93% | 0% |

enue losses increased to approximately $124 million, or about 20 percent of current tax revenues, and with a rate of a 0.01 percent, revenue losses amounted to $182 million, or approximately 28 percent of current revenues. In all these simulations the majority of taxpayers were not affected, and the number of winners and losers were of similar magnitude. Losers were concentrated in mining, construction, manufacturing and transportation, while winners were concentrated in wholesale and retail trade.

## Other Reform Options

*Coverage.* The corporate franchise tax at present gives special treatment to corporations that are financial depositary institutions and exempts corporations in other sectors, most importantly public utilities, telecommunications companies, and insurance companies, which are subject to special

taxation regimes. Although at some point there may have been justification for the special tax regimes, such as the existence of monopoly power, or difficulties in administering and enforcing a franchise tax in these sectors, most of these reasons have now largely or completely disappeared. An important option for reform of the franchise tax is to make its coverage universal to all business corporations. There should not be any major difficulty in doing this, as long as those corporations thrown back into the general regime are subject to the federal corporate income tax. This universal coverage option under the corporate franchise tax does not preclude special taxation regimes, of course, because of the difficulty in applying sales taxes to financial institutions and insurance companies, and the desirability of excise taxation of some utility services.

*Apportionment formulas.* Several options for reform should be considered in the apportionment formulas of the franchise tax. First we examine the options with respect to the apportionment formula for the net income tax. Next, we discuss options for the apportionment formula for the net worth tax, if this tax is to be kept in some form.

*Heavier weight to sales in the net income formula?* During the past decade, we have seen many states, including Ohio, that have used modified apportionment formulas. The most common modification has been the switch to a double-weighted sales factor in the traditional three-factor formula. The latter is the apportionment formula used for the net income tax component in Ohio's franchise tax. Several states have adopted formulas that give the sales factor an even larger weight, including the use of the sales ratio as the only factor in the formula.

The fundamental reason for adopting formulas giving more weight to the sales factor is to decrease the tax burden of companies with property and payroll in the state and increase it for out-of-state companies selling (but not producing) commodities within the state. The longer term goal of this policy is to encourage the location of businesses in the state.

The issue is whether the State of Ohio should consider a single-factor sales formula for the net income tax. The answer may be yes if the objective is to let Ohio become more competitive in attracting business locations vis-a-vis other states that already have adopted modified apportionment formulas. This statement does not assume that changes in the apportionment formula and therefore in state franchise taxes are decisive in affecting business location. However, this is an issue on which there is no convincing empirical evidence one way or another.[53] It should also be understood that the competitive margin granted by modifications in the formula would be erased as soon as other states introduced similar modifications in the apportionment formula.

To explore the impact of switching to a single sales factor for the net income tax in Ohio, we ran a simulation isolating this factor from any other changes. The results are presented in Table 10-28. The move would have

**TABLE 10-28**
**Simulation Results of Moving to a Single Sales Factor for the Net Income Tax**

| Net Worth ($) | Base Corporate Tax | New Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|
| Less than 1 | $35,862,764 | $34,735,433 | 0.6% | 0.4% | 99.0% |
| Over 1 - 200,000 | 32,249,202 | 2,222,534 | 1.4% | 0.0% | 98.6% |
| 200,001 - 500,000 | 25,889,826 | 2,118,991 | 20.2% | 1.5% | 78.3% |
| 500,001 - 2,500,000 | 62,081,815 | 21,540,353 | 31.4% | 8.0% | 60.6% |
| 2,500,001 - 5,000,000 | 27,672,764 | 19,932,529 | 66.1% | 6.8% | 27.1% |
| 5,000,001 - 20,000,000 | 69,590,881 | 45,915,902 | 57.1% | 13.1% | 29.8% |
| 20,000,001 - 100,000,000 | 104,136,346 | 129,760,020 | 9.3% | 12.1% | 78.5% |
| 100,000,001 - 250,000,000 | 62,431,082 | 73,473,463 | 6.0% | 18.0% | 75.9% |
| 250,000,001 - 500,000,000 | 50,381,815 | 60,251,007 | 4.1% | 12.4% | 83.4% |
| 500,000, 001 - 750,000,000 | 27,084,813 | 44,797,523 | 2.0% | 42.8% | 55.2% |
| 750,000,001 - 1,000,000,000 | 11,590,126 | 23,341,017 | 0.0% | 31.0% | 69.0% |
| Over 1 Billion | 121,069,256 | 150,329,233 | 3.7% | 54.0% | 42.3% |
| Grand Total | $630,040,690 | $608,418,004 | 6.2% | 5.1% | 88.7% |

