Fiscal Note & Local Impact Statement

Bill: H.B. 5 of the 130th G.A.  
Date: April 23, 2013  
Status: As Introduced  
Sponsor: Reps. Grossman and Henne

Local Impact Statement Procedure Required: Yes

Contents: Revises the laws governing the municipal income tax

State Fiscal Highlights

- The bill creates a seven-member Municipal Tax Policy Board to take actions concerning the statewide administration of municipal income taxes, and specifies that members receive no salary. The fiscal impact on the state, if any, is expected to be minimal.

Local Fiscal Highlights

<table>
<thead>
<tr>
<th>LOCAL GOVERNMENT</th>
<th>FY 2013</th>
<th>FY 2014</th>
<th>FUTURE YEARS</th>
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<tbody>
<tr>
<td>Municipalities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues</td>
<td>- 0 -</td>
<td>- 0 -</td>
<td>Potential loss</td>
</tr>
<tr>
<td>Expenditures</td>
<td>- 0 -</td>
<td>- 0 -</td>
<td>Potential increase</td>
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Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- The bill's provisions are likely to create, overall, a net revenue loss to municipalities, beginning with taxable years starting on or after January 1, 2015. The revenue impact on a specific municipality will be dependent on changes made by the bill and the Municipal Tax Policy Board to existing income tax ordinances. Though total revenue losses to municipalities are undetermined, they may be significant, potentially millions of dollars annually.
- Certain provisions may increase costs to municipalities to conform to changes required by the bill and the Municipal Tax Policy Board.
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) 2011 ranged from a low of 0.4% 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 $4.31 billion by the tax department in CY 2011, an increase of $256.8 million (6.3%) from CY 2010.1 Approximately $3.98 billion was collected by cities and $0.33 billion by villages. Collections ranged from $477 in the village of New Paris (Preble County) to $677.1 million in the city of Columbus (Franklin County).

The bill makes various changes to laws governing the municipal income tax, and requires municipal corporations levying an income tax as of January 1, 2015, and that intend to continue levying the tax thereafter to amend or repeal and re-enact 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.

Fiscal effect on the state

The bill creates the Municipal Tax Policy Board. The Board, composed of seven Governor-appointed municipal tax administrators, is to create rules, prescribe forms and other documents, provide instructional materials to taxpayers, and take other actions concerning the statewide administration of municipal income taxes. The bill

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stipulates that members of the Board will not receive a salary. The bill has no provision for paying potential costs that may be associated with the Board. The fiscal impact of the newly created board on the state, if any, is expected to be minimal.

**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 or with rules of the Board. Thus, the bill requires municipalities to modify, where different, their income tax laws and rules to conform to requirements of H.B. 5 and the Municipal Income Tax Board. 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.

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 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 in the municipal income tax base only 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 (Form 1040 Schedules C, E, and F, and IRS Form 4797, if not reported in the previous schedules).

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 2015, though the bulk of fiscal effects would occur in later years.

**Provisions that are likely to increase municipal income tax revenues**

The bill specifically adds to the income tax base wages of individuals under the age of 18, certain deferred compensation and stock option-related income, and self-employment income of religious leaders. This provision would increase revenues for those municipalities that may currently exempt such incomes.

Municipalities generally allow a deduction for employees’ business expenses (either 100% of Form 2016 expenses or the amount deducted for federal purposes in

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2 The bill requires a taxpayer to add employee compensation not otherwise included in the Medicare wage base for municipal income tax purposes, but that is taxed for federal income tax purposes.
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 eliminates the existing deduction for unreimbursed employee business expenses. This change would raise municipal taxable income and thus increases revenues.

The provision that specifies net profits for purposes of the municipal income tax law and requiring 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 specifically excludes from the tax base, in addition to the current mandatory exclusions: nonwages of minors; alimony and child support received; compensation for personal injuries or property damage (e.g., from insurance) except for punitive damages or lost wages; dues received by certain kinds of organizations; gains from involuntary conversions; interest on federal obligations; and nonbusiness income of a decedent’s estate. Those changes would decrease revenues of municipalities where such income is currently included in the income tax base.

