

Appendix A: Major Ohio Taxes: How they Work

The **Individual Income Tax** was first authorized by an amendment to Ohio's constitution in 1912 but was not implemented until a recession in the early 1970s. By that time, some Ohio cities had used municipal income taxes for several decades. The income tax is the only part of Ohio's tax system that takes into account the ability of a person to pay. Its graduated rate structure means that those with the highest income pay a greater share of their income in tax. Like most states, Ohio uses adjusted gross income from the federal income tax return as the starting point for determining tax liability.

The tax rates treat an individual's income like layers of a cake. These layers are often referred to as brackets. Ohio's tax has nine brackets, with the highest rates taking effect on that portion of a household's income that exceeds \$200,000. Figure A-1 shows tax rates as they existed in 2008. Very few households, about 2.4 percent in 2007, paid the highest rate. The income tax also applies to individuals who live in other states but work in Ohio, and also to those who live in other states but receive profits from an Ohio business.

Taxpayers may qualify for certain credits that lower their yearly tax bill. The most common is

a \$20 credit for each individual in the household claimed on the tax return. Individuals with taxable incomes of \$10,000 or less receive a credit that removes all tax liability. Other frequently used credits are a joint filing return when both spouses have earned income over \$500, and a retirement income credit.

The individual exemption represents the amount of income that taxpayers can claim as exempt for themselves and for each of their dependents. The exemption amount is increased automatically to take inflation into account. In tax year 2002, the exemption was \$1,200, and it incrementally increased to \$1,500 in tax year 2008.

Example: 2008 Tax Rules Applied to a Family of Three

Figure A-2 shows a simplified example of how 2008 tax rules applied to a single mother with two children and a federal adjusted gross income of \$25,000. The family would have an Ohio taxable income of \$20,500 after applying personal and dependent deductions.³⁸ Her taxable income is subject to five different brackets. She would be liable for \$371 for the portion of her income up to \$20,000 and an additional \$18 for the \$500 of her income in the \$20,000 - \$40,000 bracket, for a

Figure A-1. Ohio's Graduated Income Tax Rate Structure in 2008

Ohio Taxable Income	Rate (%)	# of Tax Returns*
\$0-5,000	0.618	745,893
\$5,000-10,000	1.236	488,352
\$10,000-15,000	2.473	438,876
\$15,000-20,000	3.091	417,900
\$20,000-40,000	3.708	1,352,831
\$40,000-80,000	4.327	1,276,311
\$80,000-100,000	4.925	291,678
\$100,000-200,000	5.741	357,295
Over \$200,000	6.240	134,035

Source: Ohio Department of Taxation.³⁷

*2007 Tax Return Data. The \$0-\$5,000 category includes taxpayers with no taxable income.

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total of \$389 before credits. After applying three exemption credits of \$20 each, her final liability would be \$329, or about 1.32 percent of her federal adjusted gross income level of \$25,000.

Figure A-2. State Income Tax on Single Parent with Two Children, 2008

Federal Adjusted Gross Income	\$25,000
Personal exemption (1) and dependent deductions (2)	\$4,500
Ohio Taxable Income	\$20,500
Tax	\$389
Exemption credits (3 @ \$20)	\$60
Ohio Tax less exemption credit	\$329
Tax Liability as % of Fed. Adj. Gross Income	1.32%

Source: The Center for Community Solutions.

It is important to note that individuals who own their own businesses or a share of a partnership also pay the income tax on their net income, that is, what federal and state tax law treat as business profits after deducting allowable expenses such as salaries, rent, utilities, and mileage. The Ohio Department of Taxation estimates that businesses contribute roughly 10 percent of the state's total income tax receipts each year.³⁹

Sales & Use Taxes are levied at a 5.5 percent rate on most retail sales of tangible goods, with the purchase of food at grocery stores or take-out food from restaurants being the major exceptions. The legislature approved a sales tax of 3 percent in 1935 to counteract the revenue decline from the Great Depression. A constitutional amendment making an exception for food purchases was approved by voters in 1936. Counties and local transit authorities are permitted to adopt "add on" local taxes of up to 1.5 percent. Nearly half of Ohio's counties have reached their maximum limit of local sales taxes, putting the combined rate paid by residents at 7 percent. Cuyahoga County has an additional transit tax of 1 percent that brings its total combined rate to 7.75 percent.

A special "auto sales" tax at the same state rate of 5.75 percent applies to the sale of motor vehicles in Ohio. County add-on sales taxes also apply. The tax does not apply to cars that customers trade in to dealers when purchasing another car.