| Economic Sectors | Base Corporate Tax | New Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|
| Agriculture, Forestry, and Fishing | $2,886,417 | $1,440,781 | 40.0% | 20.0% | 40.0% |
| Mining | 12,495,690 | 12,511,913 | 14.7% | 6.2% | 79.1% |
| Construction | 22,223,744 | 20,509,373 | 18.8% | 13.5% | 67.7% |
| Manufacturing | 288,514,301 | 335,171,073 | 18.6% | 17.7% | 63.8% |
| Transportation | 50,709,262 | 34,939,703 | 13.1% | 6.4% | 80.5% |
| Wholesale Trade | 50,174,092 | 45,808,991 | 11.1% | 6.3% | 82.6% |
| Retail Trade | 67,201,264 | 52,729,962 | 30.3% | 11.8% | 57.9% |
| Finance, Insurance, and Real Estate | 55,122,385 | 40,172,667 | 10.4% | 3.3% | 86.3% |
| Services | 60,897,755 | 53,749,529 | 3.9% | 6.5% | 89.6% |
| Unclassified | 19,815,780 | 11,384,010 | 0.2% | 0.1% | 99.7% |
| Grand Total | $630,040,689 | $608,418,004 | 6.2% | 5.1% | 88.7% |

produced a decrease in franchise revenues in 1993 of approximately $21.6 million, or a 3.4 percent decrease in revenues. This change is small enough to be associated simply with the sampling error in the simulation. Notice, however, that these results represent static changes for that particular year. That is, the results do not include any potential gains in revenues that may be realized from additional corporations moving production activities to Ohio. The distribution of winners tends to favor middle sized firms (in net worth), which are more likely to have payroll and property used in production in Ohio. The losers tend to be larger-size firms, which have relatively more sales than labor and property used in production in the state. Most of the small firms which tend to be 100 percent Ohio operations, with an apportionment ratio of 100, are not affected by the change. The distribution of winners and losers by economic sector is more even. Every sector has more winners than losers except for the service sector. On the whole, 88.7 percent of the companies are not affected, but that is mostly because of the much larger number of companies that are all Ohio companies.

Are there any significant arguments against the change in the apportionment formula? One consideration is the fact that by adopting a single sales

factor Ohio would move state corporate taxation still further from a uniform apportionment system such as the one predicated in UDITPA.[54] The lack of a uniform system creates the possibility of over-apportionment of corporation incomes among those states with a corporate income tax.[55] Those companies more adversely affected by the possible change in the apportionment formula, large corporations with extensive sales in Ohio and relatively small production facilities, will likely put up a strong campaign calling the move unfair.

*A priori* there is no overwhelming reason to use one formula over another in apportioning income. Justifications of any of the formulas can be made *ex-post,* each one better capturing the underlying causes of the tax base. In reality, the multiplicity of formulas and apportionment schemes used in other states puts Ohio, as any other state, in the position of having to care only about what formula will maximize revenue over the long run. It is important to emphasize again that the revenue perspective must be a long-term perspective, because the tax base in the state may increase or decrease as more companies locate in or outside Ohio in response to the formula adopted. Revenues in the long run will also be affected by the apportionment formulas adopted by other states. Unfortunately, there is no evidence on how important any of these effects may be on a state by state basis.

*Reforming the apportionment formula for the net worth tax.* If the net worth tax were to be kept either in its current form or as a new modified net worth tax excluding reserves and deferred taxes from the base, there are several possibilities for changing the apportionment formula for either tax. The current two factor formula could be substituted with the three-factor double-weighted formula used in the net income tax. This would have the effect of shifting the burden of the net worth tax toward out of state companies. This would be so because of the double weighting of sales and because of the exclusion of intangible income and assets from the computation of the sales and property factors, respectively. The *a priori* expectations of the impact of this change is that most winners would be concentrated among small and middle-sized companies, which would tend to be Ohio companies, and most losers would be concentrated among larger size companies, which would tend to include more non-Ohio companies.

