Law Trends

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Ohio's Commercial Activity Tax Bill
(i.e. "Bill, the CAT")

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Effective July, 1, 2005, there's a new "CAT" in town. Buried in the thousands of pages of Ohio's biennial budget bill (Amended Substitute House Bill 66, the "Bill") is the state's approach to financing operations for the next two years, and beyond. The tax, referred to as a commercial activity tax (CAT), is an excise tax on the privilege of doing business in Ohio. Differing from a franchise tax, the CAT nibbles at the first fruits of gross receipts (up to 0.26%); instead of taking a larger bite out of net worth or net income. A consumption tax, it resembles a sales tax, being based upon proceeds from the sales of business goods and services. Because of its reliance upon purchases, the state's tax base is expected to stabilize from year-to-year swings, depending less upon items which disappear over time, like the book value of depreciable equipment and buildings. It was supported by the Ohio Society of Certified Public Accountants and the Ohio State Bar Association, with some reservations.

Its purposes include making Ohio more competitive with its neighbors, tax simplification and fairness.

To make way for the CAT, the Bill chases away some taxes and puts others on a diet. The Tangible Personal Property Tax leaves over the next four years with reduced listing percentages. The Corporate Franchise Tax takes a year longer, but leaves behind a net worth tax on financial institutions and their holding companies exempt from the CAT. Personal Income Tax rates are "skinnied up" over five years, reducing the maximum rate from 7.5% to 5.925%. So are sales taxes, with a 0.5% base rate reduction from 6% to 5.5%; although the state may expect to collect more sales taxes because the price of goods and services will be fattened by the CAT. Other changes in the income tax raise the floor for taxing individuals to $10,000, and make permanent the taxation of trusts. The additional Ohio estate tax (sponge tax) has left the neighborhood, leaving behind the basic Ohio estate tax, with a top rate of 7% for estates above $500,000. The 10% roll back for commercial and industrial real property tax is gone. The CAT touches or may touch many other taxes based upon studies of its performance.

Unsure of how business will feed the CAT, the legislature gave license to the Tax Commissioner to recalculate tax rates (currently, over three established periods) in order to satisfy budget goals. Businesses with under $150,000 of gross receipts are exempt. Those with between $150,000 and $1 million will pay a minimum tax of $150 and may elect to file and pay on a calendar year basis; all others are required to file and pay quarterly.

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CAT rates don't clamp down right away; it takes a while for their teeth to sink in. The initial rate of 0.06% is in effect now through the first quarter of 2006. For the following three quarters it is expected to be 0.104%. It will continue to adjust upward until the projected final rate is achieved. When combined with the Tax Commissioner's authority to recalculate tax rates in order to satisfy Ohio's budget, business may be faced with two bites from the CAT at once, one on the phase in and the other from a deficiency in budgetary performance.

In order to succeed at a low tax rate where the combination of other taxes has failed, the CAT reaches out to touch taxpayers, both inside and currently outside Ohio's previous grasp. It touches individuals, trustees in bankruptcy, firms, companies, for profit corporations, estates, partnerships, limited liability companies, clubs, societies, S corporations and even entities disregarded for federal income tax purposes, like qualified subchapter S subsidiaries and single member limited liability companies. Activities previously off Ohio's tax diet are now on the menu. Some commercial activities found to have substantial nexus with and gross receipts sitused in Ohio are fair game for the CAT, although until now they have been something Ohio could not get its paws on.

Instead of looking to nexus, businesses are in play if they have "substantial nexus" with Ohio. Under the Bill, the CAT reaches any person who:

- owns or uses any capital in Ohio,
- is authorized to do business in Ohio,
- has a "bright line presence" in Ohio, or
- can otherwise be reached by Ohio for taxation under the constitution of the United States.

Each of these alternatives has an expansive view. For example, under the bright line test, an out of state person crosses the bright line and has presence for Ohio's CAT if the person has more than $500,000 in taxable Ohio gross receipts, has more than $50,000 in property in Ohio, spends more than $50,000 in payroll for work in Ohio, conducts more than 25% of its business activity in Ohio, ***<u>or</u>*** is otherwise domiciled in Ohio. A foreign person who merely holds a certificate from Ohio allowing it to do business in Ohio, regardless of activity, is within the CAT's reach.

Alternative approaches within the Bill assure that the CAT will cross many a company's path and not be avoided by creative uses of related entities, consolidated or affiliated groups. However for the wary, the Bill provides planning opportunities for some who elect to consolidate their reporting as a group.

After the table is set, the CAT can approach the gross receipts of persons with "situs" in Ohio under several alternative paths. Included are:

- rents and royalties from real and tangible personal property physically located in the state;
- proceeds from the sale of real property located in the state; and
- proceeds from the sale of tangible personal property received in the state by the purchaser (or received by the person upon delivery from a common carrier in interstate commerce within the state).

Also included, and less well understood are:

- gross receipts from the sale, exchange, disposition, or other grant of intellectual property (trademarks, trade names, patents, copyrights, etc.) based upon ***<u>the amount of use within the state</u>***; and
- gross receipts from all other sales and services based upon ***<u>the proportion of the purchaser's benefit in this state compared to the purchaser's benefit everywhere.</u>***

How the seller of a good or service will determine a purchaser's proportionate benefit within Ohio under this approach is part of the mystery and CAT-like stealth of the enforcement scheme yet to be determined. How high an administrative burden will be extracted from businesses as they investigate and track the multitude of customers needed in low price large volume sellers of goods and services? Several approaches are already being discussed among industry and professional groups. Since the law applies to receipts before we can unravel this mystery, key everyday business processes are challenged, including tax compliance, cost accounting, pricing of goods and services, record keeping and remaining competitive on a level playing field in the presence of valid alternative interpretations under this new law.

