



income tax revenue paid by residents separately from such revenue paid by nonresidents. Its report is due by May 1, 2015.

- Certain provisions may increase or reduce costs to municipalities to conform to changes required by the bill.

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## 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) 2012 ranged from a low of 0.6% 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 \$4.53 billion by the Tax Department in CY 2012, an increase of \$219.1 million (5.08%) from CY 2011.<sup>1</sup> Approximately \$4.18 billion was collected by cities and \$0.35 billion by villages. Collections ranged from \$3,146 in the village of New Paris (Preble County) to \$734.6 million in the city of Columbus (Franklin County).

Sub. H.B. 5 makes various changes to laws governing the municipal income tax, and requires municipal corporations levying an income tax as of January 1, 2016, 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.

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<sup>1</sup> [http://tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/local\\_government\\_funds/lg11/LG11\\_CY12.stm](http://tax.ohio.gov/divisions/tax_analysis/tax_data_series/local_government_funds/lg11/LG11_CY12.stm). A total of 601 municipalities (240 cities and 361 villages) levied the tax in CY 2012.

## **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, 2016 to prescribe a method by which nonindividual taxpayers may submit the required supplemental 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. 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. However, it is also possible the bill may have no material fiscal effect for a number of other municipalities.

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 generally 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 or deductions, 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 2016, 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 for a nonresident taxpayer are situated to the municipality where the individual performed the services. For resident taxpayers, all their unreimbursed expenses may be deducted in their municipality of residence. For municipalities that currently allow a reduction of an individual's taxable wages for unreimbursed employee expenses, this situsing provision may potentially 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 pensions, 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 as defined in the bill, received for up to 20 days per year by a nonresident individual for personal services performed in the municipal corporation. If the municipal corporation is not "a base of operation" as defined in the bill, the compensation is to be treated as earned or received where the individual is domiciled.<sup>2</sup> 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 all municipal corporations to allow NOLs to be carried forward for five years for NOLs incurred in taxable years beginning after 2016. For a municipal corporation that levies an income tax before 2016, taxpayers must use the existing carryforward period, if any, prescribed in municipal tax ordinances for losses incurred

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<sup>2</sup> For example, this exemption would apply to compensation paid to a member of the board of directors of a corporation if the member is a nonresident of the municipality or the state.

in taxable years beginning before 2017, then use a five-year carryforward starting with losses incurred in taxable years beginning in 2017 or later. However, for taxable years beginning in 2018 and through 2022, in a municipality that levies an income tax before 2016, 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, though the bill specifies that a net operating loss does not include unutilized losses resulting from basis limitations, at-risk limitations, or passive activity loss limitations. The bill specifies that the temporary 50% limitation does not apply to NOLs incurred in taxable years before 2017 and deductible under existing municipal income tax ordinances.

Most municipalities allow NOLs with carryforwards that vary by municipality. 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 2018 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. For taxable years beginning in 2023, the full NOL deduction would be allowed to taxpayers, resulting in a full reduction of revenue from this provision, when compared to current tax ordinances, for those municipalities that do not allow NOLs. Appendix A, attached to this fiscal note, provides details on the treatment of the net operating loss deduction in tax ordinances of Ohio's largest municipalities.

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 defines 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, and the employer is not required to withhold income taxes on qualifying wages paid to the employee. 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. (These provisions generally do not apply to a person performing personal services at a petroleum refinery located in a municipal corporation that imposes an income tax.) The bill generally defines a "principal place of work" for employees and requires employers to assign qualifying wages to that place of work. However, if there are two or more municipal corporations in which the employee spent an identical number of days that is greater than the number of days the employee spent in any other municipal corporation, the employer shall allocate the employee's qualifying wages among those two or more municipal corporations. A municipal

corporation to which qualifying wages are allocated shall be the employee's "principal place of work" with respect to those qualifying wages.

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 revenue, 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 revenue. 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.<sup>3</sup>

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 requires the Committee to analyze revenue data for at least 13 municipalities that would be included in a "representative sample"; at least three of the municipalities would have a population of more than 250,000; five cities or villages would have a higher ratio of business taxpayers to resident individual taxpayers relative to the state average; and five cities or villages would have a higher ratio of resident individual taxpayers to business taxpayers relative to the state average. Of the three persons representing municipal corporations, at least two must represent those that do not allow NOL carry forwards. 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. The bill requires the committee to report its finding on revenue effects by May 1, 2017, and states that the report shall contain recommendations to address revenue shortfalls, which may include, but shall not be

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<sup>3</sup> 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.

limited to, the use of supplemental funds from the Local Government Fund to mitigate those shortfalls.

### **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 must be used in determining or rebutting the presumption of an individual's domicile. The impact of this provision is undetermined, though it is probable that certain taxpayers that are paying municipal income taxes, or are currently assessed by certain municipalities for income taxes, would become exempt under the new criteria in the bill.