A second possibility would be to apportion the net worth base with a two-factor formula based on sales and property, as computed now for the net income tax. This change should still lighten the tax burden of Ohio companies compared to out-of-state companies, but quite probably less than by using the double-weighted sales three factor formula of the net income tax. A third possibility would be to use a single-factor formula, with the choice being between the property factor and the sales factor.

*Use of the throwback rule.* Ohio could join other states in introducing a throwback rule in the computation of the sales factor in the apportionment formula for net income taxes. Of course, this would help increase revenues

from the franchise tax, but in minor amounts. What the rule would do is apportion corporate income to the State of Ohio that otherwise might not be apportioned anywhere else. However, given the many differences in apportionment formulas across states under which multistate corporations have to file, the introduction of a throwback rule would tend to destroy the little cushion corporations may have to avoid the over-apportionment and, therefore, double taxation of their incomes.

*Raise the minimum payment of the franchise tax.* Regardless of what is done in other areas of the franchise tax, there is the option to increase the minimum payment under the franchise tax from its current $50 level. The current $50 may be too low to cover the expense to the Tax Department of processing a tax return. The increase in the minimum payment can be made part of a new net worth tax, as we have seen above. Table 10-29 shows the potential impact on revenues of raising the minimum payment by $50 steps from the current level of $50 to $500. At the present level of $50 the minimum tax raises $2.2 million, representing 0.36 percent of corporate franchise tax revenues. With a minimum tax of $500, revenues raised would have been $22.4 million, or 3.56 percent of corporate franchise tax revenues. These calculations are performed on the basis of the number of corporations that should have paid the minimum tax in 1993.

*Tax rates.* Ohio already has one of the highest corporate income tax rates, as discussed in Section 2. Still the possibility is there to increase tax rates. An increase of 1 percent in the top rate for net incomes above $50,000 would have generated between $40 million and $50 million in additional tax revenues in 1993.

**TABLE 10-29**
**Effect on Tax Revenue of Increasing the Minimum Corporate Tax**

| Minimum Tax Amount | Amount of Revenue Generated | Percent of Total Current Tax Revenue |
|---|---|---|
| $50 | $2,242,750 | 0.3560 |
| $100 | $4,485,500 | 0.7119 |
| $150 | $6,728,250 | 1.0679 |
| $200 | $8,971,000 | 1.4239 |
| $250 | $11,213,750 | 1.7798 |
| $300 | $13,456,500 | 2.1358 |
| $350 | $15,699,250 | 2.4918 |
| $400 | $17,942,000 | 2.8477 |
| $450 | $20,184,750 | 3.2037 |
| $500 | $22,427,500 | 3.5597 |

Other possibilities for reform in the rate structure include changing the net income threshold of $50,000 for the current lower rate of 5.1 percent, changing the lower rate itself, and introducing one or more additional brackets. Several states, including Iowa, Kentucky, and Missouri, have graduated progressive rate schedules. The advantage of the present system, with a lower rate for relatively small levels of income, is that it does offer some advantage to small businesses without sacrificing a large sum in revenues and without giving strong incentives for the breakup of larger companies into smaller units. This is a common criticism of progressive rate schedules for corporate income taxes. However, there is little empirical evidence on how important these effects may be in reality.

*Credits and other tax benefits.* There are, as we saw in Section 1, many tax credits and other tax benefits that undermine the revenue-raising capacity of the franchise tax at the present time. Some of the credits appear to be justified, in order to avoid the double taxation of assets. But most of the credits have been introduced in the spirit of the necessity of special treatment to encourage certain activities. There is no general consensus among economists about the desirability and effectiveness of these incentives; the experience of different tax systems with a variety of tax benefits is that many of these interventions do not seem to produce the desired objectives, and sometimes they may actually be harmful because of the misallocation of resources they induce.

The reform of the corporate franchise tax is clearly an opportunity to review and simplify the system of credits and tax incentives under the franchise tax. If the franchise tax is simplified with the elimination of the net worth component, there will be room to further simplify the system of tax benefits and tax incentives.

