Fiscal Note & Local Impact Statement

126 th General Assembly of Ohio

Ohio Legislative Service Commission
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BILL: **Sub. H.B. 73** DATE: **December 14, 2006**

STATUS: **As Enacted – Effective April 4, 2007** SPONSOR: **Rep. Trakas**

LOCAL IMPACT STATEMENT REQUIRED: **Yes**

CONTENTS: **Establishes a new income tax domicile test; exempts active-duty military pay and allowances from the state income tax**

State Fiscal Highlights

STATE FUND	FY 2007	FY 2008	FUTURE YEARS
General Revenue Fund			
Revenues	Potential loss	Potential loss of several millions	Potential loss of several millions
Expenditures	- 0 -	- 0 -	- 0 -

Note: The state fiscal year is July 1 through June 30. For example, FY 2006 is July 1, 2005 – June 30, 2006.

- The bill changes the residency test for income tax purposes and reduces the income tax base. The reduction in tax base decreases receipts from the tax. The bill generally restores the statutory test for residency that existed until 1993, when the General Assembly enacted the contact period test in S.B. 123 of the 120th General Assembly. Revenues from the income tax are distributed to the General Revenue Fund and to several local government funds. The General Revenue Fund receives 89.5% of receipts from the state individual income tax. Thus, the reduction in the income tax base reduces revenues to the GRF.

- The income tax exemption for active-duty military pay and allowances reduces the state income tax base, thus reducing state income tax revenue. The GRF will bear at least $4.0 million in losses from the exemption. The revenue loss depends on the number of active duty military personnel taking the exemption and their pay.

- The local government funds freeze for FYs 2006 and 2007 would result in the GRF experiencing the full revenue loss in FY 2007. In subsequent years, the revenue loss would be shared by the GRF and the local government funds according to the Revised Code distribution of income tax receipts.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2006	FY 2007	FUTURE YEARS
Counties, Municipalities, and Townships (LGF, LGRAF, LLGSF), Municipal Income Taxes, and School District Income Taxes			
Revenues	Potential loss	Potential loss	Potential loss
Expenditures	- 0 -	- 0 -	- 0 -

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- Under the state formulas for the distribution of income tax revenues, the reduction in personal income tax revenues would reduce distributions to the Local Government Fund (LGF), the Local Government Revenue Assistance Fund (LGRAF), and the Library and Local Government Support Fund (LLGSF).

- The military pay income tax exemption reduces state income tax revenues. The revenue loss depends on the number of active duty military personnel taking the exemption and their pay. The local government funds freeze for FYs 2006 and 2007 would result in no revenue loss to the local government funds in FY 2007. In subsequent years the revenue loss would be shared by the GRF, the LLGSF, the LGF, and the LGRAF according to the Revised Code distribution of income tax receipts. The revenue loss from the military pay exemption will be at least $425,000 per year starting in FY 2008.

- Changes in the residency test may also reduce school district income tax revenues because the bill reclassifies certain residents as nonresidents for Ohio income tax purposes.

- School district income tax revenues would also be reduced due to a reduction in the tax base from the military pay exemption. The revenue loss for school districts from the military pay exemption may be $114,000 or more per year. The revenue loss depends on the number of active duty military personnel taking the exemption, their pay, and their distribution among school districts.

Detailed Fiscal Analysis

Changes to the residency (domicile) test for income tax purposes

The bill changes the residency test for income tax purposes. Under current law, the "bright line" test for residency in Ohio is 120 contact days plus up to 30 days for "medical hardship" (such as for days a person is admitted into a hospital in this state). The bill restores the statutory test for residency that existed until 1993 (when the General Assembly enacted the contact period test in S.B. 123 of the 120th General Assembly) and eliminates the "medical hardship" days. The bill proposes a "bright line" of at least 183 days in Ohio to be an Ohio resident or part-year resident. Alternatively, a person may spend up to 182 days in Ohio during a calendar year and be considered a nonresident for income tax purposes.

Residency status is important because specific types of income are affected by the question of residency. Taxpayers may seek to establish residency in states other than Ohio to minimize their Ohio tax liability. A nonresident has to pay the income tax on compensation earned in Ohio and on certain other types of income allocable to Ohio. However, interest, dividends, certain types of capital gains (unearned income), and other kinds of income are considered "not earned or received in Ohio" and thus entitle nonresident taxpayers to the nonresident tax credit on some income included in Ohio adjusted gross income.

Ohioans who have residence in a state with no income tax[8] are most likely to benefit from changes in the residency test. Part-year residents receive a tax credit based on income taxes paid to another state (including taxes paid on nonwage income). Generally, taxpayers will pay income taxes to one state or both states on all of their income. However, those who have residence in a state without income tax will not pay income taxes either on their wage income earned elsewhere, or on the unearned and nonwage portions of their total income.

