Examining Ohio’s Commercial Activity Tax

by Brian Sigritz

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Introduction

On June 30, 2005, Ohio Gov. Bob Taft (R) signed into law amended substitute HB 66. This bill, the biennial budget, included a major overhaul of Ohio’s tax code. It marked the culmination of a two-year effort by the governor to reform the tax system. Taft said, “The call for tax reform has resonated in every corner of the state....T a x reform is now a reality.”

The legislation included a phaseout of the tangible personal property tax, a reduction in the individual income tax, a cut in the state sales tax rate, and an increase of the cigarette excise tax. Perhaps most significantly, a new commercial activity tax replaced the corporate franchise tax. The now-defunct corporate franchise tax was based on either a company’s net worth or net income, depending on which one was higher. The commercial activity tax (CAT) is designed to be a tax on gross receipts generated from commercial activities. When the tax is fully imposed, it will be set at a rate of 2.6 mills (0.0026).

The establishment of the CAT came with controversy. Critics contend that the tax is regressive, is unconstitutional, and does not address the state’s long-term revenue demands, and that businesses will be highly taxed even if they are not making a profit. Supporters counter that it will broaden the tax base, tax consumption rather than investment, and encourage capital investment and job creation. This report explores the reasons why many felt a change in Ohio’s tax system was needed, addresses arguments for and against the CAT, looks at whether the tax is constitutional, and offers alternatives to the CAT.

Background

One of the major reasons for establishing the CAT was the decline in revenue generated by the corporate franchise tax. In the mid-1970s, 16 percent of all tax revenue in Ohio came from the corporate franchise tax; by 2002 that amount had decreased to 4.6 percent. Also, 44 percent of businesses pay only the minimum $50 in the corporate franchise tax, while another 36 percent pay $2,000 or less. That contrasts with the 135 percent increase in consumer taxes since the 1980s.

There are several reasons for the decline in corporate tax revenue, including the increase in tax shifting and the proliferation of tax shelters. Tax shifting involves moving income to other states with lower tax rates. According to a study conducted by the Multistate Tax Commission, Ohio lost 56.9 percent of its potential corporate tax collections to tax shelters and tax shifting. That figure was the second highest in the nation, behind only West Virginia. Another reason for the declining revenue is that the corporate franchise tax caps the amount a company can owe for the net worth component. According to...
the law, all corporations, even the largest ones, have their taxes capped at $150,000. Finally, Ohio has both decreased the tax rates for businesses and increased the use of tax credits. Many of those tax credits have questionable value at best. For example, Wal-Mart received a multimillion dollar tax credit for a warehouse already constructed.

**Tax Reform Legislation**

The current movement to reform Ohio’s tax code began at the start of the 126th Ohio General Assembly. On January 18, 2005, Rep. Sally Conway Kilbane (R) introduced HB 1, which was intended to “reform Ohio’s tax code to improve economic competitiveness and foster job retention and creation, thereby making Ohio a more attractive place to live and do business.” After numerous committee hearings, the bill was eventually folded into amended substitute HB 66, the biennial budget. HB 66 altered Ohio’s tax system significantly. In addition to establishing the CAT, it adjusted many other taxes. First, it phased out the corporate franchise tax. That was done at a rate of 20 percent annually from 2006 to 2010. It also phased out the tangible personal property tax over four years at 25 percent annually. That included the tax on most business inventory, manufacturing machinery and equipment, and furniture and fixtures. It also decreased the individual income tax. Each bracket was cut 4.2 percent for the 2005 tax year, with an additional cut of 4.2 percent for each year until 2009, for a combined cut of 21 percent. Additionally, HB 66 reduced the state sales tax rate from 6.0 percent to 5.5 percent. Before 2003, the sales tax rate was set at 5.5 percent, but it was temporarily raised because of a budget shortfall. Finally, HB 66 increased the cigarette excise tax from 55 cents per pack to $1.25 per pack.11

The major element of HB 66 was the creation of the CAT. According to the Ohio Department of Taxation, the CAT is considered “a tax on the privilege of doing business in Ohio, measured by gross receipts received in an annual or calendar quarter time period.” It is not considered to be a transactional sales tax. The CAT applies to all kinds of businesses, including retailers, manufacturers, and service providers, such as lawyers, accountants, and doctors. The CAT also applies to out-of-state businesses as long as they meet one of four criteria. The CAT contains some exceptions, including exemptions for nonprofit organizations, financial institutions, insurance companies, and certain public utilities.12