The bill codifies a residency test for municipal income tax and adopts state law that determines residency for state income tax purposes. This provision is likely to reduce municipal income taxes.

The bill requires all municipal corporations to allow individuals and businesses to deduct new net operating losses and to allow a five-year carryforward of such losses, phasing in the requirement over five years; and the bill permits existing losses to continue to be carried forward if current municipal ordinances allow. For NOLs incurred before 2015, an NOL deduction and carryforward is allowed if a municipal ordinance adopted before 2014 permits the deduction and carryforward.

The new five-year NOL phase-in applies only to NOLs incurred in taxable years beginning after 2014. The NOL deduction (including carryforwards) for taxable years beginning after 2015 cannot exceed 20% of the full amount otherwise allowed; for taxable years beginning after 2016, not more than 40%; after 2017, 60%; and after 2018, 80%. For taxable years ending after 2019, the full deduction is allowed. The phase-in does not apply to NOLs incurred in taxable years beginning before 2015 and deductible at the time incurred under a municipal ordinance.

Most municipalities allow NOLs with various carryforwards (up to five years). 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. The phase-in spreads out NOL deductions over several years, and thus would lessen the immediate fiscal impact on municipalities that do not allow NOLs or those that permit fewer than five years of carryforwards. Though the bill phases in this provision that would limit its fiscal impact on the cash flow of municipal corporations,
depending on the size of tax receipts from business profits and general economic conditions, revenue losses from the NOL provisions may be sizable.

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,\(^3\) to define how such days are to be counted, and to further define how the exemption does not apply to professional athletes, entertainers, promoters of professional sports and entertainment events, and public figures. This provision, overall, is likely to decrease income currently deemed taxable by certain municipalities, and as a result, is likely to decrease municipal income tax collections.

A business that operates in more than one municipal corporation must apportion its net profit for income tax purposes. A three-part formula based on a business’ payroll, sales, and property is used to determine the portion of the business’ net profit attributable to a municipality. The bill specifies how the "sales" and "payroll" factors are to be computed in the formula for taxpayers that have income from both within and outside a municipal corporation, including the elimination of the so-called "throw-back" provision. Under current law, allocation of sales is generally made based on the destination rule: a sale of goods is made in a municipal corporation when the goods are (a) shipped and delivered within the municipal corporation, (b) delivered within the municipal corporation, but shipped from elsewhere if the business regularly solicits sales within the municipal corporation, and (c) shipped from the municipal corporation, but delivered elsewhere, if employees of the business do not regularly solicit sales at the location where the goods are delivered. The last criterion is known as a "throw-back provision."

H.B. 5 provides that goods are considered to have been sold in a municipal corporation only when the purchaser received the goods in the municipality. When goods are delivered by a common carrier, the sale location is the place where the purchaser received title to the goods. Income from the sale of services is assigned to a municipal corporation based on the extent to which the services were performed within the municipality. Thus, the bill is likely to redistribute income and profits that may be currently taxable in a municipality to another municipality, to a destination that lacks the authority to tax certain providers of goods and services (because they do not have payroll, property, or personnel in that locality), or to a locality that does not impose a municipal income tax. Therefore, statewide, the elimination of the throw-back rule and other changes to the apportionment and allocation of net income have the potential to reduce net income or profits taxable under the municipal income tax, and are likely to decrease income tax paid by certain individuals and businesses.

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\(^3\) An individual whose municipal income taxes may not be withheld due to this change 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.
The bill precludes assessments after three years 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**

Most municipalities impose their income tax on pass-through entities (e.g., partnerships, S corporations, limited liability companies, etc.) or their investors/owners. Under current law, municipal corporations may tax pass-through entity 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 prohibits municipal corporations from taxing pass-through entities at the entity level, and requires pass-through entities doing business in a municipal corporation levying an income tax to withhold and pay the tax on behalf of all owners of the entity; the owners’ individual tax liabilities for their shares of the entity’s net profit are credited with the payment, and such credit is refundable, i.e., if the credit exceeds the taxpayer's liability, the excess is paid to the taxpayer. This provision is likely to have differing impacts on municipalities, based on the business tax base of each municipality and where the owners/investors of those businesses reside. Overall, the fiscal impact of this provision is uncertain.

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.