Ohio Legislative Service Commission

Jean J. Botomogno

Fiscal Note & Local Impact Statement

Bill: Sub. H.B. 5 of the 130th G.A. (LSC 130 1581-2)

Date: November 6, 2013

Status: In House Ways and Means

Sponsor: Reps. Grossman and Henne

Local Impact Statement Procedure Required: Yes

Contents: Revises the laws governing the municipal income tax

State Fiscal Highlights

- The bill requires the Department of Taxation to prescribe a method by which nonindividual taxpayers may submit to municipalities certain required supplemental information through the Ohio Business Gateway. This provision may increase costs for the Department, but the fiscal impact, if any, is expected to be minimal.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2013	FY 2014	FUTURE YEARS
Municipalities			
Revenues	- 0 -	- 0 -	Potential loss
Expenditures	- 0 -	- 0 -	Potential increase or decrease

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- The bill's provisions are likely to create, overall, a net revenue loss to municipalities. The revenue impact on a specific municipality will be dependent on changes made by the bill to existing income tax ordinances. Though total revenue losses to municipalities are undetermined, and delayed to future fiscal years, they may be significant, potentially millions of dollars annually.
- Certain provisions may increase or reduce costs to municipalities to conform to changes required by the bill.

Detailed Fiscal Analysis

The municipal income tax

Municipal income taxes are generally imposed on wages and other compensation earned by residents of cities and villages that impose this tax, and is also paid by nonresidents working in these municipalities. Additionally, the municipal income tax is applied to business net profits attributable to activities in the municipality. Administration of the municipal income tax is strictly local, either by the cities and villages themselves or by central collection agencies under contract with various municipalities. Rates of taxation in calendar year (CY) 2011 ranged from a low of 0.4% in the city of Indian Hill (Hamilton County) to a high of 3.0% in the city of Parma Heights (Cuyahoga County). Total municipal income tax revenue was estimated at $4.31 billion by the tax department in CY 2011, an increase of $256.8 million (6.3%) from CY 2010.[1] Approximately $3.98 billion was collected by cities and $0.33 billion by villages. Collections ranged from $477 in the village of New Paris (Preble County) to $677.1 million in the city of Columbus (Franklin County).

Sub. H.B. 5 (LSC 130 1581-2) makes various changes to laws governing the municipal income tax, and requires municipal corporations levying an income tax as of January 1, 2015, and that intend to continue levying the tax thereafter to amend their existing income tax ordinances in a form to comply with the bill's limitations. A number of provisions in the bill would have no significant direct fiscal effect on the state and municipalities. However, certain provisions generally will create income gains, while others will generate revenue losses to municipalities. The fiscal impact on any particular Ohio municipality will be dependent on the specific provisions of its income tax, and the changes to it that would be required by the bill, and to an unknown extent the share of income taxes derived from business profits. LSC economists believe that, on balance, the bill will probably decrease statewide revenues to municipalities. Due to a lack of detailed statewide data on municipal income tax revenue in Ohio, revenue losses to municipalities are undetermined; however, they may be significant, potentially totaling millions of dollars annually. The LSC bill analysis provides a detailed description of the bill. Not all the provisions of the bill are analyzed in the next sections. The following are provisions that are likely to have a discernible fiscal effect on the state or municipalities.

Fiscal effect on the state

The bill permits municipal tax administrators to require taxpayers to submit additional information with annual returns, amended returns, and applications for refunds. The bill requires the Department of Taxation, by January 1, 2015, to prescribe a method by which nonindividual taxpayers may submit the required supplemental

[1] http://tax.ohio.gov/divisions/tax_analysis/tax_data_series/local_government_funds/lg11/LG11CY11.stm.

information through the Ohio Business Gateway. This requirement may increase costs for the Department of Taxation, though those costs may be absorbed as part of the normal operations of the Department.