*Make all allocable income apportionable.* As we have seen, Ohio allocates certain types of income, mostly from intangible assets, regardless of whether these incomes have a business or non-business source. Some states also allocate to the state non-business income. Yet some other states make no distinction between business and non-business income and make all types of income apportionable, as opposed to allocable.

One option for reform in Ohio is to make all types of income apportionable. This possibility is simulated in Table 10-30. This change would have been a mild revenue winner in 1993, raising $23.5 million in additional tax revenues. Again in this case, all-Ohio companies (small and middle- size) tend to be relative winners since all their incomes that before were 100 percent allocable are now apportionable at less than 100 percent, if the corporation has business outside Ohio. The relative losers tend to be larger non-Ohio companies which before could exclude allowable income not sitused to Ohio, but now would have to include all those incomes as apportionable. The distribution of winners and losers by economic sector shows

**TABLE 10-30**
**Corporation Tax without Using Schedule C (Allocable Income) in Computing Taxable Income**

| Net Worth ($) | Base Corporate Tax | New Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|
| Less than 1 | $35,862,764 | $34,427,439 | 0% | 3% | 97% |
| Over 1 - 200,000 | 32,249,202 | 2,504,658 | 5% | 1% | 94% |
| 200,001 - 500,000 | 25,889,826 | 2,268,087 | 42% | 19% | 39% |
| 500,001 - 2,500,000 | 62,081,815 | 22,980,754 | 49% | 15% | 35% |
| 2,500,001 - 5,000,000 | 27,672,764 | 22,903,800 | 34% | 5% | 61% |
| 500,000,001 - 20,000,000 | 69,590,881 | 57,024,704 | 40% | 16% | 44% |
| 20,000,001 - 100,000,000 | 104,136,346 | 157,289,230 | 31% | 53% | 16% |
| 100,000,001 - 250,000,000 | 62,431,082 | 78,633,555 | 26% | 37% | 37% |
| 250,000,001 - 500,000,000 | 50,381,815 | 67,935,855 | 21% | 76% | 3% |
| 500,000,001 - 750,000,000 | 27,084,813 | 49,018,931 | 39% | 56% | 6% |
| 750,000,001 - 1,000,000,000 | 11,590,126 | 24,047,070 | 17% | 83% | 0% |
| Over 1 Billion | 121,069,256 | 134,523,081 | 54% | 44% | 2% |
| Grand Total | $630,040,690 | $653,557,165 | 12% | 15% | 73% |

| Economic Sectors | Base Corporate Tax | New Corporate Tax | Winners | Losers | Even |
|---|---|---|---|---|---|
| Agriculture, Forestry, and Fishing | $2,886,417 | $1,249,378 | 10% | 0% | 90% |
| Mining | 12,495,690 | 12,029,018 | 29% | 44% | 27% |
| Construction | 22,223,744 | 18,732,813 | 47% | 20% | 34% |
| Manufacturing | 288,514,301 | 360,418,276 | 27% | 44% | 28% |
| Transportation | 50,709,262 | 38,412,253 | 50% | 14% | 35% |
| Wholesale Trade | 50,174,092 | 46,687,465 | 22% | 23% | 55% |
| Retail Trade | 67,201,264 | 55,493,993 | 50% | 19% | 31% |
| Finance, Insurance, and Real Estate | 55,122,385 | 46,137,737 | 39% | 43% | 18% |
| Services | 60,897,755 | 62,216,255 | 8% | 14% | 78% |
| Unclassified | 19,815,780 | 12,179,976 | 0% | 3% | 97% |
| Grand Total | $630,040,689 | $653,557,165 | 12% | 15% | 73% |

the same result. Those sectors that are more likely to have Ohio companies (e.g., construction and retail trade) tend to be winners.

*Should Ohio require combined income reporting for unitary businesses?* The advantages of mandating combined income reporting for unitary businesses are many. Fundamentally, combined income reporting eliminates artificial discrepancies in the tax base through accounting and arbitrary allocations of revenues and expenses across state boundaries.

However, combined income reporting is still controversial as an apportionment method. Critics have argued that combined income reporting is contrary to the arm's-length standard and to the formulary apportionment of a single taxpayer's income. The counter answer from proponents of combined income reporting is that the arm's-length standard and single taxpayer formulary apportionment have become fictions in a world where unitary businesses have at their disposal a variety of avenues to artificially reduce their state tax liabilities.

