



**BEFORE THE SENATE WAYS & MEANS COMMITTEE
PROPONENT TESTIMONY ON HOUSE BILL 5
DISCUSSION OF NET OPERATING LOSS CARRY-FORWARD
PERIOD AND THE THROWBACK RULE
NOVEMBER 13, 2014**

Chairman Peterson, Ranking Member Tavares and Members of the Committee,

My name is Daniel Navin and I am the assistant vice president of tax & economic policy for the Ohio Chamber of Commerce. I appreciate this opportunity to testify to the committee and explain specifically what the bill would do with respect to the above-referenced issues, why that approach was proposed, and why we believe it enhances the competitiveness of Ohio businesses. But before doing that, I would like to make some preliminary comments building upon some of Mr. Zaino's testimony.

First, while we strongly support HB 5, it can certainly be improved. I would daresay different industries, companies or individuals of our broad-based membership have particular reservations or objections about various provisions in the bill, with some even arguing the bill does not go far enough in making the municipal income tax system more business-friendly. The fact is, however, that the Ohio Chamber has come to this issue as a member of a coalition speaking with one voice, but with a willingness to work to further improve the legislation under conditions of fair compromise.

Second, most of the objections to the bill that have been raised by the Ohio Municipal League (OML) and other opponents can be summed up in three words - potential revenue loss. These are undocumented claims of potential revenue loss, with precious little evidence of the data and underlying assumptions that could be used to verify those claims, particularly in the case of the net operating loss issue.

Can I say that no city will lose revenue? Of course not. However, the same assertion holds true for the businesses and other taxpayers that the Coalition represents, as no doubt there will be taxpayers who may have to pay more tax to a particular city as a result of this bill. It is wholly unrealistic to think that in an effort of this level of complexity, involving over 600 municipalities and touching on 30 or more issues affecting probably hundreds of thousands of taxpayers, virtually everyone will come out of it without incurring any revenue loss or not having to pay more tax under certain circumstances.

Third, as the HB 5 discussion continues in the Senate and this committee, it's important to remember and always keep in mind what was in the September 2013 *Forbes Magazine* about Ohio having "the most complicated, absurd and punitive system of municipal taxation in the nation". We are trying to make balanced but significant improvements to the system, including ones that reasonably protect municipal interests while reducing the system's overall administrative complexity and the cost burden of compliance.

Throwback Rule

Business taxpayers as an entity, in contrast to individual employees who pay based on their wages/compensation, pay municipal income tax on the basis of the net profits of their business enterprise. The amount of the company's net profit subject to tax by any particular city is determined through the use of a three-factor apportionment formula that establishes ratios of the company's real property in a city divided by its total property, its payroll in the city divided by its total payroll and its sales in the city divided by its total sales. Grossly over-simplified, the company's total net profit is multiplied by the sum of the three factors divided by 3, and thus you obtain the percentage of net profit subject to taxation by the particular city involved. And then that amount is multiplied by the city's tax rate and you have the company's net profits tax liability, again grossly over-simplified.

The throwback rule relates to the sales factor. The provision at issue is current Ohio Revised Code Section 718.02 B (3), which says "sales made in a municipal corporation" means or, in other words, includes in the numerator of the sales factor:

- (3) *All sales of tangible personal property (TPP) shipped from a place within such municipal corporation to purchasers outside such municipal corporation regardless of where title passes if the taxpayer is not, through its own employees, regularly engaged in the solicitation or promotion of sales at the place where delivery is made.*

This "throwback" provision contemplates how a sale which was shipped from a location within a city to a purchaser located outside that city should be sourced, if it should be sourced at all, for municipal income tax purposes. Conversely, Section 718.02 B (2) allows a sale to be sourced outside the city if the taxpayer is regularly engaged in the solicitation or promotion of sales at the place where delivery is made. However, there is confusion about these provisions and the main reason is that there is little guidance, either from the statutes or court rulings, as to what constitutes "promotion" or "solicitation" at the place where delivery is made.