Fiscal effect on municipalities

Individual and business income tax law and rules vary by municipality. The bill expressly prohibits municipal corporations and tax administrators from adopting rules to administer a municipal income tax that conflict with statutory limitations on the tax. Thus, the bill requires municipalities to modify, where different, their income tax laws and rules to conform to requirements of Sub. H.B. 5 (LSC 130 1581-2). As such, the bill will create income gains and losses for each municipality, depending on changes that must be made to conform to those requirements. The net effect of those gross gains and losses may result in net gains for certain municipalities, depending on their specific municipal income tax laws, while generating net losses for others.

The bill generally establishes a uniform tax base applicable to all municipal corporations levying an income tax by defining the forms of income that municipal corporations may tax and the forms that they may not tax. For individuals, the tax base includes compensation, net profits from business activities minus net operating loss (NOL) carryforward, and winnings from lotteries and gambling activities. A nonresident individual's compensation is included, under particular circumstances, in the municipal income tax base if earned for work in the taxing municipality, and a nonresident's net profit is only included to the extent it is assigned to the taxing municipality under specified apportionment and allocation provisions in the bill. For individuals who have a business, net profit is defined as the profit required to be reported for federal income tax purposes on various federal forms (e.g., Form 1040 Schedules C, E, and F). However, the bill authorizes an exception to the general income tax base for a "qualified municipal corporation" that adopted as its tax base, on or before December 31, 2011, the Ohio adjusted gross income (OAGI) plus certain exemptions, allowing such municipalities to continue this modified OAGI as the tax base for the taxation of individual residents. The bill also authorizes such municipal corporations to exempt income earned by nonresident individuals and the net profits of certain persons from the tax and corresponding withholding obligations.

The next sections provide the fiscal impact of certain provisions of the bill. Please note that the listing is not exhaustive and those provisions would have differing impacts on various municipalities. Initial fiscal effects of the bill are likely to start in FY 2015, though the bulk of fiscal effects would occur in later years.

Provisions that are likely to increase municipal income tax revenues

Municipalities generally allow a deduction for employees' business expenses (either 100% of Form 2106 expenses or the amount deducted for federal purposes in Schedule A of federal Form 1040). Unreimbursed employee expenses deducted for federal tax purposes are generally business vehicle use, travel, meals, and

entertainment. The bill authorizes the existing deduction for unreimbursed employee business expenses, but only to the extent the expenses are sitused to the municipality where the individual performed the services. For municipalities that currently allow a reduction of an individual's taxable wages for unreimbursed employee expenses, this situsing provision may raise taxable income and increase revenues.

The provision that specifies net profits for purposes of the municipal income tax law and allowing for requests of information from federal income tax schedules is likely to increase revenue for those municipalities not currently requiring those additions to the other items of income in their municipal ordinances.

Provisions that are likely to decrease municipal income tax revenues

The bill allows only a taxpayer who is a professional gambler for federal income tax purposes to subtract the amount of the taxpayer's federal wagering loss deduction, thus reducing taxable income by that amount.

The bill exempts from tax all intangible income, including any such income reported on federal Schedule C, E, or F. This provision will decrease revenue for municipalities that currently tax intangible income reported in those federal forms.

The bill exempts from income tax payments from any pension plan or pension benefit, whether or not they are included in "qualifying" wages as defined in the bill (R.C. 718.01(R)), resulting in a decrease in revenue for municipalities where such pension payments are currently taxed. The bill also exempts from tax any compensation, other than qualifying wages, received for up to 20 days per year by a nonresident individual for personal services performed in the municipal corporation. The bill specifies that this provision does not apply to income of professional athletes or entertainers or public figures. These changes are likely to decrease revenue to municipalities that include in their taxable base nonwage compensation that would be exempted in the bill.

The bill requires a municipal corporation that does not levy an income tax before 2015 to allow NOLs to be carried forward for five years. For those municipalities that currently levy an income tax, the bill requires a municipal corporation that levies an income tax before 2015 to use a carryforward period prescribed by the municipalities for taxable years beginning in 2015 or 2016, then requires a five-year carryforward starting in taxable year 2017. However, for taxable years beginning after 2016 and before 2022, in a municipality that levies an income tax before 2015, a business may deduct only 50% of the business net operating loss that would otherwise be allowed. During this period, the business is allowed to carryforward some of the unused losses.

