

Ohio's New CAT

Faith Williams and Mark Engel¹
Bricker & Eckler, LLP

Introduction

In July 2005, Ohio adopted a new system of business taxation. The previous tax structure, adopted decades ago, perhaps was appropriate for Ohio's old manufacturing economy. But the State's outdated tax climate was one of several factors that have made it difficult for Ohio to retain employers, and to attract "new economy" businesses.

The state's biennial budget bill, signed into law on June 30, 2005, includes the most comprehensive reform of Ohio's taxes in 50 years.¹ The new business tax structure eliminates the tangible personal property tax and, for most businesses, phases out the corporation franchise tax. A new tax -- the Commercial Activity Tax (CAT) -- is now imposed on most corporations, sole proprietorships, partnerships and other pass-through entities having \$150,000 or more in Ohio taxable gross receipts in a calendar year.

The state and taxpayers are working to interpret provisions of the new law, and to determine how to implement it. As expected, there are many "details" still under discussion between the business community and the Ohio Department of Taxation. Administrative rules and other guidance are still under development.² This article provides a summary of the statutory provisions as we understand them.

Insurance companies and financial institutions are not subject to the Commercial Activities Tax. The new tax law, however, may affect insurance holding companies and non-insurance affiliates. And everyone doing business in Ohio should understand the structure of the CAT and other key provisions of the new tax system. This article first outlines provisions governing the CAT, then provides more detailed information about how the new tax law affects insurance companies and their affiliates.

The CAT

The Commercial Activity Tax is an annual tax imposed upon the privilege of doing business in Ohio. The CAT is a type of gross receipts tax, and is imposed at a rate of .0026 on the taxable gross receipts of virtually all commercial activity in Ohio.³

"Gross receipts" is broadly defined to include the total amount realized, without any deduction, in a transaction or transactions that contribute to the production of gross income, including the fair market value of any property and any services received, and any debt transferred or forgiven as consideration. Among the excluded receipts are interest, except interest received as part of a credit sale, dividends and distributions received, capital gains, capital contributions to retirement plans and charitable institutions, and compensation, including deferred amounts, paid to employees.⁴

Gross receipts are calculated on the same basis that the taxpayer uses for federal income tax purposes. Allowances are made for cash discounts taken, returns, bad debts, and amounts received from the sale of a receivable to the extent the receipts from the underlying transaction were included in the taxpayer's gross receipts.

"Taxable gross receipts" means those gross receipts allocated to Ohio. Receipts from the sale of tangible personal property delivered to customers in Ohio, and receipts from the sale of services in proportion to the extent that the benefit of the service is received in Ohio, are all allocated to Ohio.

Receipts from property that is brought into Ohio, and then removed from Ohio to another location, are not considered Ohio receipts. So, for example, a third party administrator doing business in Ohio will not be subject to the CAT based on monies transferred by a customer for the purpose of paying claims. Receipts

from the right to use intellectual property, such as copyrights, patents, and trademarks, are allocated to Ohio to the extent the receipts are based on the extent of the use of the property in Ohio, or to the extent the receipts are based on the right to use the property in Ohio. Receipts from services are in Ohio to the extent the benefit of the service is received in Ohio. The place where the purchaser ultimately uses or receives the service determines the portion of the benefit received in Ohio.⁵

Taxpayers: Insurers are "Excluded Persons"

“Taxpayers” are all persons who are required to file returns or pay the CAT. “Person” is broadly defined to include individuals, joint ventures, corporations, pass-through entities, and disregarded entities.⁶

Insurance companies, financial institutions, dealers in intangibles, and public utilities are all subject to separate tax structures established under Ohio law. As such, they are considered “excluded persons” for purposes of the CAT.⁷ The premium tax paid by insurance companies, as well as the separate tax structures applicable to these other "excluded persons", have not changed; there were no revisions to Ohio's insurance premium tax structure or rate.⁸

As discussed below, however, it is possible that insurance companies and their affiliates must register under the CAT. Additionally, insurance holding companies may file as a "consolidated elected taxpayer."

Insurance Companies. An insurance company is any person engaged in the business of insurance of any character, engaging in the business of entering into contracts substantially amounting to insurance, or indemnifying or guaranteeing against loss or damage or acting as a surety.⁹ Only an insurance company that actually pays the premium tax is excused from the CAT; otherwise, the company is required to pay the CAT on its gross receipts.

Insurance holding companies are not excluded from the CAT. However, interest, dividends and distributions, and capital gains are generally excluded receipts under the CAT and will not be taxed to the insurance holding company.

Dealers in Intangibles. A “dealer in intangibles” is every person who keeps a place of business in Ohio and engages in a business that consists primarily of lending money, or discounting, buying, or selling bills of exchange, drafts, acceptances, notes, mortgages, or other evidences of indebtedness, or in buying or selling investment securities.¹⁰ Thus, a person who engages in any of these activities, but who does not maintain a place of business in Ohio, is not a dealer in intangibles. In addition, financial institutions are not dealers in intangibles.