Combined income reporting is not a panacea, either. Mandating it will re-

quire a very clear set of regulations in complex areas. Combined reporting should be distinguished from consolidated return filing. The following paragraphs describe some of these distinctions, and briefly review the scope of issues that would have to be decided if mandatory combined income reporting were adopted.

Combined reporting is an approach for determining the income attributable to a state from each of the corporations that are members of an affiliated group of companies conducting a unitary business in several states.[56] When there is more than one corporation in the affiliated group doing business in the state, the unitary income apportioned to the state is in turn apportioned among the different companies with nexus in the state.[57] Depending on the type of combined reporting, not all affiliated corporations in a group may be combined. Combination applies to a "unitary business," and the determination of what this is can vary.

It is important to distinguish between the filing of "combined income reports" and the filing of "consolidated returns." These two terms are at times used interchangeably, but they are quite different things. The objective of combined income reporting is not to tax the income of the affiliated group as a whole or the filing of a consolidated return. Rather, the objective is to determine the portion of the income from the unitary business attributable to the companies with nexus or operations in the state. The combined income report is an information return rather than a tax return. Each corporation in a combined report with nexus in the state still has to file its own corporate tax return. See Box 10-2 for the steps followed in combined income reporting.

By contrast, in a consolidated return the total net income of the corporations in the group is filed in a single return and a single tax is paid (even though each of the corporations is jointly and severally liable for payment). In the case of consolidated returns, net income is not limited to that related to a specific unitary business. Of course, when the consolidated business operates in more than one state, apportionment will be necessary in the consolidated return. See Box 10-2.

Two important decisions would have to be made if the State of Ohio were to require combined income reporting for all unitary businesses. These concern the "basis," or how far and wide the combination should go, and the "standards," or how to determine which corporations should file a combined report.[58]

The choices for basis are essentially three, although some combinations of these three are also possible: worldwide combination, which includes all domestic and foreign income; domestic or water's edge combination, which includes only United States source income; and a nexus combination which includes only companies with nexus in the state, or corporations domiciled in the state, or some combination thereof.

**BOX 10-2**
**State's Apportionment in Combined Income Reports***

Under a combined income approach the share of income of the unitary business that is taxable in the state is determined as follows:

First, define the scope of the unitary business and what corporations should be made part of the combined report.

Second, determine the net income derived by the unitary business inside and outside the state, eliminating all income and expenses attributable to internal transactions within the unitary group itself.

Third, determine the share of the unitary group's income that is allocable to the state and then determine the part of the unitary business income that is apportioned to the state, and apply the statutory formula for apportioning the unitary business income (not directly allocable).

Fourth, divide the total net taxable income of the unitary business attributable to the state among the corporations of the group that have nexus within the state according to the distribution among them of the factors used in the apportionment formula.

*Adapted from John L. Coalson, Jr. and Michael T. Ptrik, "Consolidated or Combined Returns and Alternative Corporate Reporting Methods: A Georgia Perspective," Journal of State Taxation, Vol. 8, No.2, Fall 1989, pp.132-151.

The standards used to determine when a group of affiliated companies actually constitutes a unitary business vary. The most common standard is based on the "three unities" of common ownership, common management, and common operation or use. Common ownership is typically interpreted to exist when 50 percent or more of the stock of a corporation is owned by another corporation. Common management is typically interpreted to exist when there are overlapping boards of directors or common managers in key positions. Common operation is interpreted to exist when there are common functions of management, financing, accounting, advertising, or purchasing.

Other standards used rely on the existence of dependency or contributions between affiliated corporations, similarities in the line of business, or significant intercorporate transactions.

*Net operating losses.* The state could introduce a carry back provision for NOLS, to be more competitive. However, the present provision of no carry back allowed does not put Ohio at a disadvantage with neighboring states and avoids some of the revenue instability associated with the carry back provision.

*Joining the Multistate Tax Compact?* Joining the Multistate Tax Compact and subscribing to UDITPA (The Uniform Division of Income for Tax Purposes Act) would require some important changes in the Ohio corporate franchise tax, most importantly in the apportionment formula. There would be the advantage of adding clarity and standardized procedures. The state tax administration also would benefit from the multistate audits and interpretive rulings done by the Tax Compact for specific business sectors. However, joining UDITPA may be unfavorably regarded in the business community.

