Bill Analysis

Peter A. Cooper Legislative Service Commission

S.B. 261*

124th General Assembly
(As Introduced)

Sen. Carnes

BILL SUMMARY

- Increases the tax on cigarettes from 24¢ per pack of 20 to 74¢.
- Permits cigarette tax stamps to be purchased on credit throughout the year.
- Defers the corporation franchise tax and personal income tax benefits that otherwise would result from the accelerated depreciation deduction recently enacted by Congress.
- Eliminates statutory language requiring a portion of foreign source dividends received by a corporation to be included in the corporation's franchise tax base measurement.

CONTENT AND OPERATION

Cigarette tax increase

(R.C. 5743.02, 5743.023, 5743.322, and 5743.32; Section 3)

The state imposes taxes on cigarettes at the rate of 1.2¢ per cigarette (12 mills), which is equivalent to 24¢ per pack of 20 cigarettes. The taxes consist of two levies, one at the rate of 1.1¢ and another at the rate of 0.1¢. Revenue from both taxes is paid into the General Revenue Fund. The taxes are payable by wholesale and retail dealers, generally by the purchase of tax stamps that must be affixed to cigarette packages. (Two "use" taxes also are levied at the same rates

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* *This analysis does not address appropriations, fund transfers, and similar provisions. See the Legislative Service Commission's Fiscal Note for S.B. 261 for an analysis of such provisions.*

on cigarettes purchased by consumers and on which a dealer has not yet paid the Ohio tax.)

The bill increases the total tax to 3.7¢ per cigarette, or 74¢ per pack of 20 cigarettes. The bill also combines both existing levies into a single levy. The use tax levies also are increased by the same amount and combined into a single levy.

The increased rate applies immediately when the bill becomes law, and applies to cigarettes on hand (i.e., in a dealer's inventory or not yet sold) on the effective date of the increase. In order for the increase to be collected for "on hand" cigarette stocks, the bill requires dealers to report the number on hand when the increase takes effect and pay the additional tax on those cigarettes. The report and payment is due June 20, 2002, or 20 days after the increase takes effect, whichever is later. Dealers also must pay the increase for stamps they previously purchased but have not yet affixed to packages. A penalty of $1 is imposed for each day a dealer is late in paying the increase for on hand cigarettes and not-yet-used stamps. The state may enforce payment of the additional "on hand" tax (and the penalty, if it applies) by assessment.

The bill affects only the rate of the state tax on cigarettes; it does not affect the rate at which counties are permitted to tax cigarettes, or the rate of the tax on tobacco products other than cigarettes.

Purchasing cigarette tax stamps on credit

(R.C. 5743.05)

Under ongoing law, cigarette dealers must pay the cigarette tax primarily through purchasing tax stamps from the state. They may purchase stamps on credit if they file a bond with the state to secure eventual payment; payment is due within 30 days after the stamps are delivered. However, stamps currently may not be purchased on credit during the last two months of a fiscal year (specifically, between May 2 and June 30).

The bill permits stamps to be purchased on credit during the last two months of a fiscal year, just as they may during the rest of the year.

Suspension of accelerated depreciation deduction

(R.C. 5733.04, 5733.043, 5733.045, 5733.05, 5747.01, and 5747.011; Section 4)

The bill modifies the corporation franchise tax computation in a manner that, in effect, defers the Ohio tax benefits resulting from the accelerated depreciation deduction permitted by recent changes in federal tax law. Instead of the entire benefit being claimed immediately, it is spread out over six years. The bill does not entirely eliminate the Ohio tax benefits from the federal acceleration; taxpayers still recover their costs more quickly than under the conventional depreciation schedules.

Federal law permitting accelerated depreciation

Recent federal legislation permits businesses, in computing federal income tax, to claim a larger share of their depreciation deduction earlier than under conventional depreciation schedules.[1] Specifically, the legislation permits businesses to immediately deduct 30% of the cost of qualifying business or income-producing property in the year it is acquired; this 30% is in addition to the first-year depreciation allowed under the conventional depreciation schedules (which, in the case of most tangible personal property, ranges from 3.75% of cost to 33.33%, depending on the property's cost recovery period and the depreciation convention used).[2] The conventional depreciation schedules apply to the remaining 70% of the cost. The accelerated depreciation deduction allows businesses to recover the cost of their property acquisitions more quickly by moving an additional 30% of the cost recovery into the first year; it does not change the amount of depreciation deducted over the property's recovery period.

