Ohio's Biennial Budget Bill

Significant Tax Law Changes Enacted

After months of deliberations, revisions, and hours of floor debate in the Ohio General Assembly, Governor Kasich signed the biennial budget bill, Am. Sub. H.B. 59 (the "Budget Bill"), on June 30, 2013. The Budget Bill authorizes state spending for the 2014 and 2015 fiscal years and contains many policy changes, especially in the tax area. The goal of these tax policy changes is to give Ohioans more buying power and to help create more jobs.

Background

Governor Kasich's Original Budget: As you may recall, Governor John Kasich introduced a bold set of tax reforms in his initial budget proposal in February 2013. The governor's proposal called for a 20% across-the-board personal income cut phased in over three years, as well as a new small business income deduction that was available to owners of pass-through entities and sole proprietors. The originally proposed small business income deduction would have allowed an owner to deduct up to $375,000 of business income on the owner's Ohio personal income tax return. To pay for these proposed tax cuts, Governor Kasich called for implementation of Ohio's sales and use tax on all services and transfers of intangibles, as well as major changes to Ohio's severance tax system.

House-Passed Version: The Ohio House of Representatives rejected Governor Kasich's original tax reform proposal and replaced it with a modest personal income tax cut paid for from existing revenues and some relatively minor tax law changes. The House-passed version of the Budget Bill called for a 7% across-the-board personal income tax cut and did not include the small business income deduction.

Senate-Passed Version: The Ohio Senate made its own mark on the Budget Bill by eliminating the House's 7% across-the-board personal income tax cut and replacing it with a small business income deduction similar to Governor Kasich's original concept. Again, these cuts were paid for from existing revenues and other relatively minor tax law changes.

Conference Committee: The Budget Bill went to a joint House-Senate conference committee for reconciliation of the differences between the House and Senate-passed versions of the bill. Essentially, the conference committee adopted both an across-the-board personal income tax cut and a small business income deduction paid for from existing revenues and other tax and spending changes (described below). The House and Senate accepted the conference committee report on June 27, 2013.

As a result, the final Budget Bill contains significant personal income tax cuts but does not include:

- The proposed expansion of the sales and use tax base to include nearly all services and transfers of intangibles; or
- The proposed overhaul of the severance tax system.

THE FINAL BUDGET BILL - TAX CUTS

The final Budget Bill contained the following major tax cuts:

- **Personal Income Tax Cut**: A permanent 10% across-the-board personal income tax rate reduction which is phased in over a three year period as follows:

Calendar Year	Rate Reduction
2013	8.50%
2014	0.5%
2015	1.0%

The 2013 rate reduction is retroactive back to January 1, 2013.

- **Small Business Income Deduction**: A small business income deduction for up to $250,000 of Ohio business income. Ohio business income is essentially Ohio apportioned income that passes to an individual owner of a pass through entity, such as a partnership, S corporation, sole proprietorship, and some limited liability companies. The Ohio portion of income reported to the owner on federal form K-1 or reported on an individual taxpayer's federal schedule C will generally qualify as deductible Ohio business income. Amounts reported as wages to an S corporation owner do not constitute Ohio business income, which means S corporation owners may not receive the full benefit of this deduction.

	Maximum Ohio Business Income	Maximum Deduction	Maximum Tax Savings[1]
Single or Joint Filers	$250,000	$125,000	$6,666
Married Filing Separate Filers	$125,000 each	$62,500 each	$3,999

According to details released by the General Assembly's Republican leadership, these personal income tax cuts result in nearly $5.2 billion of tax reductions over three years. The cost of these tax reductions are paid for out of existing revenues ($2.5 billion) and various other "*tax reform*" items ($2.7 billion).

> ***ZHF Observation***: The personal income tax cuts may have a significant unintended impact on those businesses that have negotiated job retention or job creation tax credits in exchange for major new investments. These credits are measured by the amount of personal income tax that is withheld on employee wages. If the Ohio Department of Taxation lowers the withholding tables to reflect the personal income tax reductions, then such credits could automatically decrease by ten percent.

