Hahn Loeser + Parks LLP

PREPARE FOR PROPOSED OHIO TAX REFORM

State Tax Advisory Notice - June 2005 (*Updated*)

Tax directors, government affairs managers and other executives of businesses headquartered in and/or conducting operations in Ohio should monitor the tax reform debate and begin to plan for anticipated changes in the tax law and how such changes will impact their own companies' Ohio-based activities.

The Governor, the Ohio House, and the Ohio Senate have presented different tax reform proposals. Most recently, the Senate passed its own version of the State Budget. The final bill, which must be passed by July 1, may have elements of all three proposals.

Proposed changes to Ohio tax law could significantly impact all businesses headquartered in and/or doing business in Ohio. Governor Taft and both the Republican and Democratic leadership of Ohio's General Assembly have indicated that the time is right for a major overhaul of the State's tax regime. Presumably recognizing what is evidenced by the results of an October 2004 study conducted by the Washington, D.C.-based Tax Foundation, reporting that Ohio ranks twenty-ninth in terms of its "State Business Tax Climate Index,"[1] Ohio government leaders are working in earnest to reform Ohio's tax system. They understand the principle that a state's tax system directly affects business leaders' decisions to create jobs and otherwise make capital investments in that state. They also recognize that tax law changes therefore affect competition between neighboring states. Our government leaders are hoping that a revised tax system will improve Ohio's economic climate and help encourage companies to set up operations here.

Governor Taft announced his plan for Ohio tax reform on January 18, 2005 and provided specific details in his February 8, 2005 State of the State speech. Proposed tax reform language was introduced as part of the biennial budget bill (H.B. 66) and the related tax reform bills (H.B. 1 and S.B. 1). The House budget proposal, passed on April 12, 2005, retains a large portion of the Governor's tax reform package. On June 2, the Ohio Senate passed its version of H.B. 66. The Senate bill includes important differences from the House version in two areas: the tangible personal property tax and the Commercial Activities Tax. House and Senate members who have formed a joint conference committee are currently working on the final legislation which must be signed into law by the Governor no later than July 1, 2005.

We have summarized below highlights of the tax provisions of H.B. 66 and have noted the differences in the Senate bill. Tax directors, government affairs managers and other executives of businesses headquartered in and/or conducting operations in Ohio should monitor the tax reform debate and begin to plan for anticipated changes in the tax law and how such changes will impact their own companies' Ohio-based activities. The members of Hahn Loeser & Parks' Taxation and Employee Benefits Section are available to assist management teams of affected companies with their evaluations of the various proposals for Ohio tax reform, including modeling, forecasting and, where appropriate, advocating changes to the proposals.

PROPOSED ESTABLISHMENT OF COMMERCIAL ACTIVITIES TAX

H.B. 66 maintains Governor Taft's proposal to enact the commercial activities tax (the "CAT"). This new tax, if adopted, is an excise tax for the privilege of doing business in Ohio and will be levied on Ohio gross receipts. It will apply to any legal person with more than $40,000 in annual taxable gross receipts in Ohio regardless of the person's legal or

[1] The State Business Tax Climate Index, as compiled by the Tax Foundation, represents a composite of five indices relating to major features of a state's tax system that impact business decisions and the economy in general: the corporate income tax, the individual income tax, the sales and gross receipts tax, the unemployment insurance tax and the state's fiscal balance. Hodge, Scott A., Moody, J. Scott and Warcholik, Wendy P. "Background Paper-State Business Tax Climate Index." Tax Foundation. (October 2004, No. 45.)

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organizational form. The Senate version of H.B. 66 raises the minimum amount of gross receipts that are subject to CAT from $40,000 to $200,000. The CAT applies not only to corporations which are currently subject to the Ohio franchise tax, but also to partnerships, limited liability companies, S corporations, sole proprietors, business trusts and estates, which are not subject to the corporate franchise tax.

Nonprofit organizations are subject to CAT, but only to the extent that they generate unrelated business taxable income that is subject to federal income tax. Making nonprofit organizations subject to CAT is significant, as income realized by nonprofit organizations, including unrelated business taxable income taxed for federal purposes, is currently not subject to the Ohio franchise tax.

The House bill provides that business organizations whose gross receipts fall between $40,000 and $1,000,000 will pay $100 of CAT. The Senate bill raised the minimum CAT from $100 to $175. Gross receipts in excess of $1,000,000 will be taxed at a rate of .26%. The CAT will be gradually phased in by 2010.

Organizations, which under Governor Taft's proposal and H.B. 66 are exempt from CAT, include the following:

- Banks, savings and loan companies, other financial institutions, bank and financial holding companies and affiliates of the foregoing;
- Insurance companies and their affiliates, even those that are not insurance companies;
- Public utilities subject to and paying the public utility excise tax; and
- Dealers in intangibles subject to and paying the dealers in intangibles tax.

Only gross receipts "sitused" to Ohio are subject to the CAT. H.B. 66 consists of various situsing rules for the inclusion of income in the CAT tax base. Representative proposed statutory inclusions are: gross rents and royalties from real property located in Ohio; gross rents and royalties from tangible personal property 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; 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 Ohio; and gross receipts from the sale of services in proportion to the purchaser's benefit in Ohio as compared to the purchaser's benefit everywhere where the benefit ultimately received is "paramount" in determining this proportion.