The sales tax has become less productive as the economy moves away from tangible products and toward consumption of services, many of which are not covered by the sales tax. Periodically the state has added more services, but large segments of the service economy, such as legal services, remain untaxed. In the most recent round of base broadening (2003), the list of purchases subject to sales tax expanded to include delivery charges, laundry and dry cleaning, personal care services (i.e. skin care, manicures, tattoos, massages, but not haircuts), and gym memberships.

Another long-term issue is the growing amount of sales on the Internet. When the seller is located in another state and does not have a physical presence in Ohio, the state cannot force the seller to collect sales taxes even though under law they are required to be paid. Ohio has joined with other states in a Streamlined Sales and Use Tax Agreement to harmonize their sales tax laws and encourage voluntary collections by on-line retailers. Eventually the consortium hopes to convince Congress to change federal law.

The **Commercial Activity Tax (CAT)** began in 2005 as a replacement for corporate franchise and tangible personal property taxes. The CAT applies to gross receipts from goods and services sold in Ohio. It is a privilege tax that all businesses must pay in order to conduct their trade in Ohio. The rate was phased in over five years and has now reached its full rate of 0.26 percent of gross receipts. Businesses with less than \$150,000 in gross receipts are exempt from payment; those with annual receipts between \$150,000 and \$1 million pay a flat fee of \$150.

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This shift to taxing business receipts for sales in Ohio, rather than equipment or income, is at the center of the 2005 tax changes. The CAT applies to most for-profit businesses in Ohio regardless of the type of business organization (i.e., partnerships, S corporations, trusts, and others).⁴⁰ Out-of-state businesses with taxable gross receipts in Ohio are subject to the tax if they have over \$500,000 in sales in the state.⁴¹

Legal Challenge to the CAT: The CAT survived a major court challenge from the food industry. In *Ohio Grocers Association v. Levin*, decided in September 2009, the Ohio Supreme Court upheld the tax's constitutionality. The suit alleged that the CAT violated the Ohio constitution's prohibition against applying an excise tax, such as the sales tax, to food consumed off the premises of the retailer. The grocers argued that the CAT, which is applied to a business' gross receipts, is an illegal excise tax on the sale of food at their stores. The state argued successfully that the CAT is a tax on the privilege of doing business in Ohio, and not an excise tax. The ruling will preserve approximately \$188 million dollars in annual revenue and means that the state will not have to repay \$355 million of previous years' tax collections. Even with this favorable decision, expected CAT collections of \$1.4 billion per year still do not match revenue levels of the two taxes it replaced. Replacing the local tangible personal property tax alone would require over \$1.6 billion per year, leaving the state with a \$400 million hole to fill with GRF funds. As things now stand, other programs have to be cut for the state to maintain its commitment to reimburse schools and local governments for their losses.

The Corporate Franchise Tax used to be Ohio's most important business tax. Previously, it applied to businesses organized as corporations but not to partnerships, sole proprietorships, or limited liability companies. Opponents of the tax argued that it had a high statutory rate that was detrimental to attracting business, but the

tax was nonetheless ineffective in raising revenue due to numerous loopholes. Others who wanted to keep the tax pointed out that some of the loopholes could have been closed and reporting requirements changed to prevent corporations from shifting income to other states to avoid Ohio taxes. During the five-year phase-out period, receipts from the tax consistently performed above expectations, indicating that the tax was more effective than many acknowledged.⁴²

As the result of the 2005 tax changes, the tax now applies only to financial corporations. Previously, non-financial corporations calculated their liability on both the net worth of the corporation and on the basis of net income, and paid whichever was higher. Financial corporations pay on the basis of net worth alone.

Tangible Personal Property Tax (repealed). The TPPT was a local tax on physical property used in business, which includes furniture, fixtures, machinery and equipment, and inventory. As part of the 2005 changes, the TPPT was phased out in tax years 2006 through 2009 for most businesses. TPPT revenue amounted to over \$1.6 billion per year distributed to local governments and schools.

Before its phase-out began, the TPPT was assessed on 25 percent of the value of machinery, equipment, furniture, and fixtures, and 23 percent of the value of inventories.⁴³ Local property tax millage rates were then applied to the assessed value. TPPT liability was phased out between tax year 2006 and tax year 2009. Telephone company tangible personal property tax will be eliminated in tax year 2011. Any new investments in manufacturing machinery or equipment made after July 1, 2005, were exempted from the TPPT.