[1] Maximum Tax Savings is calculated based on the fully phased-in 10% personal income tax reduction and applying the highest marginal rate of tax, which currently applies to incomes above $208,500. Also, this amount is not net of the federal income tax increase that may result due to a lower state tax deduction for federal income tax purposes.

The Final Budget Bill – Tax Increases and Reforms

The Budget Bill includes many tax law changes that are designed to either help pay for the personal income tax cuts described above, improve Ohio's tax system, or both. The tax increases contained in the Budget Bill will raise $2.7 billion over the next three years.

Sales and Use Tax Changes: The Budget Bill makes several changes to Ohio's sales and use tax law. The most significant change is a 0.25% increase to the statewide sales and use tax rate, raising the statewide rate from 5.5% to 5.75%. The new rate goes into effect starting September 1, 2013. The Budget Bill also incorporates other changes, which include:

- *SSTP* - Ohio will now become a full member in the Streamlined Sales Tax Project, which is designed to aid the collection of sales and use tax on Internet and catalog sales.

- *Digital Goods* - Imposition of the sales and use tax on digital goods transferred electronically. A digital good includes digital audiovisual works (videos), digital audio works (music), and digital books (ebooks). Photographs transferred electronically will not be subject to tax.

- *Magazine subscriptions* - Imposition of the sales and use tax on magazine subscriptions. Magazines that are distributed as controlled circulation publications will continue to be exempt from sales and use tax. A controlled circulation publication is a magazine that has at least twenty-four pages, comprised of at least twenty-five percent editorial content, and among other requirements, is circulated without charge to the recipient.

- *Data Center Exemption* - Allows the Tax Credit Authority to enter into an agreement which exempts from sales and use tax equipment for a computer data center if an investment of at least $100,000,000 is made for three continuous years and the payroll of the data center is at least $1,500,000 annually for three continuous years.

- *Cable Television Service Provider Exemption* - The Budget Bill enacts a "status" sales tax exemption for certain sales to or by a cable television service provider or radio or television broadcast station regulated by the federal government. One example of the impact of this change is that a cable company that electronically sells a movie would not be required to collect the newly imposed sales tax on the sale of that movie (see above), but other businesses that do not qualify for such "status" will be required to collect the new sales tax for the electronically transferred movie.

- *Exemption of Sales to Certain Non-Profit Corporations* - The Budget Bill provides an exemption for purchases by a non-profit corporation that leases a recreational facility used by a professional athletic team or minor league affiliate from an eligible county. The lease must require certain net revenue be paid to the county and upon dissolution of the corporation, all net assets of the non-profit must be distributable to the county's board of commissioners. Currently, Lucas County is the only "eligible county" (home of the Toledo Mud Hens).

Personal Income Tax Changes: In addition to phasing in lower income tax rates and adding a small business income deduction, the Budget Bill makes other changes to the personal income tax that are designed to reform the personal income tax and, in many cases, to raise revenue to offset those cuts. These changes include the following:

- *Indexing* - The indexing of personal income tax brackets for inflation are frozen for three years including tax years 2013, 2014, and 2015.

- *Gambling Losses* - The personal income tax deduction for gambling losses claimed as an itemized deduction on an individual's federal income tax return is no longer deductible against Ohio adjusted gross income. As a result, casual gamblers will pay tax on their winnings, but will not be permitted to offset their winnings against their losses. This is effective for tax years beginning on or after January 1, 2013. This was in Governor Kasich's original tax reform proposal.

- *No Double Tax Credit* - The $20 personal income tax credit for individuals claimed as a dependent on another's federal income tax return is eliminated. This was in Governor Kasich's original tax reform proposal and is effective for tax year 2014.