These new and sometimes aggressive approaches appear poised for challenge by industry groups. Three of which, the "substantial nexus," food tax and "purchaser's benefit" approaches have already weighed in with the media for a CAT fight.

Consistency with the tax policy chosen has left certain taxpayers exempt, at least for now. The CAT ignores banks and other financial institutions, insurance companies, public utilities, the state and its political subdivisions. Also left unscathed are nonprofit organizations, since it touches only business activity, even though a nonprofit entity may generate business income unrelated to a federal tax exemption (UBI). UBI escaping the CAT appears, at least to this author, as an anomaly, a CAT and mouse game which may later fall prey to the state's revenue scheme.

Over time, business owners and managers will learn to think of the CAT differently than they have its ancestors, and will adjust and plan accordingly. While the terrain appears familiar, the attack is focused differently. The CAT pounces on gross receipts, calculated in the same manner as for federal income tax purposes, i.e., accrual or cash basis; with a deduction for bad debts, cash discounts and sales returns and allowances. No deduction, however, is allowed for the cost of goods sold or other expenses (direct or overhead), although they contribute to the production of income. Examples include: the cost of sales; cost of services like wages, outside labor and professional fees; and rental.

The CAT won't eat just anything; there's a list of at least 26 items it won't touch. Some receipts have been carved out, at least for now, like those from the sale of gasoline (a two year exemption). Also off the menu are employee compensation; dividends; capital gains and distributions; charitable contribution receipts; qualified retirement plan receipts; proceeds received from loans, stocks and bonds; and damages received from litigation.

For many businesses, the material reduction of tax rate may provide a welcome relief. If not, some may find that the trade off of a low rate CAT in place of a higher personal property tax on inventory and equipment will lessen their combined state tax burden. For others, applying it to gross receipts will be hard to swallow. Service providers which pay little or no personal property tax, will pay more. The focus on gross receipts as opposed to net income will redistribute the tax burden among businesses in changed proportion: the greater the operating cost, the greater the proportionate tax burden. One example of CAT slashed earnings is the wholesale and retail grocery supply industry. Although stores and retail chains have responded over time by adding complementary higher margin inventory, grocery's low margin, high volume sellers now face paying 0.26% of gross receipts, on margins ranging from only 1% to 2%. When comparing this impact to that on 50% margin businesses, the relative fairness of a net income tax or a net worth franchise tax is apparent. In our example, the CAT devours about 17% of earnings, as opposed to 0.52% for others, which is about 33 times more (3300%). This impact can leave low margin businesses with an opinion more like Bill, the CAT, has hocked up a hairball, than provided fairness and equity. Perhaps low margin businesses will find legislative safe havens as the CAT takes larger and larger bites out of earnings as the rates phase in. Or, they may find that there is more than one way to skin a CAT. Until then, expect them to do their best to pass along this meal to consumers.

Business, as with any tax, will pass the CAT along in the cost of goods and services sold to customers. However, there is no such thing as just one CAT in a neighborhood. As it passes from suppliers to manufacturers, and to other intermediaries on its promiscuous way to the ultimate consumer of the good or service, the CAT will breed layer upon layer of additional tax. Although income, franchise, and personal property taxes work in a similar manner, none is as broad or potentially prolific as the CAT, so this inflationary effect can produce a rather fat result over time.

When an entire industry operates on a large volume low margin approach, with a fair number of intermediaries along the way, the combined effect of this layering can be destructive. The ultimate consumer may not be willing to absorb the entire burden, or powerful intermediaries may refuse to absorb all or part of the CAT as an increase in price.

Sales tax, another consumption tax, provides a purchase for resale exemption which eliminates (or at least substantially reduces) this layering of tax, and also provides an exemption for sales of food items at retail because it is so regressive. That is, lower income consumers spend higher percentages of their disposable income on food, thus placing the tax burden on those least able to bear it. The CAT is not so kind. It provides neither the protection of a purchase for resale exemption nor the relief from tax to the retail consumer of food items. Whether business will be resilient enough to absorb or pass on the burden of the CAT in the short term remains to be seen. Focus on the issue now may permit business to respond while rates are still low, and minimize any damage.

As with any tax bill of this nature, there are penalties for failure to comply, regardless of how difficult it might be to understand its provisions. The first filing requirement is a mandatory CAT registration by all taxpayers, which has a deadline of November 15, 2005. This is a document which we or your tax return preparer would be pleased to assist you with filing. The first tax returns will be due in February, 2006.

With the new penalties, though, the legislature has provided a broad tax amnesty opportunity for non-complying taxpayers to avoid penalties and half the interest obligation. It is available to taxpayers who have not been contacted by the Ohio Department of Taxation. It applies to all sales, use, corporate franchise, personal income and school district income, and personal property taxes unpaid as of May 15, 2005. Amnesty opens January 1, 2006 and closes 46 days later on February 15, 2006.

As we become more familiar with this new breed of CAT, and necessary refinements are provided to the Bill, we should be able to provide more than these general comments. Please contact Gary Harden as you have questions regarding the CAT, or if you would like to explore how it may affect your business.

Mr. Harden, a member of the Firm, focuses his practice on federal taxation, benefits and general business law. He has been listed in Best Lawyers in America for each of the last 10 years and Ohio Super Lawyers each year since its inception.

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