### **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 tax paid by a pass-through entity owned by the resident. This provision may reduce revenue to municipalities that do not allow such treatment of taxes paid by pass-through entities.

### **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, some of which are mentioned below.

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, though this provision may not apply with respect to ownership interest in S-corporations unless distributive shares of the profits are subject to tax in the municipal corporation. This provision is likely to create a revenue loss for municipalities that do not allow such treatment or offsets of gains and losses, including those from NOL carryforwards.

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 \$200 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.

#### **Consolidated tax returns**

Generally, once a parent of an affiliated group of corporations elects to file a single consolidated return at the federal level or the state level, instead of separate returns for each of its affiliates, it must continue to do so while it remains in existence, unless it gets the Internal Revenue Service's permission to file separate federal returns. For purposes of municipal taxation, the parent company may use apportionment and allocation factors (based on property, sales, and wages) to reflect corporate activity within the municipality when filing municipal income tax returns. However, the group must continue to file a consolidated tax return with the municipality, unless the tax administrator grants permission to deconsolidate, or is permitted to deconsolidate at the municipal income tax level after obtaining IRS's permission to deconsolidate at the federal level.

The bill appears to allow a parent company of an affiliated group, after five years, to elect or not to file separate municipal income tax returns for each affiliate. (The election may be made after each five-year period.)<sup>4</sup> The bill also provides for the parent company to include or not gains and losses of pass-through entity affiliates or their allocation factors when filing municipal income tax returns. Those changes would allow strategic reductions in municipal income tax liabilities by corporate parents, and thus potentially would result in revenue losses to some municipalities.

#### **Municipal income tax revenue reporting study committee**

The bill also creates a municipal income tax revenue reporting study committee to study the feasibility of requiring municipal corporations to report information on income tax revenue paid by residents separately from such revenue paid by nonresidents. The committee shall be composed of the following: three members of the Senate; three members of the House of Representatives; and six members representing

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<sup>4</sup> The bill also appears to require a parent to file a consolidated municipal income tax in a year the taxpayer has filed a federal consolidated tax return, though this may occur after a tax administrator determines "by a preponderance of the evidence that intercompany transactions have not been conducted at arm's length and that there has been a distortive shifting of income and expenses with regard to allocation of net profits to the municipal corporation."

business interests or municipal corporations that levy an income tax. The bill specifies that the members of the committee are not compensated or reimbursed for expenses. The committee shall study the costs and benefits of, and challenges involved in, requiring that municipal corporations report the information on taxes paid by nonresidents. On or before May 1, 2015, the committee shall issue a report of its findings and recommendations with respect to the reporting requirement. The committee shall provide copies of the report to the Governor, the President and Minority Leader of the Senate, and the Speaker and Minority Leader of the House of Representatives. The committee shall cease to exist on May 1, 2015.

### **Taxpayer bill of rights**

The bill requires that tax administrators generally conduct, except in cases involving suspected criminal activity, an audit of a taxpayer during regular business hours and after providing reasonable notice, and provide to the taxpayer a written description of the roles of the tax administrator and of the taxpayer during an audit and a statement of the taxpayer's rights, including any right to obtain a refund of an overpayment of a tax, assistance or representation by an attorney, accountant, bookkeeper, or other tax practitioner. A taxpayer may refuse to answer any questions asked by the person conducting an audit until the taxpayer has an opportunity to consult with the taxpayer's attorney, accountant, bookkeeper, or other tax practitioner. If the tax administrator fails to substantially comply with the provisions of the taxpayer bill of rights, the tax administrator, upon application by the taxpayer, shall excuse the taxpayer from penalties and interest arising from the audit. Under certain conditions specified in the bill, a taxpayer aggrieved by an action or omission of a tax department or an employee of the municipal corporation may bring an action in the court of common pleas of the county in which the municipal corporation is located. Upon a finding of liability on the part of the tax administrator or the municipal corporation, the tax administrator or the municipal corporation shall be liable to the taxpayer in an amount equal to the sum of compensatory damages and costs of litigation and attorneys' fees sustained by the taxpayer. If the court determines that a taxpayer's conduct in the proceedings section is "frivolous," as defined in the bill, the court may impose a penalty against the taxpayer in an amount not to exceed \$10,000 which shall be paid to the municipality. These provisions may increase costs to certain municipalities.

### **Problem resolution officer**

The bill requires tax administrators of municipal corporations with a population larger than 30,000 to appoint at least one problem resolution officer to assist taxpayers with pending administrative cases. The bill does not require municipalities to hire a problem resolution officer. Thus, this provision may increase costs for municipalities that do not have such officers only for those municipalities that decide to hire staff specifically for this purpose.