*The reform of local income taxes.* There is ample room for standardization and simplification of these taxes. Ideally, at the very least, all local jurisdictions would adopt the same basic tax structure and procedures, although they would be able to vary the rates. Some degree of discretion in the ability to raise revenues is desirable, to increase efficiency and accountability in local governments.[59] Under this approach each business would still have to file a tax return in each of the jurisdictions where it operates. An even more simplified approach would be to rely on centralized filing with the State Department of Taxation and to devise a system for the apportionment of collections among local jurisdictions. This approach would significantly reduce compliance costs for businesses, and in theory it could be structured to allow differentiated rates for local jurisdictions.

## Elimination of the Franchise Tax

The last option to consider is the complete elimination of the corporate franchise tax. Four states (Nevada, South Dakota, Washington, and Wyoming) have at present no corporate income tax.[60] The substitution of corporate income tax revenues with existing taxes, such as the personal income tax or the sales tax, is quite feasible. The corporate income tax yielded $630 million in 1993. This revenue could have been collected from the personal income tax by either of two changes: 1) getting rid of the following credits and income exclusions: social security and railroad retirement exclusions, personal exemption credits, senior citizen credits, joint filer credits, and retirement income credits (all major credits and adjustments on the individual income tax); or 2) by a 0.5 percent surcharge on taxable income (ef-

fectively increasing all rates by 0.5 percent). The elimination of the corporate income tax would create a more attractive business climate. State corporate income taxes, including the corporate franchise tax in Ohio, represent double taxation of corporate income because of their lack of integration with the personal income tax. This double taxation is imposed on top of the double taxation of corporate income at the federal level where there is no integration of the two taxes either. An additional attraction of completely eliminating the corporate income tax is that the state would not have to continue to rely on an unstable and probably declining source of revenues. The main disadvantage of eliminating the corporate franchise tax is that there would be a shift of tax burdens now borne by nonresidents (as owners of capital and consumers) to state residents. Although a portion of the franchise tax is surely exported, that may not be the case with substitute taxes such as the personal income tax or the sales tax.

# APPENDIX
## TAX RETURN SAMPLE DATA USED IN THE MICRO-SIMULATIONS

Sampling was performed on the basis of a master file of taxpayers from the Ohio Department of Taxation. This file had information coded from the first page of the corporate return. In total there were approximately 107,000 taxpayers. Most of the information needed to construct the tax calculator was not available from the tax return's first page. This necessitated the drawing of a sample of fully filled-out tax returns. The sample originally designed contained the complete set of the largest 500 companies in terms of tax liability. We added to them a random sample of just over 1 percent of the remaining firms that accounted for an additional 1,000 firms. A small number of firms with no taxable income but "large" net worth tax liability was also included to make sure that firms were represented.

After the coding of entire data, some tax returns were not usable due to taxpayer errors and omissions. In addition, some tax returns were not available because they were in the audit process. The final sample contained 1377 firms representing 44.2 percent of the total franchise tax revenues collected by the state. The results from this sample were "blown-up" to the entire set of taxpayers. Because we used three different samples (a full sample of the largest companies, a full sample of zero or low profit but high net worth firms, and a random sample of the remaining firms), different "blown up" factors were used so that the revenue contribution for each sample matched the population from which it was drawn. The sample returns after being "blown-up" replicated 99 percent of the actual revenue collected in 1993. The tax calculator built replicated the corporate income tax forms. The calculator was used to develop the base core analysis and was modified to develop the simulation results.

# ENDNOTES

1. The authors would like to thank the Ohio Department of Taxation for the effort of collecting the sample return data used in the simulation of the corporate franchise tax in this chapter and for general information and guidance. We would also like to thank Wen Tsui and Joe Timmerman for their valuable research assistance. We would also like to thank the Tax Committee of the Ohio Chamber of Commerce for information and insights in the various corporate income tax issues covered in this chapter.

2. "Doing business" in the state is evidenced by a number of activities, such as listing the company in the phone book or the licensing of software. Ohio takes one of the most aggressive stands in determining nexus. Some of these are reviewed below in the comparison of Ohio franchise tax with that in other states.