To qualify for this additional, "bonus" depreciation deduction, property generally must be acquired between September 11, 2002, and September 10, 2004.[3] The bonus depreciation deduction is (arguably) incorporated into the computation of the Ohio corporation franchise tax and personal income tax once the pertinent Ohio statutes are next amended, except to the extent the statute is amended to offset or modify the effects of the change in federal law.

Add-back of accelerated depreciation

(R.C. 5733.04(I)(17) and 5747.011(A) and (B))

The bill requires corporations subject to the franchise tax, and individual business owners subject to the personal income tax, to add back 5/6 of the additional bonus depreciation when it is claimed for federal tax purposes.[4] In

[1] Section 101 of the Job Creation and Worker Assistance Act of 2002, Pub. Law No. 107-147, 26 U.S.C. 168(k).

[2] If the property qualifies for the Section 179 expensing deduction, the 30% depreciation deduction applies to the balance remaining after the expensing deduction.

[3] Special rules apply to determine the acquisition date for some kinds of property.

[4] That is, an individual who owns a business as a sole proprietor, or through a "pass-through" entity such as a partnership, S corporation, or limited liability company. The bill does not affect estates subject to the income tax.

effect, taxpayers are permitted to deduct only 1/6 of the federal depreciation bonus claimed in the year property is acquired. In each of the five succeeding years, 1/6 of the bonus deduction is allowed in addition to the depreciation allowed under the conventional schedules. By the sixth year, the bonus depreciation amount is entirely recovered. (In the case of corporations, the amount of the deduction for any year is subject to adjustment in order to account for the actual effect of the add-back and deduction on the corporation's tax; this is described below under "***Adjustment in corporation's deduction***.")

The add-back does not affect the adjusted basis of the property. (Property's adjusted basis is the property's cost that, at a given time, has not yet been recovered through depreciation.)

Example

To illustrate how the bill operates, consider a taxpayer acquiring depreciable property in 2002 at a cost of $100,000. Assume that the applicable recovery period for the property is ten years; the taxpayer does not apply Section 179 expensing; and the taxpayer uses the MACRS mid-year convention. As shown below, the taxpayer must adjust its income in the first year by adding back $25,000 of the $30,000 bonus, and then adjust its income in the next five years by deducting $5,000 each year until the add-back is recovered.

Effect of depreciation add-back

Year	Deduction before bill's adjustment (annual/cumulative)	Deduction after bill's adjustment (annual/cumulative)	Difference (cumulative)
2002	$37,000	$12,000	($25,000)
2003	12,600/49,600	17,600/29,600	(20,000)
2004	10,080/59,680	15,080/44,680	(15,000)
2005	8,064/67,744	13,064/57,744	(10,000)
2006	6,454/74,198	11,454/69,198	(5,000)
2007	5,159/79,357	10,159/79,357	0
2008	4,585/83,942	4,585/83,942	0
2009	4,585/88,527	4,585/88,527	0
2010	4,592/93,119	4,592/93,119	0
2011	4,585/97,704	4,585/97,704	0
2012	2,296/100,000	2,296/100,000	0

Adjustments in corporation's deduction

(R.C. 5733.043)

In the case of a corporation subject to the franchise tax, the 1/5 deduction claimed during the five-year period is adjusted to account for the actual effect the deduction has on the corporation's tax liability. For example, a net worth-basis corporation does not make a recovery deduction in any year that its Ohio net income (disregarding the deduction) is greater than zero.[5] If the deduction would cause the corporation's Ohio net income to become negative, then the corporation is entitled to deduct the amount by which the Ohio net income is less than zero. In the case of a net income-basis corporation whose tax basis is not affected by the deduction, it is permitted to deduct the entire 1/5 of its depreciation bonus. If the corporation's tax basis would be affected by the deduction, causing it to be a net worth-basis taxpayer, then the deduction is adjusted to the extent required to cause its tax computed on the basis of net worth to equal its tax computed on the basis of net income.

In computing the available five-year deduction, the net income of a corporation filing a combined franchise tax report with commonly owned or controlled affiliates must reflect the combined income.