## Appendix A

### NOL in tax ordinances of Ohio's largest municipalities

Data from the Ohio Business Gateway indicate that about 60% of all Ohio municipalities that levy an income tax allow NOL deductions with carryforwards of up to five years, and those receive about 53% of total statewide municipal income tax revenues. Another 10% of municipal corporations allow carryforwards of up to three years, while collecting approximately 10% of statewide municipal income taxes. The remaining 30% of municipal corporations, which currently do not allow NOLs, collect roughly 37% of statewide municipal income taxes. Those municipalities are likely to experience the most reductions in revenue from NOL provisions in Sub. H.B. 5. The table below provides details on the treatment of NOLs in tax ordinances of the largest municipalities (based on income tax receipts) across the state.

<b>Treatment of Net Operating Losses by Largest Ohio Municipal Corporations</b>			
<b>Municipal Corporation</b>	<b>2012 Income Tax Collections</b>	<b>Percentage of Statewide Collections</b>	<b>NOL and Carryforwards, Number of Years</b>
Columbus	\$734,574,788	16.2%	No
Cleveland	\$338,046,790	7.5%	Yes, five years
Cincinnati	\$334,930,176	7.4%	Yes, five years
Toledo	\$158,522,842	3.5%	Yes, five years
Akron	\$132,439,409	2.9%	Yes, three years
Dayton	\$101,533,962	2.2%	No
Dublin	\$75,430,513	1.7%	No
Canton	\$45,506,906	1.0%	Yes, three years
Youngstown	\$45,360,986	1.0%	Yes, five years
Kettering	\$40,929,081	0.9%	Yes, three years
Solon	\$40,849,411	0.9%	Yes, five years
Westerville	\$38,723,401	0.9%	No
Mentor	\$36,100,204	0.8%	Yes, five years
Oregon	\$34,870,905	0.8%	Yes, five years
Parma	\$33,997,011	0.8%	Yes, five years
Blue Ash	\$32,679,637	0.7%	Yes, five years
Springfield	\$30,364,333	0.7%	No
Strongsville	\$29,074,716	0.6%	Yes, five years
Beachwood	\$26,720,881	0.6%	Yes, five years
Euclid	\$24,925,965	0.6%	Yes, five years
Independence	\$24,426,014	0.5%	Yes, five years
Fairfield	\$23,973,447	0.5%	Yes, three years
Twinsburg	\$23,537,424	0.5%	No
Mansfield	\$23,335,975	0.5%	No
Mason	\$22,383,868	0.5%	Yes, five years
Hamilton	\$22,056,839	0.5%	Yes, three years
Findlay	\$22,044,345	0.5%	Yes, five years

<b>Treatment of Net Operating Losses by Largest Ohio Municipal Corporations</b>			
<b>Municipal Corporation</b>	<b>2012 Income Tax Collections</b>	<b>Percentage of Statewide Collections</b>	<b>NOL and Carryforwards, Number of Years</b>
Cleveland Heights	\$21,993,687	0.5%	Yes, five years
Elyria	\$21,630,188	0.5%	Yes, five years
Sharonville	\$21,541,108	0.5%	Yes, three years
Westlake	\$21,384,694	0.5%	Yes, five years
Whitehall	\$21,171,373	0.5%	No
Shaker Heights	\$21,082,579	0.5%	Yes, five years
Worthington	\$21,056,614	0.5%	No
Newark	\$19,932,018	0.4%	No
Middletown	\$19,659,982	0.4%	Yes, five years
New Albany	\$19,563,041	0.4%	No
Cuyahoga Falls	\$19,252,832	0.4%	Yes, five years
Lakewood	\$19,252,828	0.4%	Yes, five years
Grove City	\$19,085,048	0.4%	No
Hilliard	\$19,083,794	0.4%	No
Green	\$19,074,594	0.4%	Yes, five years
Lorain	\$18,639,033	0.4%	Yes, five years
Delaware	\$18,074,847	0.4%	Yes, three years
Brook Park	\$17,694,985	0.4%	Yes, five years
Warren	\$17,645,592	0.4%	No
Hudson	\$17,600,926	0.4%	Yes, five years
Middleburg Heights	\$17,220,219	0.4%	Yes, five years
Lancaster	\$17,061,307	0.4%	No
Bowling Green	\$16,077,219	0.4%	Yes, five years
<b>Top 50</b>	<b>\$2,942,118,334</b>	<b>65.0%</b>	

Ohio's 50 largest municipal corporations, based on income tax collections, collected about \$2.94 billion, or roughly two-thirds of the \$4.53 billion in municipal income tax receipts in CY 2012. Among those largest municipalities, 28 municipal corporations allow an NOL deduction with a five-year carryforward (50% of tax collections of this group), and seven allow an NOL deduction with a three-year carryforward (10% of tax collections). The remaining 15 do not allow an NOL deduction (40% of tax collections).

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