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All companies with taxable gross receipts above $1 million are required to pay the CAT. Companies with gross receipts between $150,000 and $1 million pay a privilege tax of $150, while companies with gross receipts below $150,000 do not pay the CAT. When fully phased in, companies with gross receipts above $1 million will pay the $150 privilege tax plus a rate of 0.26 percent on gross receipts. Gross receipts are “the total amount realized, without deduction from the cost of goods sold or other expenses incurred, from activities that contribute to the production of gross income.” That includes the performance of services, sales, and rentals or leases. Not included are such items as employee compensation, interest, dividends, capital gains, proceeds from loans or stocks, and damages received from litigation.13

**Proponents**

The major proponents for the changes proposed in HB 66 were the Taft administration and the Ohio Business Roundtable, a nonpartisan organization composed of the chief executive officers of the state’s largest businesses. The Taft administration argued before the House Finance and Appropriations Committee that Ohio’s tax laws were outdated and did not reflect the state’s modern economy. They emphasized that even though the corporate franchise tax rates were high, the collection rates were low compared with other states. They believed that the new CAT would adequately replace the revenue lost by phasing out the corporate franchise tax. According to the Department of Taxation’s projections, the CAT would initially bring in $265 million in 2006, and would bring in $1.5 billion by the time it was fully implemented in 2010. The tax rate could also be adjusted after two years if the CAT was generating either too much or too little revenue. The Taft

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9Drew, supra note 6.
10Policy Matters Ohio, supra note 4.
12Ohio Department of Taxation, supra note 2.
13Id.
administration said the CAT would be a positive change because its low rate of 0.26 percent would minimize the distortion of economic decisions. Administration officials also argued that the tax would not harm consumers because it would not function like a sales tax, and instead would fall on the business entity.  

The Ohio Business Roundtable also argued strongly in favor of the creation of the CAT. One reason for the group’s support was its belief that the CAT would spread the business tax burden throughout all sectors of the economy because the tax would be applied to anyone with gross receipts over $1 million. The Roundtable argued that the corporate franchise tax unfairly overburdened the manufacturing and retail sectors of the economy. The Roundtable also argued that, unlike the corporate franchise tax, the CAT would be almost impossible to avoid. According to the Roundtable, this would make the system more equitable and all businesses, no matter what their size, would have to pay their fair share of taxes. Finally, the group contended that the CAT would create an incentive for new business investments and the creation of new jobs in Ohio. Under the old tax system, a business’s taxes increased when it bought new equipment or added new jobs. With the CAT, a business would not face an increased tax burden for investing in their company.  

Opponents

The Ohio business community was greatly divided on the creation of the CAT. Whereas the Ohio Business Roundtable supported the CAT, the Ohio Chamber of Commerce strongly opposed it. In testimony before the House Ways and Means Committee, the Ohio Chamber of Commerce agreed that tax reform in Ohio was needed, but it did not believe that the CAT was the best solution. First, the chamber was concerned that the CAT would automatically increase a company’s tax liability for every dollar increase in sales. The chamber also thought the new tax would adversely affect business-to-business sales and raise prices at all points during the manufacturing supply chain. The chamber was concerned that the CAT would harm new businesses and businesses that are not profitable. Under the new system, a company would be taxed on all sales, even if they were not making a profit. Furthermore, the chamber believed that the tax would have a particularly negative effect during recessions. To illustrate its point about the harmfulness of the CAT, the chamber discussed the history of gross receipts taxes in other states. According to the chamber, Indiana repealed its gross receipts tax in 2002, West Virginia and Minnesota repealed theirs nearly 20 years ago, and the tax remains unpopular in both New Jersey and Washington.  

The chamber was concerned that the CAT would harm new businesses and businesses that are not profitable. Several corporations also testified against the CAT. The Ford Motor Co. said, “The Commercial Activity Tax would be a tax increase on our Ohio-based facilities and on our Ohio-based suppliers. Ford would ultimately absorb this cost as a direct reduction to our profit margins, which would impair our ability to hire or retain workers and to make additional capital investment.” Ford was particularly concerned because the tax would be applied every time a product is turned over. Sharing Ford’s concerns was Dana Corp., a Toledo-based company supplying axles, driveshafts, engines, frames, and transmissions. Dana Corp. went against other members of the Ohio Manufacturers Association and opposed the bill because it believed that the CAT would be regressive. That is because the CAT would tax companies even if they were not profitable. Dana Corp. felt that some consideration must be given to a company’s ability to pay its taxes.