Allocating, apportioning the add-back and five-year deduction

(R.C. 5733.04(I)(17)(c), 5733.043(C)(2), 5733.045(B)(1)(b), and 5747.011(B)(3), (C)(2), and (D)(1)(b))

If a corporation's depreciated property is of a kind that income arising from it is allocable to Ohio to some extent for tax purposes, then the amount added back must be allocated to Ohio to the same extent; otherwise, it is apportioned. Accordingly, the five-year deduction must be made from a corporation's allocable income if income arising from the property is allocable. (Under the franchise tax law, income from a corporation with interstate operations is either allocated to a state or apportioned among the states where the corporation operates, depending on the nature and source of the income. Generally, capital gains and rents arising from property located or used in Ohio are allocable entirely to Ohio; dividends paid by a person with physical assets in Ohio are allocable at least in part to Ohio; and certain intangible income arising from activities in Ohio are allocable at least in part to Ohio. Other income is apportioned among all of the states where the company operates in proportion to its business presence in those states.)

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[5] *A corporation's franchise tax is computed on the basis of its net worth or its net income; the corporation's tax is charged on the basis that yields the greater tax amount.*

Similarly, the add-back of the depreciation bonus passed through to individual owners of a pass-through entity is allocable if income from the depreciated property is allocable as nonbusiness income, and apportionable as business income if income from the property is apportionable as business income. The five-year deduction must be made from nonbusiness income if income arising from the property is nonbusiness income. (Under the personal income tax, nonbusiness income is allocated, and business income is apportioned, for the purpose of computing the nonresident tax credit and the amount of a nonresident owner's pass-through income that is subject to Ohio income tax.)

Pass-through entity owners

(R.C. 5733(I)(17)(a) and 5747.011(B)(1))

In the case of a corporation that is a partner in a partnership or that owns a share of another kind of pass-through entity, the corporation must add back 5/6ths of the corporation's share of the bonus depreciation deduction passed through the entity to the corporation. In the case of an individual who owns a share of a pass-through entity, the add-back applies notwithstanding an existing requirement that individuals account for their entire passed-through share of income items (i.e., their entire share of the federal bonus depreciation) for the purpose of computing the nonresident credit and the amount of a nonresident owner's pass-through income that is subject to Ohio income tax.

Early disposal of property

(R.C. 5733.045 and 5747.011(D))

The bill permits a taxpayer to recover the entire add-back if the taxpayer sells, trades, or otherwise disposes of the property before the add-back is completely recovered and if the disposition results in a gain or loss that is recognized for tax purposes. The recovery is made by deducting the amount not yet recovered from the taxpayer's net income apportioned or allocated to Ohio (i.e., apportioned or allocated depending on whether income arising from the property is apportionable or allocable). In terms of the example above, if the taxpayer sold the property at the end of the third year and recognized a gain or loss, the taxpayer may deduct the remaining $10,000. However, if the recognized gain is less than the realized gain, then the amount recovered in the year the disposition occurs is reduced in the same proportion that the realized gain exceeds the recognized gain; the taxpayer may continue to deduct the remaining unrecovered amount over the rest of the five-year period.

Election for closed taxable years

(Section 4)

If a corporation's taxable year ends in 2002 but before the bill's effective date, it may elect to apply the add-back (and the related five-year deduction to recover the add-back) to its tax year 2003 tax report. The election is revocable as long as the revocation is made before the 91st day after the applicable statute of limitation on refunds and assessments.

Removal of unconstitutional franchise tax base adjustment

(R.C. 5733.04(I)(2))

The bill modifies the statutory language governing a deduction from the net income-based measure of the corporation franchise tax. The modification reflects a 2000 Ohio Supreme Court decision that invalidated the language insofar as the language did not permit corporations to fully deduct dividends they receive from a foreign (non-U.S.) affiliate. (*Emerson Electric v. Tracy* (2000), 90 Ohio St.3d 157.) Before the Court decision, corporations were permitted to deduct, among other foreign-source income items, dividends received from a related corporation having little or no business presence in the United States. But, by statute, corporations could deduct only 85% of such dividends in computing the net income tax base. The Court held that, by denying the deduction for 100% of such foreign-source dividends, the statute violated the Foreign Commerce Clause of the United States Constitution.

The bill makes the statutory language consistent with the Court's decision.

HISTORY

ACTION	DATE	JOURNAL ENTRY
Introduced	04-25-02	p. 1733

S0261-I.124/jc