Dealers in intangibles are required to file special tax returns and to pay the special tax imposed under Revised Code Chapter 5725. Only a dealer that actually pays the dealers in intangibles tax is excused from the CAT; otherwise, the person is required to pay the CAT on its gross receipts.¹¹

Financial Institution. A “financial institution” includes (i) a national bank, federal savings association or bank, branch of a foreign depository, small business investment company, or chartered farm credit company, all as defined or chartered under federal law; or (ii) a banking institution organized under the laws of any state.¹² If a person is a financial institution, it cannot be a dealer in intangibles. Financial institutions remain subject to the franchise tax based upon their net worth.¹³ A financial institution that actually pays the franchise tax is excused from the CAT.

Bank, financial, and savings and loan holding companies are also excluded persons and are not subject to the CAT.

Subsidiaries. Persons that are 50% or more owned by a financial institution, and whose activities are limited to those permitted for a financial holding company under federal law, are also excluded from the CAT.¹⁴

The new law also was intended to provide that a person that is 50% or more owned by an insurance company that is authorized to do the business of insurance in Ohio is excluded from the CAT. These subsidiaries were to continue to be taxed under the corporation franchise tax. However, there is some indication that the Ohio Department of Taxation is concerned about this provision, and may interpret it to exclude only certain types of subsidiaries. Discussions are underway to clarify this issue.

Combined Filing under the CAT. Under the CAT, there is mandatory combined reporting for two or more entities having at least 50% of the value of their ownership interests owned or controlled, directly or constructively through related interests, by common owners.¹⁵ Alternatively, a group of two or more persons may elect to be treated as a “consolidated elected taxpayer”.¹⁶ If consolidated elected taxpayer status is elected, all persons meeting the ownership requirements must be included, whether or not they have nexus with Ohio. The consolidated elected taxpayer may elect whether to include foreign corporations that meet the ownership requirements, but the election applies to all such corporations. In addition, the group can elect to include all entities meeting either the 50% or more, or the 80% or more, ownership threshold. Receipts from all transactions made among members of the group are eliminated, including members that are not subject to the CAT. The entity is treated as a single taxpayer and members have joint and several liability for the tax; the election applies for eight quarters and there is automatic renewal unless the persons opt-out.

Dealers, insurance companies, and financial institutions that are excluded from the CAT must still be included in a consolidated elected taxpayer that is elected by a related entity subject to the CAT, provided the 50% ownership requirement is met. All receipts from transactions between the members of the group are excluded, as are receipts from third parties that are received by financial institutions, insurance companies, and “qualifying dealers in intangibles.” A “qualifying dealer in intangibles” is one that is a member of a consolidated group that includes a financial institution or an insurance company. Thus, if a dealer is a member of a consolidated elected taxpayer and no financial institution or insurance company is a member of the group, the receipts of the dealer are included in the tax base of the consolidated elected taxpayer.

All groups of taxpayers that meet these ownership requirements, but that do not elect to be consolidated elected taxpayers, must file as “combined taxpayers.” Of particular importance to many insurance holding companies, “combined taxpayers” cannot eliminate receipts from transactions between members of the group. In other words, the group would be subject to tax on so-called “intercompany transfers.” There are two other significant differences between combined taxpayers and “consolidated elected taxpayers”. For combined taxpayers, persons without nexus in Ohio need not be included; and the combination is not limited to eight quarters.

For both “combined taxpayers” and “consolidated elected taxpayers”, the group is treated as a single taxpayer and files a single return. Since the group is treated as a single taxpayer, there is a single \$1 million exclusion for the entire group. As new persons or taxpayers meet the ownership requirement, they must be added; as existing persons or members fall below the threshold, they are eliminated and must file on an independent basis.

A provision calling for “bright line presence” is contained in the bill. A taxpayer has “bright line presence” in Ohio if it (i) has property in Ohio with an aggregate value of at least \$50,000; (ii) has payroll in Ohio of at least \$50,000; (iii) has taxable gross receipts of at least \$500,000; (iv) has at least 25% of its total property, payroll or sales in Ohio; or (v) is domiciled in Ohio. Challenges to the validity of this provision may be taken directly to the state supreme court.

Reporting and Paying the CAT. All persons must register by the later of November 15, 2005, or within 30 days after having receipts in excess of \$150,000 in a calendar year.¹⁷ No person may engage in business in Ohio without registering. If a taxpayer fails to pay the CAT, the attorney general may seek proceedings in quo warranto to suspend the taxpayer's right to engage in business, similar to existing franchise tax law procedures.¹⁸

Credits. Limited credits are available against the CAT. These include the jobs creation tax credit and the jobs retention tax credit.¹⁹ In addition, the Jobs Creation Tax Credit, previously unavailable to insurance companies, has been extended to insurers.²⁰ The credit may be taken against the premium tax.