Consequently, some municipal tax administrators have taken the position that sales shipped from a city to destinations (such as townships that cannot impose a municipal income tax) outside that city are taxable in the place where shipment originated, unless the taxpayer can show that the sale resulted from activities equivalent to door-to-door solicitation. But we all know that the world of product sales and marketing back in the

1950s, 60s and 70s is vastly different from what it is today in terms of promoting and/or soliciting a company's product to consumers or customers.

The issue really comes to a head when a company is advertising/promoting/soliciting its products directly to consumers online or over the internet through the use of such techniques as targeted marketing or a number of other customer outreach activities. House Bill 5 attempts to bring some clarity to the issue by setting out criteria for situsing to a municipality sales and rentals made and services performed, as follows:

- 718.02 D (1) Gross receipts from sales of TPP are sitused to the city in which the sale originated. A sale of property "originates" in a city if, regardless of where title passes, the property meets any of the following criteria:
- (a) The property is shipped or delivered within the city from a stock of goods located within the city;
 - (b) The property is delivered within the city from a location outside the city, provided the taxpayer is not regularly engaged in the solicitation or promotion of sales at the place where delivery is made;
 - (c) The property is shipped from a place within the city to purchasers outside the city, provided the taxpayer is not regularly engaged in the solicitation or promotion of sales at the place where delivery is made.

Although the bill does not attempt to define promotion or solicitation, it does remove the requirement in (c) that promotion or solicitation must occur "through the taxpayer's employees" before the sales comprised of the products that are shipped to a customer outside the city of origin must be "thrown back" into the numerator of the sales factor for purposes of calculating what is owed to the city of origin. At the policy level, however, there is a fundamental unfairness to a rule which basically says unless the taxpayer is specifically soliciting sales from its customer outside the city of origin, and especially so if the other city is a township where there is no municipal income tax, then those sales will have the effect of increasing the tax liability of the company to the city of origin. This is the major reason why the Ohio Chamber opposes the throwback rule and would prefer that it be abolished.

Net Operating Loss Carry-Forward Period

This issue has been the most thorny and problematic one related to HB 5. The Chamber and the Coalition acknowledge there could be revenue losses incurred by municipalities depending upon how many business taxpayers actually incur and deduct their NOLs, and depending as well upon the underlying assumptions for their revenue/loss estimates. This is particularly true of those municipalities who have an NOL carry-forward period of less than five years.

In recognition of those concerns, the Coalition has made several compromises on the issue. First, we offered to phase-in the impact of the new uniform five-year period over five years for new NOLs incurred beginning in tax year 2015 (now 2016) and made clear that NOLs incurred before 2015 would be allowed (or not) according to existing

rules. Second, we limited the deductibility of post-2015 NOLs by expressly saying such NOL deductions cannot exceed 50% of the full amount otherwise allowed. Third, we agreed to extending the phase-in period to six years, so that the full NOL deduction for taxpayers would not be fully in force until NOLs incurred in or beyond tax year 2022. Finally, we supported an NOL Review Committee that would evaluate and quantify the potential financial impact of the five-year carry-forward period authorized under the bill.

That is four compromises compared to the original proposal. As mentioned in Mr. Zaino's testimony in a broader context but no less applicable with regard to this issue, the Coalition has neither seen nor heard of any compromise coming from HB 5 opponents that would be uniform and therefore applicable to all cities. They have put forward a "status quo" concept that would allow a city to choose either a zero, one, three or five year NOL, which is virtually the same as current law.

The whole idea of the bill's uniform NOL period is to minimize the complexity and compliance burden on businesses operating in multiple cities. There are many companies including small businesses that make sales in a number of cities across the state, and the burden of keeping track of what percentage or how much of a previously-incurred NOL is deductible in a given year in a given city can be significant.

Conclusion

The passage of meaningful municipal tax reform and uniformity legislation is critical to Ohio businesses. Ohio undoubtedly has the most complicated local income tax system in the United States and is the only state in which municipalities have wide berth in making and administering their own tax rules and regulations. This lack of uniformity causes many employers to incur needless and expensive tax compliance and return preparation costs that are not imposed on businesses operating in any other state. House Bill 5 will lead to a vast improvement in Ohio's municipal tax structure, making it easier to do business in Ohio and improving our economic competitiveness.