Two nonbusiness groups also argued against the CAT for different reasons. One, Policy Matters Ohio, is a nonprofit, nonpartisan group that researches issues affecting low- and middle-income Ohioans. Policy Matters argued that the CAT rate of 0.26 percent was too low and that the amount of revenue collected would be inadequate. Policy Matters believed that there was no sense in establishing a new tax system if it would be unable to address Ohio’s needs. Finally, the Ohio Fair Schools Campaign testified regarding its concerns over the CAT. According to HB 66, school districts would receive a significant portion of the new CAT revenue to replace the revenue they lost from the elimination of the tangible property tax. That would occur until

2018, when the amount school districts receive from CAT revenue would drop from 44.2 percent to 0 percent. The Ohio Fair Schools Campaign contended that unless the school funding provision was changed, Ohio’s schools would face a catastrophic funding crisis in 2018.20

Constitutionality

In addition to the other criticisms levied against the CAT, the Ohio Grocers Association has recently threatened to file a lawsuit claiming the CAT is an unconstitutional excise tax. The Ohio Grocers Association, a statewide organization of retail grocers including Kroger, Giant Eagle, and independent grocers, is concerned that the CAT would be applied to the sale of food that is consumed off-premises. According to Jason Wetzel, spokesperson for the Ohio Grocers Association, the Ohio Constitution forbids the imposition of an excise tax on the sale of food for human consumption off the premises from where the food is sold. Wetzel said, “This is a form of an excise tax. It performs like one, it acts like one, it is one. The tax is applied every time there’s a sale. It’s a hidden sales tax.” The Ohio Department of Taxation countered those charges and said that the CAT is a constitutional method of taxing businesses for vital government services. Additionally, the Department of Development said that grocers have a responsibility to pay their fair share of taxes.21

Alternatives

The new CAT was not the only option presented for altering Ohio’s corporate tax system. Other options included reforming the corporate franchise tax, creating an alternative framework, or removing corporate taxes entirely.

Policy Matters Ohio advocated reforming Ohio’s corporate franchise tax using four techniques. One technique would adopt mandatory combined reporting. In that system, companies that operate as a single business must report as one taxpayer. Sixteen states currently require combined reporting. Furthermore, the Department of Taxation estimates that combined reporting would generate $200 million in additional annual revenue. Another technique for reform is to require large corporations to disclose their corporate franchise tax returns.22 If there is greater transparency, businesses would be less likely to use tax shelters. Third, Policy Matters Ohio proposed eliminating the $150,000 net worth cap, thereby increasing tax revenue. Finally, Policy Matters Ohio called for a moratorium on new tax credits and incentives.23 Tax incentives, which have not proven effective in generating business, result in a smaller tax base and a decreased revenue source.

Because legitimate concerns have been raised regarding the CAT, the new tax must be monitored closely to ensure that it is not producing unnecessary harm.

In contrast to the CAT, the Ohio Chamber of Commerce proposed an Alternative Framework for Ohio Tax Reform. Under the alternative framework, the corporate franchise tax would remain but the tax base would be increased and the rates of the corporate franchise tax would be reduced. By increasing the base and reducing the use of tax incentives, the chamber of commerce believes that Ohio can maintain tax revenue while at the same time cutting tax rates. The alternative framework also calls for a doubling of the net worth cap from $150,000 to $300,000 for corporations. Finally, the plan advocates imposing a business privilege/license tax. That would establish the minimum amount of taxes that must be paid by all business entities. For example, under the business privilege/license tax, a business with sales between $2 million and $3 million would be required to pay at least $1,000 in taxes.24

A final alternative is the elimination of corporate taxes. One reason to support the elimination of corporate taxes is that overall they generate a small amount of revenue. Also, the state corporate tax systems are complex and consume a high administrative cost. David Brunori, contributing editor of State Tax Notes, said that corporate income taxes “consume an inordinate amount of intellectual firepower and economic resources in terms of planning, compliance, and administration.” He added, “The only people who really make money from the state corporate income tax system are the major law firms and big accounting firms.”25

Conclusion

For more than two decades, corporate tax revenue has declined in Ohio and throughout the nation.

22Policy Matters Ohio, supra note 4.
Some of the reasons include the increased use of tax incentives, not requiring combined reporting, the increase in tax shelters, and the lack of uniformity in tax laws. As a result of the declining revenue and the high administrative costs, some people have called for the abandonment of corporate taxes altogether. That is unlikely to happen because there is neither widespread public nor private support for replacing corporate taxes. Politicians and citizens believe that corporations should have to pay at least a small amount for the government services they consume.26

Because corporate taxes are likely to remain, it is important to ensure that they satisfy the principles of sound tax policy, including: the provision of appropriate revenue, neutrality, being fair and equitable, being easy and economical to administer, and accountability.27 Although Taft and his administration would contend that the CAT fulfills all of those principles, opponents of the tax have raised serious questions. For example, Policy Matters Ohio reported that the CAT rate is not high enough to produce the necessary tax revenue. Also, corporations such as the Ford Motor Co. and Dana Corp. believe that the tax is unfair because it overburdens some industries and causes harm to unprofitable corporations. Because legitimate concerns have been raised regarding the CAT, the new tax must be monitored closely to ensure that it is not producing unnecessary harm.


27Id.