3. Since 1993 railroad companies no longer pay the public utility excise tax and are instead subject to the regular franchise tax.

4. Other corporations exempted from the franchise tax are nonprofit corporations (except for some consumer and agricultural cooperatives), municipal corporations, credit unions, real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits (ORC 1733.43, 5733.01, 5733.09, and 5733.10).

5. States are not allowed to tax interest from federal obligations if they exempt interest income from state public obligations.

6. See the Department of Taxation's Annual Report 1992, page 21, for recent significant court decisions involving the issue of allocable versus apportionable income.

7. Dividends are allocated to the state according to the "Ohio-to-be-everywhere" ratio for the book value of assets of the payor company. Dividends from Domestic International Sales Corporations and from corporations for which there is no information on the location of assets are apportioned.

8. Trademark royalties are not considered patent or copyright royalties, and they are treated as apportionable income.

9. Prior to 1982 the carry forward period was five consecutive years.

10. The gross profit portion of income received but not yet earned is includable in the value of the stock, as are net deferred tax liabilities. Contingent liabilities are included in the computation of net worth if the corporation cannot reasonably estimate the amount of the liability or if it cannot be established that the liability is to be incurred in the current period.

11. Intangible assets are not part of goodwill if they can be sold and purchased separately with an identifiable value.

12. This tax offers a mild incentive for filing a combined franchise report. The entire group of corporations pay only the two tier litter tax once as a group rather than individually by each corporation.

13. For a more detailed analysis of the effects of credits, or economic development in Ohio, see Michael Wasylenko, "The Role of Fiscal Incentives in Economic Development: How Ohio Stands Relative to its Competitor States," Chapter 9 in this volume.

14. The Amended Substitute Bill 32 extended the credit for qualifying new investments with respect to property acquired before 1989. This Bill also created a refundable credit, while the original new investment credit is a non-refundable credit.

15. The conditions are regulated in Ohio Revised Code Section 5733.052 and Tax Commissioner's Rule 5703-5-06.

16. Each of the corporations combining incomes must have income other than dividend income within Ohio.

17. Corporations without business nexus in Ohio may be included in a combined income report with approval of the Commissioner. However, these corporations must derive income in the same fashion as the taxpayer corporations.

18. In a recent case the Ohio Board of Tax Appeals held that corporations filing combined franchise tax reports for prior years may not add retroactively another corporation to the combined group without consent of the Commissioner. The Commissioner had withheld consent, arguing that the subsidiary which was trying to add to the combined group had no income allocable or apportionable to the state of Ohio (*The Tranzonic Companies and Subsidiaries v. Tracy,* Ohio Board of Tax Appeals, December 4, 1992).

19. ACIR (1993).

20. The representative tax system is defined by the ACIR at the average state corporate income tax rate times the national corporate profits apportioned to the state according to a three factor (sales, property and employment) formula.

21. Note that Figure 1-9 uses two scales, in millions for Ohio and in billions for all states.

22. However, S corporations do face a number of restrictions which do not affect C corporations. S corporations cannot have more than 35 shareholders, they can issue only one type of stock, they must be domestic corporations, and they may not be part of an affiliated group.

23. See Robert Carrol and David Joulfaian (1993).

24. See Alan J. Auerbach and James Poterba (1993).

25. From an average of 10.9 percent in the 1960s the profit rate fell to 7.2 percent during the 1970s and 4.9 percent during the first half of the 1980s.

26. The Supreme Court has ruled that the taking of sales orders by a traveling salesman does not constitute nexus when those orders are filled and delivery is made from a location outside of the state. However, a permanent employee in the state for sales activities may be outside the spirit of the Supreme Court ruling.

27. For the rationale behind different formulas, see Peggy B. Musgrave (1994b).

28. Approval of the Tax Commissioner is required.

29. These deductions are related to the domestic corporation dividends subject to the 70 percent deduction.

30. Of course, the federal government imposes an alternative minimum tax but this falls on income (at 20 percent on the regular net income base grossed up for tax preferences) rather than assets.

31. Besides Pennsylvania, other states with significant net worth taxes are Alabama, Kentucky, Louisiana, Mississippi, North Carolina, Tennessee, and Texas.