Penalties. Numerous penalties that may be abated by the tax commissioner are imposed:

- Failure to timely pay or file returns: Greater of \$50 or 10% of the tax.
- For deficiencies: Up to 15% of the deficiency.
- Failure to register within 60 days of notification: Up to 35% of tax due.

In addition, there is a penalty if the taxpayer fails to pay the tax electronically. The penalty is 5% of tax due during the first two quarters after notification, and 10% thereafter.²¹

Audits. There is a four-year statute of limitations. Refunds may be set-off by other liabilities owed to the state, and may be applied against future liability in lieu of a cash refund.

Audits may be conducted using samples; the consent of the taxpayer is not required.²² However, sampling procedures must be established by administrative rule. Pre-assessment interest is imposed on all deficiencies, and additional interest accrues if payment is not made within 60 days of the assessment. Protest proceedings are identical to those for other taxes. The tax commissioner may prescribe the documents and records that must be maintained in order to assure compliance with the tax. While information is generally confidential, the tax commissioner may publish electronically a list of the names, business names, addresses, and account numbers for all taxpayers.

Successor Liability. If a person sells at least 75% of its business, or quits business, any tax is due within 15 days. The person purchasing the business must withhold an amount from the purchase price unless the purchaser obtains a receipt from the tax commissioner that all taxes are paid. If the purchaser fails to withhold from the price, the purchaser is personally liable for the tax. There is no provision for personal liability for officers, owners, or parties responsible for filing returns or paying the tax.

Other Tax Changes

In addition to imposing the CAT, H.B. 66 made other changes to Ohio's tax laws.

Real Property Tax. The 10% roll back in real property taxes for most commercial and industrial property was eliminated. Property that is (i) owned or leased and used for farming; (ii) improved with one-, two-, or three-family dwellings; or (iii) vacant land determined by the county auditor to be held for one of these specified purposes, remains eligible for the roll-back. This change is effective with the 2005 tax year and will be reflected on bills paid in 2006.

Personal Income Tax. The trust tax was made permanent. In addition, beginning in tax year 2006, personal income tax rates are reduced 4.2% per year for five years, until the top marginal bracket is reduced to 5.95% in 2010.²³

Tax Amnesty. A tax amnesty for sales, use, corporation franchise, personal and school district income, and personal property taxes unpaid as of May 15, 2005, was established. The amnesty period will run from January 1, 2006 through February 15, 2006. During that period, taxpayers may pay any tax and one-half the

interest that is otherwise due in satisfaction of unpaid or unreported tax liability. Amnesty is limited to those taxpayers who have not previously been contacted by the department about the liability or an audit.²⁴

Conclusion

The legislation enacted in Ohio in 2005 made sweeping changes to the state's tax structure for businesses. While insurance companies are not directly affected by the imposition of the new Commercial Activity Tax, there are implications for insurance holding companies and non-insurance subsidiaries. The ramifications of the new business tax will not be known for some time.

¹ Mark Engel, Esq. is a partner in the firm of Bricker & Eckler, LLP, and assisted in the preparation of this article.

² The tax changes addressed in this article were enacted in Ohio House Bill 66. Most of the provisions of the Commercial Activity Tax are codified in Ohio Rev. Code 5751.

³ Current information regarding interpretation and enforcement of Ohio's Commercial Activities Tax can be found at www.tax.ohio.gov.

⁴ Ohio Rev. Code Sec. 5751.03 (2005).

⁵ Ohio Rev. Code Sec. 5751.02 (2005).

⁶ The siting of gross receipts is addressed in Ohio Rev. Code Sec. 5751.033 (2005).

⁷ Ohio Rev. Code Sec. 5751.01(A) (2005).

⁸ Ohio Rev. Code Sec. 5751.01(E) (2005).

⁹ See Ohio Rev. Code Secs. 5725 and 5729.

¹⁰ Ohio Rev. Code Sec. 5725.01 (2005).

¹¹ *Id.*

¹² Ohio Rev. Code 5751(E)(4) (2005).

¹³ Ohio Rev. Code Sec. 5751.01(E)(3) (2005).

¹⁴ See Ohio Rev. Code Sec. 5733 (2005).

¹⁵ Ohio Rev. Code Sec. 5751.01(E)(8) (2005).

¹⁶ Ohio Rev. Code Sec. 5751.012 (2005).

¹⁷ See Ohio Rev. Code Sec. 5751.011 (2005).

¹⁸ Ohio Rev. Code Sec. 5751.04 (2005).

¹⁹Ohio Rev. Code Sec. 5751.11 (2005).

²⁰ Ohio Rev. Code Sec. 5751.50 (2005).

²¹ *See* Ohio Rev. Code Secs. 122.17, 5725.32 and 5729.032 (2005).

²² Ohio Rev. Code Sec. 5751.06 (2005).

²³ Ohio Rev. Code Sec. 5751.09 (2005).

²⁴ Ohio Rev. Code Sec. 5747.02 (2005).

²⁵ Additional information about Ohio's 2005 – 2006 tax amnesty program can be found at www.tax.ohio.gov/amnesty.