- *Phase-out of $20 Tax Credit* - The $20 personal income tax credit for individuals is eliminated for taxpayers with Ohio adjusted gross income of $30,000 or more effective for tax year 2013 and after.

- *Composite Returns for Nonresidents* - Under prior law, the Ohio Department of Taxation's interpretation was that a nonresident investor included in a composite return that had no other Ohio source income was ineligible to file a separate Ohio individual income tax return. Investors included in a composite return are subject to the highest marginal tax rate, unable to claim a personal or dependent exemption, and cannot claim any non-business credits. Nonresident investors included in a composite return are now eligible to file a separate individual income tax return that will provide a credit against tax due for amounts paid by the entity filing the composite return and will allow nonresident investors to claim a personal and dependency exemption and non-business credits.

- *Earned Income Credit* - Beginning with tax year 2013, a taxpayer with adjusted gross income of $20,000 or less will be allowed to claim an Ohio earned income tax credit equal to five percent of the earned income tax credit allowed for federal income tax purposes. Taxpayers who claim the federal earned income tax credit and have Ohio adjusted gross income greater than $20,000 are still eligible for the Ohio earned income tax credit, but the credit may not exceed fifty percent of the Ohio tax due.

Real Estate Tax Changes: The Budget Bill makes several changes related to real property taxes that reforms the real property tax system and helps pay for the personal income tax cuts.

- *Residential Real Property Tax Rollbacks Eliminated* - Under current law, the state pays 12.5% of the real property taxes that are imposed on residential real property. Residential real property includes rental property with three or less units. Most home owners do not realize that the state is paying this tax on their behalf. The Budget Bill phases out this state payment by eliminating the 10% and 2.5% property tax rollbacks on new and replacement levies. The state will continue to pay the rollbacks on existing levies and on renewals of existing levies.

- *Homestead Exemption* - Changes are made that will phase out the homestead property tax exemption over time. Currently, the homestead exemption is available to homeowners that are age 65 or older, regardless of financial need. The Budget Bill eliminates the homestead exemption for individuals that become age 65 after January 1, 2014 and that make over $30,000 of income each year. If an individual already qualifies under the homestead exemption in tax year 2013 (calendar year 2014), that individual will continue to qualify regardless of financial need. Some unique rules apply to owners of manufactured and mobile homes.

Commercial Activity Tax Changes: Several changes were made to the commercial activity tax ("CAT") by the Budget Bill.

- *Phase-Out of the $1 Million Exemption* - Under current law, CAT taxpayers with less than $150,000 owe no CAT. Further, for up to the first $1 million of taxable gross receipts a CAT taxpayer owes the minimum tax of $150. The Budget Bill essentially phases out the benefit of the $1 million exclusion for larger businesses for tax periods beginning on or after January 1, 2014. The new minimum tax due will be imposed as follows:

Annual Taxable Gross Receipts	Minimum Tax Due
$0 - $150,000	$0
$150,001 - $1,000,000	$150
$1,000,001 - $2,000,000	$800
$2,000,001 - $4,000,000	$2,100
Over $4,000,000	$2,600

Although the minimum tax structure has changed, the 26 mill rate will continue to be imposed on the total amount of taxable gross receipts greater than $1,000,000.

ZHF Observation: The minimum tax for each calendar year is due on May 10th of the calendar year. It remains unclear whether penalties will be applied to taxpayers that, in hindsight, find they underpaid their minimum tax. Further, a question remains on how or whether taxpayers that, in hindsight, overpay their minimum tax will get a refund of such tax.

- *Electronic Filing* - CAT filers required to file annually must now pay and file CAT returns on an electronic basis. Previously, only quarterly CAT filers were required to file and pay on an electronic basis.

- *Qualified Distribution Center Penalty Structure* -The Budget Bill changes the penalties for a distribution center that is granted the status of a qualified distribution center and subsequently is determined to not qualify. The penalty is equal to the amount of tax due from all suppliers to the distribution center if the distribution center was not granted the status of a qualified distribution center. The penalty does not include any interest or penalty on the tax due.

