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Out With The Old And In With The New: Ohio Abandons Its Corporate Franchise Tax And Enacts A Commercial Activities Tax

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Ohio is abandoning its corporate franchise tax and, effective for tax year 2006, enacting a commercial activities tax ("CAT"). The Ohio Department of Taxation is phasing out its corporate franchise tax over five years for all corporations other than financial institutions and their majority-owned nonfinancial affiliates. Beginning July 1, 2005, the CAT imposes a new business privilege tax on the basis of annual gross receipts.

Ohio established its corporate franchise tax in 1902. Originally it was a tax on net worth but in 1971 grew to a tax computed on the basis of net worth or net income. Taxpayers owe the amount of tax from the higher yielding computation. Currently, the rate of tax on general business corporations is 0.4% of net worth or 8.5% of net income (5.1% on the first \$50,000).

Commercial Activities Tax

The Senate passed an amended substitute version of the biennium budget bill on June 1, 2005 (Sub. H.B. 66). The bill imposes a CAT on business organizations having taxable gross receipts in excess of \$40,000. The CAT, however, does not apply to financial institutions, dealers in intangibles, insurance companies, affiliates of the foregoing, public utilities, and nonprofit organizations with no unrelated business income.

The CAT is an excise tax for the privilege of doing business in Ohio but, unlike the current corporate franchise tax, the bill levies the CAT on the basis of gross receipts instead of net worth or net income. The bill also makes the CAT part of the "price" for purposes of calculating sales and use taxes. If a taxpayer under the CAT makes sales subject to the sales and use tax, the price used to base the tax is computed without any deduction for the CAT paid by the taxpayer-seller.

The first tax return and tax payment are due February 10, 2006, based on gross receipts for the six-month period running from July 1 through December 31, 2005.

Persons Subject to Commercial Activities Tax

Any legal person in Ohio regardless of the person's legal or organizational form with more than \$40,000 in annual taxable gross receipts is subject to the CAT. This includes corporations, partnerships, LLCs, S-corporations, sole proprietors, business trusts, etc. The CAT also applies to nonprofit organizations to the extent the nonprofit generates unrelated business income that is taxable for federal income tax purposes. A public utility operating as a combined company must pay the CAT on the basis of taxable gross receipts from its activities as an electric company, rural electric company or any other activities that cannot be attributed to the activities of a heating or natural gas company. The activities relating to heating or natural gas are taxed via the public utility excise tax.

The bill exempts "excluded persons" from the CAT. An "excluded person" is a legal person with either annual taxable gross receipts under the \$40,000 threshold, or is a member of an "excluded persons" list. This list includes banks and other financial institutions, bank holding companies, financial holding companies, savings and loan holding companies, financial services companies subject to state or federal supervision, insurance companies paying the insurance company tax, public utilities paying the public utility excise tax, persons formed for securitization purposes, and dealers in intangibles paying the intangibles tax. All excluded persons that are C-corporations remain subject to the corporate franchise tax.

A group of commonly owned or controlled persons can elect to file and pay tax on a consolidated basis. This is available in exchange for excluding otherwise taxable gross receipts from transactions with other members of the group. If a group elects consolidation, however, the group must report and pay the CAT on every member's taxable gross receipts even if there is no substantial nexus with Ohio. Each member is subject to assessment and remains jointly and severally liable for the tax and associated penalties and interest.

Computation of Commercial Activities Tax

The CAT levies tax in two parts. First, the tax is \$100 on the first \$1 million in taxable gross receipts, due for the first time on May 15, 2006. Second, the CAT charges a rate of 0.26% on taxable gross receipts in excess of \$1 million. This rate is effective at least for the first two years.

The CAT applies to taxable gross receipts. Taxable gross receipts are total gross receipts situated to Ohio. These include amounts realized from the sale, exchange, or other disposition of property, amounts realized from performing services, and amounts realized from rentals, leases, or other use or possession of the taxpayer's property or capital. The bill prescribes specific situsing rules for various kinds of gross receipts. Below is a list of various receipts and how they are situated in Ohio.

The bill calculates gross receipts using the same accounting method used for federal income tax purposes. If cash discounts are allowed and actually taken in a transaction,

the discount is deductible from gross receipts. Moreover, the bill allows a bad debt deduction for uncollectible payments from transactions that were previously included in taxable gross receipts. There are specific exclusions from the calculation of gross receipts. Below is a list of exclusions.

