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Tax Law Alert

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Ohio budget bill H.B. 64 proposes significant changes to tax structure

On Feb. 11, 2015, the biennial budget bill appropriating money for 2015 and 2016 was introduced in the Ohio House of Representatives. The bill incorporates Gov. Kasich's proposals, which were released earlier this month in his Blueprint for a New Ohio. Generally, if enacted in its current form, there would be an overall reduction in personal income tax, with an increase in sales tax, severance tax and commercial activity tax (CAT).

Sales Tax

If enacted, the state portion of the sales tax would increase from 5.75 percent to 6.25 percent. Further, the base of goods and services upon which sales tax can be charged would be expanded. As for goods, if implemented, car and watercraft dealers would be required to collect sales tax on a larger portion of the price if a trade-in is part of the transaction.

With respect to services, the following would also become subject to state sales tax for the first time:

- Cable service;
- Transactions in which bad debt is transferred;
- Travel services; and
- Services provided by the state or other governmental entity.

And importantly, sales tax would also be collected on the following services, "**regardless of the profession of the provider of the service,**" unless provided by an employee to his or her employer:

- Research and public opinion polling services, including broadcast media rating services, political opinion polling services, marketing analysis or research services, statistical sampling services and opinion research services, economic research and analysis, and sociological research and analysis;
- Public relations services, defined as "designing or implementing public relations campaigns designed to promote the interests and image of one or more clients;"
- Lobbying services, defined as an "activity that serves to influence the behavior or opinion of an individual, an industry or an organization;"
- Management consulting services, defined as an "activity that provides advice and assistance to businesses and other organizations on business issues" and includes a laundry list of activities which could qualify, such as "financial planning

and budgeting, equity and asset management, records management, office planning, strategic and organizational planning, site selection, new business startup, business process improvement, human resource management, marketing issues and planning, new product development, pricing strategies, licensing and franchise planning, manufacturing operations improvement, productivity improvement, production planning and control, quality assurance and control, inventory management, distribution and warehouse operations, materials management and handling, telecommunications management and utilities management;"

- Parking of a motor vehicle;
- Debt collection services; and
- Repossession services.

Along with these increases, the deduction available to vendors for their collection of the sales tax for the government would be capped at $1,000.

The changes to the sales tax included in H.B. 64 are significant due to the broad language used. If enacted, the bill poses potentially large problems for professional service providers such as accountants and attorneys because the language "regardless of the profession of the provider of the service" would expand the application of the sales tax to cover portions of services these groups provide. For example, some attorneys and accountants provide debt collection services, which would be subject to sales tax under this language.

Without knowing the intent behind the inclusion of this broad language, it is impossible to know to what extent the sales tax would apply to services. First, the language could be viewed to mean what it says, that the sales tax will apply to only those attorneys, accountants, and other professionals who specifically provide the enumerated services, like an attorney who acts as a debt collector. In this way, the broad language would simply be a tool to ensure uniform enforcement of the sales tax, regardless of the occupation of the service provider.

Alternatively, the addition of this expansive language could be a way for Gov. Kasich to implement the taxing scheme that he failed push through the legislature in 2013. Under his last budget proposal, legal and accounting services would have been explicitly subjected to sales tax, through a provision which directly named the services for taxation. The provision created an uproar and was struck down by the legislature. This new vague language could be a way for the governor to avoid drawing as much direct opposition to his controversial sales tax initiative. Furthering this idea, the general language could also be used to give the Department of Taxation license to create explicit regulations broadly imposing sales tax on accounting and lawyering services, without requiring debate amongst the legislators.

Regardless of the intent, if enacted as written, H.B. 64 could open the door for the collection of sales tax on some portion of accounting and legal services. As applied, this practice would create a significant number of problems. First and foremost, enforcement of the provision would intrude on attorney-client privilege because enforcement would necessarily include investigation as to what kind of advice was provided by an attorney to their client. In addition, the classification of attorney-provided advice as "business" advice is problematic. Ethically, attorneys are required to advise clients as to what they are entitled to do under the law — provide "legal" advice—not necessarily provide advice as to which option would be best from a business standpoint. Therefore, would classification of legal services as "consulting services" for sales tax purposes place an attorney at risk of malpractice? This proposal could be a nightmare to apply, for businesses, as well as for the Department of Taxation.

Income tax

Personal income taxes would be reduced, with particular reductions for low income individuals and small business owners. First, the income tax rates would be reduced by just under 30 percent by 2016, with the highest tax bracket being taxed at 4.533 percent in 2015 and 4.106 percent in 2016, down from 5.333 percent in 2014. Further, small business owners could deduct the following:

- All Ohio small business income from businesses with gross receipts not exceeding $2 million; and
- One half of all Ohio small business income from each business that has gross receipts over $2 million, capped at an aggregate total of $62,500 for spouses filing separately or $125,000 for all other individuals.

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Under the bill, "Ohio small business income" would mean income, attributable to Ohio, which is reportable as business income on an individual's tax return. "Business income" would mean income arising out of activities in the regular course of a trade or business. In practice, the deductions would apply to income produced by a sole proprietorship, partnership, or S corporation.

Additionally, for lower income individuals, the amount for personal exemptions would be increased as follows:

- From $2,200 to $4,000 for each of the taxpayer and any dependent, where the taxpayer's income on an individual or joint return is less than $40,000; and
- From $1,950 to $2, 850 for each of the taxpayer and any dependent, where the taxpayer's income on an individual or joint return is between $40,000 and $80,000.

Severance Tax

The structure of the severance tax would be altered to incorporate an average price—the spot price—into the calculation of tax owed for extraction of natural resources horizontal drilling techniques. In the bill, a "horizontal well" is defined as "a well that is drilled for the production of oil or gas in which the wellbore reaches a horizontal or near horizontal position in the Point Pleasant, Utica, or Marcellus formation and the well is stimulated." The new severance tax formula for those horizontal wells would be as follows:

Total Volume Extracted x "Average Quarterly Spot Price" x Percent Tax (See Chart Below)

Here, the "average quarterly spot price" is equal to the average closing price of the natural resource set to be taxed, for the calendar quarter starting six months prior to the current quarter. For ease of calculation, the spot price would be posted by the tax commissioner at the end of the first month of each new quarter. The percentage of tax charged for natural resources extracted would be as follows:

Severance Tax Rates for Horizontal Wells (By Natural Resource)		
Gas	Processed	4.5%
	Unprocessed	6.5%
Oil		6.5%
Condensate		6.5%
Natural Gas Liquids		6.5%

For all other wells, the severance taxes would be as follows:

- Oil - $0.20 per barrel
- Gas - $0.03 per thousand cubic feet

In addition, wells other than horizontal wells would be exempt from the severance tax altogether if they produced less than 910,000 cubic feet per quarter or 3,640,000 cubic feet a year.

Commercial Activity Tax

The most important change to the CAT is the proposed tax rate increase from 0.26 percent to 0.32 percent per dollar on gross receipts over $1 million. Additionally, the tax owed on the first $1 million for businesses whose gross receipts were less than $2 million would be reduced to $150. Currently, businesses whose gross receipts are between $1 million and $2 million pay a flat rate tax of $800 on their first million dollars of income.

H.B. 64 proposed a substantial number of changes to the state's tax structure. This article is not a complete discussion of all changes.

For more information, please contact Mark Snider, Abbigail Brothers or any member of Porter Wright's Tax and Personal Wealth Practice Group.