Most municipalities allow NOLs with various carryforwards. However, a number of municipalities currently disallow net operating losses. Those municipalities are likely to experience reduced revenue from this provision, depending on the extent of the reduction in municipal taxable income from businesses and individuals. Although the 50% limitation for taxable years beginning after 2016 and before 2022

would lessen the annual fiscal impact on the cash flow of municipalities that do not currently allow NOLs or those that permit fewer than five years of carryforwards, depending on the size of tax receipts from business profits and general economic conditions, total statewide revenue losses from the NOL provisions are likely to be sizable.

The bill modifies the "casual" or "occasional" entrant exemption to increase the number of days, from 12 to 20 per year, that a nonresident individual may work in a municipal corporation without incurring income tax liability there and to define how such days are to be counted. The bill generally prohibits a municipal corporation from taxing the compensation paid to a nonresident individual who worked in the municipality for 20 days or fewer in a year. Such compensation is not exempt if the individual works more than 20 days in the year **and** the employer elects to withhold income taxes for every day the employee worked in the municipal corporation, including the first 20 days. The bill prohibits a municipal corporation from taxing any compensation paid to a nonresident employee of an employer with less than $500,000 in annual gross receipts, if that employer's only fixed location is not located in the municipal corporation. The bill makes other changes to the withholding requirements for the municipality of location of employers with less than $500,000 in gross receipts. The occasional entrant-related provisions, overall, are likely to decrease income currently taxed by certain municipalities or withheld by employers, and as a result, are likely to decrease municipal income tax collections.[2]

A business that operates in more than one municipal corporation must apportion its net profit for income tax purposes. A three-part formula based on a business' payroll, sales, and property is used to determine the portion of the business' net profit attributable to a municipality. The bill specifies how the "sales" and "payroll" factors are to be computed in the formula for taxpayers that have income from both within and outside a municipal corporation, including the elimination of the so-called "throw-back" provision. Under current law, allocation of sales is generally made based on the destination rule: a sale of goods is made in a municipal corporation when the goods are (a) shipped and delivered within the municipal corporation, (b) delivered within the municipal corporation, but shipped from elsewhere if the business regularly solicits sales within the municipal corporation, and (c) shipped from the municipal corporation, but delivered elsewhere, if employees of the business do not regularly solicit sales at the location where the goods are delivered. The last criterion is known as a "throw-back provision."

The bill modifies the apportionment of net profits for purposes of when goods are considered to have been sold in a municipal corporation. The bill provides that

---

[2] An individual whose municipal income taxes may not be withheld due to the changes may still owe tax to his or her city of residence, or not owe tax if the individual resides in a nontaxing locality. Potential amounts due, but not withheld, may or may not be collected.

goods are considered to have been sold in a municipal corporation if (1) the goods are delivered within the municipal corporation, regardless of where title passes, if shipped or delivered from inventory within the municipality, (2) goods are delivered within the municipal corporation, regardless of where title passes, even if transported from a point outside such municipal corporation if the taxpayer's employees regularly solicit sales in the municipality, (3) shipped from the municipality to purchasers outside such municipality, regardless of where the title passes, if the taxpayer is not, through its employees or the employees of a related member, regularly engaged in solicitation of sales where the delivery is made. Though LSC has not fully analyzed the changes in LSC 130 1581-2, the bill is likely to redistribute income and profits that may be currently taxable in a municipality to another municipality, to a destination that lacks the authority to tax certain providers of goods and services (because they do not have payroll, property, or personnel in that locality), or to a locality that does not impose a municipal income tax. Therefore, statewide, the elimination of the throw-back rule and other changes to the apportionment and allocation of net income have the potential to reduce net income or profits taxable under the municipal income tax, and are likely to decrease income tax paid by certain individuals and businesses.