Phase-In of Commercial Activities Tax

The Department recognizes that the bill imposes the CAT at the same time as the bill phases out the corporate franchise tax. To deal with this, the bill phases in the CAT for all taxpayers other than those having annual taxable gross receipts of less than \$1 million.

In the first six months of the CAT, the tax is \$50 on the first \$500,000 in taxable gross receipts during that period, plus 0.06% on taxable gross receipts in excess of \$500,000 during that period. Taxpayers must file the return for this semiannual period no later than February 15, 2006. In first quarter 2006, only 23% of the CAT as normally computed is payable; for the four quarters running from April 2006 to April 2007, 40% of the normal tax is due; for the four quarters running from April 2007 to April 2008, 60% of the normal tax is due; for the four quarters running from April 2008 to April 2009, 80% of the normal tax is due; from April 2009 on, the tax is payable on the basis of the permanent computation of 0.26%.

Phase-Out of Corporate Franchise Tax

Beginning with tax year 2006, the bill, using even increments, phases out the corporate franchise tax over five years. This applies to all corporations other than "excluded persons." For example, in 2006, corporations owe the greater of the minimum tax (\$50 or \$1,000, depending on the corporation's employment level and gross receipts) or 4/5 of the tax they would otherwise owe under current law after deducting nonrefundable credits. In 2007, corporations owe the greater of the minimum tax or 3/5 of the tax they otherwise would owe after deducting nonrefundable credits. The fraction declines in 2008 to 2/5 and in 2009 to 1/5, thus phasing the corporate franchise tax out by 2010.

Phase-Out of Tax on Business Personal Property

The bill exempts machinery and equipment installed, or first used in business in Ohio, after the end of 2004 from property taxation. For machinery and equipment used in business in Ohio before the end of 2004, tax on the property is phased-out over two years. The property will be totally exempt in 2007. In 2005, the property tax is 25% of its value, as provided under current law. In 2006, the tax is 12-1/2% of its value. In 2007 and thereafter, the property is exempted from taxation.

Currently, there is a phase-down of taxes on business inventory. The bill accelerates the current phase out period and eliminates taxes on business inventory by 2010. Under the bill's schedule, the assessment rate for 2005 and 2006 remains at 23%. In 2007, the rate is 21%, then in 2008, it is 14%. In 2009 it is 7% and in 2010 and thereafter, it is 0%.

The bill also phases-out taxation on "furniture and fixtures" over five years. The current assessment rate is 25%. To accomplish the phase-out, the bill uses five equal 5% increments. By 2010, the bill exempts all furniture and fixtures.

A portion of the CAT will fund the newly created School District Tangible Property Tax Replacement Fund and the newly created Local Government Tangible Property Tax Replacement Fund. Both funds provide reimbursement to school districts and other local taxing units for the net revenue reduction that will result from the bill's exemption and phase-out of machinery and equipment and furniture and fixtures, and the accelerated business inventory phase-out. The bill sets forth specific computations and procedures for the Tax Commissioner and the Department of Education to implement the reimbursement.

Elimination of Exemption for Patterns, Dies, Jigs, and Drawings

Currently, patterns, dies, jigs, and drawings held for personal use and not for sale in the ordinary course of business, including as inventory, are exempt. After the end of tax year 2005, the bill eliminates the exemption, thus making patterns, dies, jig, and drawings taxable in 2006.

An exemption remains, however, for the cost of drawings used by most public utilities and all interexchange telecommunications companies. As long as the drawings provide the utility's or company's services they are exempt. To qualify for the exemption, the utility or company must document all costs relating to the drawings. This exemption does not apply to drawings of electric companies or of combined companies acting as electric companies.

Temporary Tax Amnesty Program

A temporary tax amnesty program will run from November 1, 2005 to December 15, 2005. The program concerns delinquent state taxes, tangible personal property taxes, county and transit authority sales taxes, and school district income taxes. The program applies only to taxes that were due and payable on May 1, 2005 but were unreported or underreported and remain unpaid on the program's commencement date. The program, however, excludes assessed taxes and audit conducted or pending taxes.

During the program, if a person pays the full amount of delinquent taxes and one-half of any accrued interest, all penalties and the other one-half accrued interest are waived. Moreover, a person participating in the program is immune from criminal prosecution or any civil action with respect to the taxes paid through the program.