The Senate bill expands the scope of activities taxable under CAT to any activity conducted for or resulting in gain, income, or profit. The Senate version expressly provides that the tax applies to all persons with substantial nexus with Ohio. In addition, two new exemptions from CAT were granted in the Senate bill. First, a new exclusion is available for receipts for services provided to a financial institution in connection with issuing, processing, servicing, and managing loans or credit accounts, if such financial institutions and the receipt beneficiaries have at least 50% of their ownership interests owned and controlled by common owners. The second exclusion applies to gross receipts realized by a person engaged in selling securities for the amount in excess of the gain on the sale of those securities.

PROPOSED ELIMINATION OF CORPORATE FRANCHISE TAX

Ohio's corporation franchise tax is currently imposed on domestic corporations for the privilege of exercising their franchises and on foreign corporations for the privilege of conducting business in Ohio, owning or using capital or property in Ohio or holding a certificate authorizing them to do business in the State. The tax is an annual excise tax equal to the greater of the amount computed on a net worth basis and the amount computed on the net income basis.

H.B. 66 phases out the franchise tax by 2010, as the CAT is meant to serve as its replacement as a levy for doing business in Ohio.

PROPOSED ELIMINATION OF TANGIBLE PERSONAL PROPERTY TAX

Ohio's tangible personal property tax is imposed on all business machinery, inventory, and equipment. Over time, H.B. 66 completely eliminates this tax. The Governor's plan did not eliminate the furniture and fixture portion of the tangible personal property tax. H.B. 66 exempts from personal property taxation all machinery and equipment used in business that is first placed in service in Ohio after the end of 2004. For machinery and equipment used in business in Ohio before the end of 2004, taxation of the property is phased out over two years so that the property will be totally exempt in 2007 and thereafter. H.B. 66 provides a rate schedule which phases out the taxation of business inventory by 2010. It also phases out the taxation of furniture and fixtures in equal, five-percentage-point increments, over five years beginning in 2006, such that furniture and fixtures are exempt from the Ohio tangible personal property tax beginning in 2010.

The Senate bill phases out taxation of all general business tangible personal property in even increments over four years such that the tangible personal property tax would end in 2009. The Senate version also reinstates the property tax exemption for patterns, jigs, dies, and drawings provided under current law.

This notice is not meant to contain legal advice. We recommend that you consult a tax professional to analyze how potential changes in Ohio tax law may affect the particular facts and circumstances relating to your business or personal tax situation.

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PROPOSED CHANGES AFFECTING INDIVIDUALS

H.B. 66 reduces personal income tax dollar amounts and rates by 21% over five years, beginning in 2005. Currently, the top marginal rate applicable to Ohio individual income is 7.5%. Pursuant to the proposed bill, an individual's Ohio taxable income in excess of $200,000 will be taxed at a rate of 5.925% after the five-year phase-in.

Under existing law, the income tax applies to certain trusts for taxable years beginning in 2002, 2003 and 2004. H.B. 66 makes application of the personal income tax to trusts permanent, beginning in 2005.

Ohio law currently permits individual taxpayers to take a deduction for certain tuition costs and fees paid by them on their own behalf or on behalf of a spouse or dependent during the taxable year. This deduction applies to tuition and related fees paid to a state university or other postsecondary institution located in Ohio. The total amount of tuition and fees that may be deducted by a taxpayer for all taxable years is $5,000. The deduction is not available to individuals filing a joint return with combined federal adjusted gross income ("AGI") in excess of $100,000 and is not available to single filers having AGI in excess of $50,000. H.B. 66 eliminates the deduction for tuition and fees. It provides that the deduction is not available for any taxable year beginning after December 31, 2005.

H.B. 66 eliminates the additional estate tax (also known as the sponge tax) retroactively to 2002.

PROPOSED SALES TAX CHANGES

Ohio imposes a sales tax on most retail sales and rentals of tangible personal property and certain services. The state may collect a use tax when a business does not collect and remit a sales tax. The use tax is assessed on tangible personal property stored, used, or consumed in Ohio and on taxable services when the benefit of the service is realized in Ohio. Ohio's sales and use tax, from July 1, 2003 to June 30, 2005, is levied at the rate of 6%, which represents a temporary 1% increase, known as the "penny sales tax."

On July 1, 2005, the sales and use tax rate is scheduled to revert to 5%, i.e., a reduction of the 1% penny tax. H.B. 66 establishes a permanent sales and use tax of 5 ½%, effective July 1, 2005, and thereby retains the "half penny sales tax."

OTHER SIGNIFICANT PROPOSED CHANGES IMPACTING OHIO COMMERCE

- H.B. 66 eliminates the 10% rollback for real property that is not classified by the county auditor as "qualifying properly," i.e., lands and improvements thereon that are used for residential or agricultural purposes. It also adds a .001 real property transfer tax.
- H. B. 66 increases the real property transfer fee, from $1, or 10¢ for each $100 or fraction of $100, whichever is greater, of the value of the real property to the greater of $1 or 20¢ for each $100 or fraction of $100 of the value of that property.
- The House bill increases the kilowatt-hour tax by approximately 30% for all electric distribution companies, except self-assessors. It also increases from 4% to 5% the percentage rate assessed on the total price of all electricity distributed to an industrial or commercial self-assessor.

For more information, please contact any of our tax attorneys listed below.

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