

TESTIMONY REGARDING HOUSE BILL 326

Before the House Ways and Means Committee

David A. Froling
Tax Counsel for the Ohio Council of Retail Merchants

September 24, 2015

Good morning Chairman McClain and members of the Committee. My name is Dave Froling. I am a state and local tax partner with the law firm Vorys, Sater, Seymour and Pease LLP. I am testifying today on behalf of the Ohio Council of Retail Merchants.

The Council is pleased this Committee is committed to quickly fixing the drafting problems set forth in Am. Sub. H.B. 64. At the outset however, it is important for the Council and the Committee to be on the same page as to the nature of the drafting problems. In the Council's view there were two significant drafting problems in Am. Sub. H.B. 64. That said, H.B. 326 attempts to fix only one of the problems, and in doing so, H.B. 326 created a tax problem that did not exist in Am. Sub. H.B. 64.

The First Drafting Problem

The Council understands the first drafting problem to be this: Am. Sub. H.B. 64 amended the Ohio individual income tax by adopting a flat 3.0% tax rate to apply against an individual's "taxable business income." "Taxable business income" is the individual's "business income" that remains after the individual claims their small business deduction. For certain amounts of "taxable business income" the flat 3.0% tax rate was *higher* than the marginal income tax rates that applied to "business income" *before* Am. Sub. H.B. 64 became law. And for certain amounts of "taxable business income" the flat 3.0% tax rate was *higher* than the new marginal income tax rates set forth in Am. Sub. H.B. 64 that apply to all income other than "taxable business income." Thus, some observers viewed the 3.0% flat tax rate on "taxable

business income” to be a tax increase in certain instances notwithstanding the General Assembly making the small business deduction more robust and the General Assembly lowering all marginal income tax rates by 6.3%. Table A shows the problem clearly.

Table A

Under Am. Sub. H.B. 64, “taxable business income” up to \$40,000 is subject to an income tax rate that is *higher* than the marginal income tax rates that would otherwise apply.

<i>Am. Sub. H.B. 64: 2015 Income Tax Rates</i>		
Col. A	Col. B	Col. C
Income and tax brackets set forth in R.C. 5747.02.	Tax Rates for all income other than “taxable business income”	Tax Rates for “taxable business income”
\$5,000 or less	0.495%	3.000%
\$5,001 to \$10,000	0.990%	3.000%
\$10,001 to \$15,000	1.980%	3.000%
\$15,001 to \$20,000	2.476%	3.000%
\$20,001 to \$40,000	2.969%	3.000%
\$40,001 to \$80,000	3.465%	3.000%
\$80,001 to \$100,000	3.960%	3.000%
\$100,001 to \$200,000	4.597%	3.000%
More than \$200,000	4.997%	3.000%

With this understanding in mind, the Council understood the purpose of H.B. 326 was to have the tax rate on “taxable business income” on income amounts up to \$40,000 mirror the marginal income tax rates. The amending language in H.B. 326 is overly complicated and not a model of clarity. That said the Council is of the view that H.B. 326 solves the first drafting problem but in doing so, H.B. 326 created a new tax problem that did not exist in Am. Sub. H.B. 64. Table B on the next page shows the new problem clearly.

Table B

Under H.B. 326, “taxable business income” between \$40,001 and \$62,500 is subject to a 3.465% income tax rate instead of the 3.000% tax rate that was set forth by Am. Sub. H.B. 64.

<i>H.B. 326: 2015 Income Tax Rates</i>			
Col. A	Col. B	Col. C	Col. D
Income and tax brackets set forth in R.C. 5747.02.	Tax rates for all income other than “taxable business income”	H.B. 326 tax rates for “taxable business income”	Am. Sub. H.B. 64 tax rates for “taxable business income”
\$5,000 or less	0.495%	0.495%	3.000%
\$5,001 to \$10,000	0.990%	0.990%	3.000%
\$10,001 to \$15,000	1.980%	1.980%	3.000%
\$15,001 to \$20,000	2.476%	2.476%	3.000%
\$20,001 to \$40,000	2.969%	2.969%	3.000%
\$40,001 to \$62,500	3.465%	3.465%	3.000%
\$62,501 to \$80,000	3.465%	3.000%	3.000%
\$80,001 to \$100,000	3.960%	3.000%	3.000%
\$100,001 to \$200,000	4.597%	3.000%	3.000%
More than \$200,000	4.997%	3.000%	3.000%

The Committee can see how the tax rates on income up to \$40,000 are the same whether the income is “taxable business income” or all other income. That said income between \$40,001 and \$62,500 is taxed at 3.465% even though such income was taxed at a flat 3.0% in Am. Sub. H.B. 64. As you can also see, income greater than or equal to \$62,501 is taxed at the flat 3.0% rate. There is no rational reason to tax a small band of income at a rate higher than 3.0% when all other income is taxed at a rate of 3.0% or lower - - especially when Am. Sub. H.B. 64 taxed such income at a *lower* rate. The Council would like to add two more points to put this new problem in context. First, the new drafting error results in the taxpayer paying \$104.63 more in tax than what Am. Sub. H.B. 64 required (i.e., \$62,500-\$40,000=\$22,500 x .465%). Second, the new drafting error does not exist for taxable years 2016 and later.

Drafting language to correct this new tax problem is not difficult and in this regard the Council suggests the General Assembly adopt the tax table set forth at Table C.

Table C

Proposed Solution: Create a new tax table at R.C. 5747.02(A)(4) for “taxable business income.”