The bill precludes assessments after the later of three years after a person filed the return subject to the assessment or after the due date of the return, or one year and 60 days after an appeal of an assessment becomes final, except when a person fails to remit taxes held in trust or fails to file a return, a taxpayer agrees to a longer period, or files a fraudulent return, and limits the amount of penalties and interest that may be charged for failure to file returns or pay taxes on time. These provisions are likely to reduce municipal income tax revenues for municipalities that assess taxpayers beyond the three-year limitation in the bill and collect revenues from those assessments.

Other provisions

Creation of a municipal income tax net operating loss review committee

The bill creates a temporary 11-member committee composed of taxpayer, municipal, and legislative representatives to study and issue a report on the potential fiscal impact of the five-year NOL carryforward requirement, provided adequate data is received. The bill specifies that members of the committee are not to receive compensation or reimbursements of expenses. The bill requires municipalities that levy an income tax to report specified information about revenue losses from NOLs to the committee.

Residency and domicile

The bill defines "domicile" as the principal residence a person intends to use for an indefinite period of time and provides that an individual is presumed domiciled in a municipality if the tax administrator reasonably concludes that the individual is domiciled there. The bill specifies a list of factors that may be used in determining or rebutting the presumption of an individual's domicile, but allows a tax administrator or

an individual to use other relevant factors. The impact of this provision is undetermined.

Resident credit for tax paid to other municipalities

The bill requires municipal corporations that allow residents to claim a credit equal to all or a portion of the tax the resident paid elsewhere to allow it for taxes the resident paid to all municipal corporations, including the municipal corporation of residence that allows the credit.

Taxation of pass-through entities

Most municipalities impose their income tax on pass-through entities (PTEs, e.g., partnerships, S-corporations, limited liability companies, etc.) or their investors/owners. Under current law, municipal corporations may tax PTEs net profits at either the entity level or the owner level, but not both. However, a municipal corporation may make that choice separately for each class of entity (e.g., tax partnerships and LLCs at the partner or member level, and tax S-corporations at the entity level). The bill makes several changes to the taxation of PTEs.

The bill prohibits municipal corporations from taxing the income from PTEs at the individual owner level, except for residents of the municipal corporation, but exempts residents' distributive shares of net profits from an S-corporation unless the municipal corporation taxed such shares of residents before 2015.

The bill requires municipal corporations to tax PTEs, including S-corporations, at the entity level, similar to corporations. However, the bill also authorizes a resident individual to use losses incurred by a PTE attributable to the individual's share to offset "any other" net profit. This provision is likely to create a revenue loss for municipalities that do not allow such treatment.

The bill requires that a business be allowed to deduct net profit or add losses of a PTE of which the business is an owner, unless the PTE profit or loss is included as a part of an affiliated group. Also, the bill provides that exempt income of the PTE keeps its character when transferred to the owners.

De minimus payment or refund amounts

The bill specifies a minimum threshold at $100 for filing estimated tax payments, and a minimum filing and payment threshold of $10 for taxpayers. In addition, the bill does not require municipal corporations to issue refunds of $10 or less. The de minimus provisions would reduce both revenues and costs to municipal corporations.

Synopsis of Fiscal Effect Changes

This addendum summarizes the difference in fiscal effects between LSC 130 1581-2 and H.B. 5, As Introduced.

LSC is unable to quantify the fiscal changes in LSC 130 1581-2 when compared to the introduced version of the bill. However, when compared to current law, both versions of the bill will reduce revenue to municipalities.

The substitute bill somewhat reduces the fiscal cost of the NOL provisions in the introduced bill by limiting in specified years the deduction to 50% of incurred losses. The elimination of the Municipal Income Tax Board does not change the fiscal effect of H.B. 5 on the state. The fiscal impact change of the taxation of PTEs is uncertain, when compared to the introduced version of the bill, though those provisions potentially create net statewide revenue losses. Changes to the casual entrant exemption provisions in the substitute bill are likely to have the same similar negative fiscal effects as H.B. 5, As Introduced. Similarly, changes to the apportionment of net profits related to the situsing of sales in both versions of the bill will decrease municipal income tax revenues.

HB0005H1.docx/lb