32. See A. Estache (1990).

33. See Peter D. Byrne (1994).

34. Business taxes on assets are actually used as a method of presumptive income taxation based on the idea that capital assets will produce some minimum rate of return on average or otherwise the enterprise would get out of the business.

35. Allowing the asset tax to be carried forward as a credit still does not solve the major problem discussed below that the tax imposes a burden when the firm can least afford it. Actually, the credit provides relief when the firm is in a better position and may not need the relief as much.

36. Some countries with taxes on gross or net assets have addressed this problem by exempting newly formed companies for several years. Ohio does not have a similar provision regarding the net worth tax.

37. The credit, it is argued, also may have served as a check on property tax increases at the local level, since increases in property taxes meant decreases in state taxes. However, it may have worked the other way around. With the credit in place local jurisdictions may have had an incentive to increase property taxes, since the credit it was the state and not the companies that actually had to pay the tax (for as long, of course, as the companies were paying the net worth tax component of the franchise tax rather than the net income component).

38. The situsing rules are for the most part those in the statutes of the intangible property tax, which was repealed in 1986. In terms of complexity, business representatives often referred to the instructions for situsing, investment in subsidiaries, which is 25 pages long.

39. The marginal effective rates of taxation are calculated by assuming identical pre-tax rates of return for different assets and economic sectors and calculating an after-tax rules of return for each type of investment after all aspects of taxation affecting those investments are taken into consideration.

40. See Charles E. McLure, Jr. (1986). Peter Mieszkowski and John Morgan (1984).

41. The only receipts excluded from the business done factor are management fees for services by a parent company for a subsidiary without a profit element, and the proceeds from the sale of some assets.

42. See Charles E. McLure, Jr. (1984); George N. Carlson and Harvey Galper (1984) and Alicia H. Munnell (1992).

43. Section 162 of the 1991 Budget Bill.

44. See Jeffrey P. Sherman (1991).

45. See the *1994 Multistate Corporate Tax Guide*.

46. The UDITPA (Uniform Distribution of Income for Tax Purposes Act) approach is to allocate only non-business income. This latter is defined as originating in assets not in use for daily business activities.

47. The Ohio Board of Tax Appeals has ruled that the "aggregate" or (conduit) principle applies to the computation of the franchise tax. This means that all income and deductions realized by a partnership are transplanted as such to the corporate partner for the calculation of its franchise tax.

48. For example, businesses with distribution services among different local governments in theory need to keep track of how long a truck and driver spends in each jurisdiction in the course of a day.

49. We are grateful to the Department of Taxation for making the data available. The sample of tax returns and the micro-simulation methodology are described in the Appendix.

50. Of course, this principle should not apply only to incorporated businesses but rather to all types of legal forms of enterprises.

51. The proposals from the business community with respect to the repeal of the net worth tax have not been necessarily consistent in the sense that they factor both the proposition of revenue neutrality and a reformed net worth tax with a cap and other features (e.g. lower rates) which may make revenue neutrality impossible.

52. The proposal from the business community also suggests that the maximum cap in the schedule should be used for a combined group. However, the rationale of the tax as a minimum payment for services or the privilege to do business in the state suggests that each corporation in a combined group should pay this type of tax separately.

53. See M. Wasylenko, "The Role of Fiscal Incentives in Economic Development: How Ohio Stands Relative to Its Competitor States," Chapter 9 in this volume.

54. UDITPA adopts the three factors formula with equal weights for sales, payroll and property.

55. However, nationwide there does not appear to be significant over apportionment. See Steven M. Sheffin and Jack Fulcher (1984).

56. See for example, James F. Buresh and Marc S. Weinstein (1982).

57. Often the second-stage apportionment is not done with the entire income apportioned to the state assessed to the "key corporation" of the group in the state.

58. Several administrative issues would also need to be addressed, involving rules for the consolidation of intercompany transactions, the merging of different accounting periods, how to address partnerships in the affiliated group, how to deal with foreign source income, and whether there should be some modification of the apportionment formula to recognize the different nature of some of the corporations, such as financial institutions and insurance companies.

59. By efficiency what is meant is that the residents of some jurisdictions may have higher preferences for public services, and the system of local finances should let these jurisdictions fulfill these preferences on a voluntary basis.

60. Michigan does not have a corporate income tax, but it has a "single business tax," which is a modified value-added tax (VAT).