Col. A	Col. B
Income and tax brackets	Tax Rates for “taxable business income”
\$5,000 or less	0.495%
\$5,001 to \$10,000	0.990%
\$10,001 to \$15,000	1.980%
\$15,001 to \$20,000	2.476%
\$20,001 to \$40,000	2.969%
More than \$40,000	3.000%

The Second Drafting Problem

The second drafting problem associated with Am. Sub. H.B. 64, which H.B. 326 does not address at all, relates to the pass-through entity withholding tax. Am. Sub. H.B. 64 did not adjust the pass-through entity withholding tax to account for the small business deduction and the new 3.0% flat tax on “taxable business income.” Accordingly the amount of Ohio income tax that a pass-through entity withholds from its investors’ distributive share of income is grossly overstated compared to what the nonresident pays in Ohio income tax when the nonresident files his/her Ohio individual income tax return.

By way of background, in 1997 the 122nd General Assembly enacted the pass-through entity withholding tax. The withholding tax is imposed on pass-through entities doing business in Ohio. That said the pass-through entity just withholds Ohio income tax from its investors that are individuals who are non-residents of Ohio.

At the outset it is important to understand that the amount a pass-through entity withholds equals the “tax base” times the “tax rate.” The result of this mathematical equation

needs to be reasonably close to the nonresident individual's Ohio income tax bill when the nonresident files his/her Ohio personal income tax return.

While there are a multitude of problems with the pass-through entity withholding tax the Council will limit its testimony today to just discussing the problems as they relate to the small business deduction and the flat 3.0% tax on business income.

The problems with the pass-through entity withholding tax are significant and two-fold. First, the withholding "tax base" is too high because the tax base does not allow the pass-through entity to take into account the nonresident's Ohio small business deduction. This causes the pass-through entity to withhold Ohio income tax on income that Ohio does not tax. This is an egregious error on Ohio's part. In 2015 this means that potentially up to \$187,500 of a nonresident's income is subject to pass-through entity withholding tax even though Ohio does not tax that income. In 2016 and forward, this means potentially up to \$250,000 of the nonresident's income is subject to pass-through entity withholding tax even though Ohio does not tax such income.

Second, the withholding tax rate is too high. The withholding tax rate is 5.0% which is two-thirds *greater* than the 3.0% tax on "taxable business income." Recall that in 1997 when the 122nd General Assembly enacted the pass-through entity withholding tax the withholding tax rate was one-third *lower* than the highest marginal income tax rate, which was 7.5% in 1997. The lower withholding tax rate made sense in order for Ohio to effectively account for the nonresident's federal income tax deductions that Ohio incorporated into the Ohio personal income tax. Now that Ohio's withholding tax rate is at least two-thirds *greater* than Ohio's income tax rate this is yet another egregious error on Ohio's part that the General Assembly must correct. To put this withholding tax problem into real numbers, 5.0% of

\$250,000 is \$12,500. The individual investor is giving Ohio an interest free loan of at least \$12,500 that Ohio will not refund to the investor for roughly 18 to 24 months. The General Assembly cannot allow this to continue. Indeed the U.S. Constitution precludes Ohio from discriminating against nonresidents in favor of residents. Moreover, not correcting the problem defeats the purpose of the small business deduction and lower marginal income tax rates because the problem delays getting needed capital back into the hands of investors to allow the investors to increase their investment in their business through capital improvements or increased jobs.

Table D shows the problem associated with the withholding tax rate.

Table D

Pass-Through Entity Withholding Tax Problem: The problem is two-fold. First, the withholding tax base does not allow the pass-through entity to take into account the individual’s small business deduction. Consequently the withholding tax base in 2015 is potentially \$187,500 too high and in 2016 is potentially \$250,000 too high. Second, the withholding tax rate is a flat 5.0% when the individual’s effective income tax rate is no higher than 3.0% and likely much lower than 3.0%.

<i>Pass-Through Entity Withholding Tax rates as compared to Ohio’s individual income tax rates</i>			
Col. A	Col. B	Col. C	Col. D
Income and tax brackets	Individual Income Tax Rates for all income other than “taxable business income”	Individual Income Tax Rates for “taxable business income” as set forth in Exhibit C	Pass-Through Entity Withholding Tax Rate
\$5,000 or less	0.495%	0.495%	5.000%
\$5,001 to \$10,000	0.990%	0.990%	5.000%
\$10,001 to \$15,000	1.980%	1.980%	5.000%
\$15,001 to \$20,000	2.476%	2.476%	5.000%
\$20,001 to \$40,000	2.969%	2.969%	5.000%
\$40,001 to \$62,500	3.465%	3.000%	5.000%
\$62,501 to \$80,000	3.465%	3.000%	5.000%
\$80,001 to \$100,000	3.960%	3.000%	5.000%
\$100,001 to \$200,000	4.597%	3.000%	5.000%
More than \$200,000	4.997%	3.000%	5.000%

Fortunately the legislative fix is easy. The correcting legislation needs to do three things. First, give nonresidents the same rights as residents. Pass-through entities do not have to

withhold Ohio income tax for residents because Ohio law requires residents to make estimated income tax payments. Ohio law should not require pass-through entities to withhold Ohio income taxes from any nonresident provided the nonresident agrees in writing to make estimated income tax payments directly to Ohio. Second, the withholding tax rate should be no higher than 2.0% which would ensure the withholding tax rate is no worse than two-thirds of the flat 3.0% tax on “taxable business income.” Third, the pass-through entity should be allowed to take into account the investor’s small business deduction when the pass-through entity calculates the investor’s tax base.

This concludes my remarks. I appreciate your attention and I thank you for your time. I would be happy to answer any questions you may have.