Receipts and Ohio Situsing

- Gross rents and royalties from real property located in Ohio.
- Gross rents and royalties from tangible personal property to the extent it is located or used in Ohio.
- Gross receipts from the sale of real property located in Ohio.
- Gross receipts from the sale of tangible personal property if the property is received in Ohio by the purchaser; the place where tangible personal property is ultimately received after all transportation has been completed will be considered the place where the purchaser receives the property even when the purchaser accepts property in Ohio and then transports the property by common carrier or by other means of transportation to a location outside Ohio; tangible personal property that is delivered into a foreign trade zone located in Ohio to a person in that zone, solely for purposes of further delivery out of state and without regard to the passage of title and to repackaging for further shipping purposes, is sitused to the location at which the person or person's affiliated customer completes delivery of the property to a location outside Ohio.
- Gross receipts from the sale, exchange, disposition, or other grant of the right to use trademarks, trade names, patents, copyrights, and similar intellectual property to the extent the receipts are based on the amount of use of the property in this state; if receipts are based on the right to use property and the payor has the right to use the property in Ohio, receipts are sitused to Ohio to the extent they are based on the right to use the property in Ohio.
- Gross receipts from the sale of services, and all other gross receipts not otherwise sitused as provided above, are sitused to Ohio in the proportion to the purchaser's benefit in Ohio as compared to the purchaser's benefit everywhere; where the benefit ultimately is received is "paramount" in determining this proportion.
- Gross receipts from the sale of electricity and electric transmission and distribution services are sitused in the same manner as under the corporation franchise tax.

Excluded Amounts From Gross Receipts

- Interest income, except interest on credit sales.
- Dividend income, distributions received, and distribution or proportionate shares from a pass-through entity.
- Receipts from assets for which capital gain treatment is given under federal law but without regard to the holding period.
- Proceeds attributable to the repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, COD, or marketable instrument.

- The principal amount received under a repurchase agreement or on account of any transaction properly characterized as a loan to the taxpayer.
- Contributions received by a trust, plan, or other arrangement, any of which is described in section 501(a) of the I.R.C., or to any of the various pension and deferred compensation plans given favorable tax treatment.
- Compensation received by an employee for services rendered to or for an employer, including fringe benefits and expense reimbursements.
- Proceeds from the issuance of the taxpayer's own stock, options, warrants, puts, or calls, or from the sale of the person's treasury stock.
- Proceeds on the account of payments from life insurance policies.
- Gifts or charitable contributions, membership dues, and payments received for educational courses, meetings, meals, or similar payments to a trade, professional, or other similar association; fundraising receipts if excess receipts are donated or used exclusively for charitable purposes; and proceeds received by a nonprofit organization except those proceeds realized with regard to its unrelated business income.
- Damages in excess of amounts that, if received without litigation, would be gross receipts.
- Property, money, and other amounts received or acquired by an agent on behalf of another in excess of the agent's commission, fee, or other remuneration.
- Tax refunds and other tax benefit recoveries.
- Pension reversions.
- Contributions to capital.
- Sales and use taxes collected by a vendor (including out of state vendors).
- Federal and state excise taxes on cigarettes and other tobacco products paid by any person (exclusion applies only to the various classes of dealers, distributors, manufacturers, or sellers of cigarettes or tobacco products).
- Federal and state excise taxes on liquor and other alcoholic beverages paid by any person (exclusion applies only to agency stores and the various classes of permit holders; exclusion for agency stores does not apply to agency compensation).
- Federal and state excise taxes on gasoline, diesel, or other motor vehicle fuel (exclusion applies only to the various classes of motor fuel dealers).
- Pari-mutuel wagers on horse racing.

- Ohio lottery ticket receipts received by a lottery ticket sales agent in excess of commission, bonus, or reimbursement.
- Receipts from selling hunting, fishing, and other ODNR-issued licenses by authorized agents in excess of their \$1 fee.
- Receipts received by a motor vehicle dealer from sales to another motor vehicle dealer for the purpose of resale by the purchasing dealer.
- Amounts received relating to transactions between an electric company and a regional transmission organization that are mandated by the Federal Energy Regulatory Commission, even if those amounts are received in the ordinary course of the taxpayer's trade or business and are a form of payment for a transaction specified as "taxable gross receipts."
- Any receipts the taxation of which is prohibited by the Ohio Constitution, the United States Constitution, or federal law.
- Real estate broker's fees are included in taxable gross receipts only to the extent the fees are retained by the broker and not paid to another broker of an associated salesperson.■



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