- *Agricultural commodities* - The Budget Bill grants an exclusion from taxable gross receipts for agricultural commodities sold by an agricultural commodity handler.

Tax Credit Changes Related to Economic Development: The Budget Bill also made changes to various tax credits that are related to economic development.

- *Technology Investment Tax Credit* - The technology investment tax credit program is eliminated. The technology investment tax credit offered a state tax credit for investors in small, research and development, and technology-oriented firms. Funding for this program ran out in the past biennium and additional funding was not provided during this budget. Taxpayers previously granted a technology investment tax credit certificate are still able to claim the credit against Ohio taxes. An alternative program still available for Ohio tax credits is InvestOhio.

- *Job Retention Tax Credit* - The Budget Bill allows a refundable job retention tax credit to a business whose principal place of business is not located in the same political subdivision as the required capital investment as long as the business maintains a unit or division with at least 4,200 employees at the approved project site. A business eligible for the refundable job retention tax credit must continue to have annual payroll of at least $20,000,000 and invest at least $5,000,000 at the project site.

New Motor Fuel Receipts Tax: Due to some very unique constitutional and industry challenges, the CAT has never *mixed well* with the way in which the motor fuel industry does business. For example, in *Beaver Excavating Co. v. Testa,* 134 Ohio St.3d 565, 2012-Ohio-5776, the Ohio Supreme Court held that any CAT measured by motor fuel sales must be spent on road construction and related activities, and not used for general revenue fund purposes. This decision creates tracking and enforcement issues for the industry and government. To help address this and other challenges that are unique to the motor fuel industry, the Budget Bill creates a new tax on motor fuel receipts and excludes such receipts from the CAT.

The new tax is first effective July 1, 2014. The tax is imposed on the gross receipts of a motor fuel supplier. A motor fuel supplier means either of the following: 1) a person that sells, exchanges, transfers, or otherwise distributes motor fuel from a terminal or refinery rack to a point outside of the distribution system, if the person distributes such motor fuel at a location in Ohio, or 2) a person that imports or causes the importation of motor fuel for sale, exchange, transfer, or other distribution by the person to a point outside of a distribution system in Ohio. The tax rate is 65 mills (0.0065) and, unlike the CAT, the statute does not prohibit the tax from being passed on to customers (however, the statute also does not expressly permit the tax to be passed on to customers). Taxpayers subject to the new motor fuel receipts tax will remain subject to the CAT through June 30, 2014.

Governor's Line Item Veto

Although adopted by the conference committee and passed by the House and Senate, Governor Kasich vetoed the following tax-related provisions:

- Adoption of "click-through" nexus for remote sellers.
- A new sales and use tax exemption for aerospace vehicle research and development goods and services that are not capitalized on the taxpayer's books and records.
- A new sales and use tax exemption for the sale of gold coins and metal bullion.
- An expansion of the Historical Rehabilitation Tax Credit allowed per taxpayer, from $5,000,000 to $10,000,000. The Historical Rehabilitation Tax Credit provides a 25 percent tax credit for rehabilitation expenses to owners and lessees of historically significant buildings.
- An expansion of the New Markets Tax Credit to allow taxpayers to receive an Ohio New Markets Tax Credit without obtaining a federal New Markets Tax Credit.
- A personal income tax deduction for the fair market value of services provided by dentists and dental hygienists under the Hope for a Smile Program.

Next Steps

The Budget Bill contains several changes that may impact you or your business. Certainly, issues will arise that require technical corrections or further guidance. ZHF is uniquely qualified to assist you in evaluating how the Budget Bill provisions impact you and in pursuing any technical changes to the law that may be necessary to properly implement intent of these broad tax changes.

If you would like to further discuss the Budget Bill or any other state and local tax matter, please do not hesitate to contact any member of our team.

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