Exhibit 1 summarizes the potential effect of the bill on various groups of taxpayers.[9] The bill may potentially induce nonresident persons living most of the year elsewhere to spend more time in Ohio without the "risk" of becoming a resident for tax purposes. The additional time spent in Ohio by this group of taxpayers may increase sales tax revenues. The bill is also likely to stimulate certain part-year residents to reduce the time spent in Ohio so they become nonresidents for tax purposes if the change is beneficial and reduces their overall income tax liability. This would create a loss of revenues from the income tax and from the sales and use tax.[10] Part-year residents with large amounts of nonwage income who become nonresidents would cause Ohio to lose income tax revenue on much of that nonwage income. Finally, the bill

[8] Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, do not tax income. New Hampshire and Tennessee do not tax earned income, but tax income from interest and dividends.

[9] This illustrative summary does not purport to describe all potential effects on taxpayers.

[10] Compared to the revenue loss from the income tax, revenue gain to the sales tax from H.B. 73 is likely to be smaller. For example, for Ohioans with income above $100,000, the average sales and use tax liability is estimated at $1,355 in CY 2005 (data from the Internal Revenue Service for a taxpayer with two exemptions). In contrast, the average income tax liability for taxpayers in that group is estimated at $16,875 in TY 2002 (data from the Tax Department).

may induce certain Ohio residents to consider establishing a residence elsewhere and spend increasing amount of time there as the major components of their federal adjusted income progressively shift from earned income to unearned income.

Overall, the bill increases the number of part-year Ohio residents that will be reclassified as nonresidents for income tax purposes. Several thousands part-time Ohio residents may be affected by the bill. The net revenue loss from the bill is likely to be several millions of dollars. LSC is unable to provide a more precise estimate of the net revenue loss from publicly available data.[11] The Department of Taxation estimates H.B. 73 will reduce income tax revenues between $25 million and $30 million per year. Revenue losses may be reduced by the income tax cuts included in HB 66, the main appropriations bill of the current biennium.[12]

Revenue from the income tax is distributed to the General Revenue Fund (GRF, 89.5%), the Library and Local Government Support Fund (LLGSF, 5.7%), the Local Government Revenue Assistance Fund (LGRAF, 4.2%), and the Local Government Fund (LGF, 0.6%). The bill reduces revenues to all these funds. However, due to the FY 2006-2007 freeze in the revenue distribution to local government funds, the GRF will bear the revenue loss in FY 2007.

Exhibit 1
Simplified summary of potential behavioral change within taxpayer groups with H.B. 73

(A) Nonresidents of Ohio for tax purposes	Persons taxed on Ohio-sourced income from business or compensation; not taxed on nonwages and unearned income; not taxed if all income is earned income and was earned outside Ohio; nonresident tax credit for income received and taxed in another state
For example: 4 months (120 days) in Ohio; 8 months (245 days) outside Ohio	Under H.B. 73, these taxpayers may increase the time spent in Ohio to 181 days and remain nonresidents; no gain from income tax; potential increase in sales tax revenues
(B) Part-year residents of Ohio for tax purposes	Persons taxed on all income from business, compensation, unearned income; resident tax credit for income taxed by another state
For example: 5 to 6 months (150 days to 180 days) in Ohio; 6 to 7 months (180 days to 215 days) outside Ohio	Under H.B. 73, these taxpayers will become nonresidents for tax purposes, particularly if they also reside in a nonincome tax state; loss of income tax revenues and loss of sales tax revenues
(C) Residents of Ohio for tax purposes	Persons taxed on all income from business, compensation, unearned income; resident tax credit for income taxed by another state
For example: 8 months (245 days in Ohio) and 4 months (120 days) outside Ohio	Under H.B. 73, these taxpayers may increase the time spent outside Ohio and become nonresidents for tax purposes; loss of income tax revenues and loss of sales tax revenues

[11] The Tax Department examined income tax returns from TY 2000 through TY 2002 during the period when S.B. 287 (123rd General Assembly) allowed 30 additional contact days for charity work or hardship. The analysis indicates that more than 6,300 taxpayers with income above $100,000 switched from residents to nonresidents. More than 1,300 of those taxpayers moved to a nonincome tax state and claimed several millions of dollars worth of nonresident tax credits.

[12] H.B. 66 cut the marginal income tax rate 4.2% for all tax brackets for tax year 2005 and an additional 4.2% (from 2004 rates) in each of the years from tax year 2006 through tax year 2009.

Fiscal impact of the change in residency test on school districts

Changes to the residency test reduce the Ohio Adjusted Gross Income, which is the starting point for the calculation of the school district income tax. Thus, the bill will also reduce school district income tax revenues for school districts that have current residents that would be reclassified as nonresidents.

Military Pay Income Tax Exemption

The bill exempts, to the extent included in federal adjusted gross income (FAGI) and not otherwise allowable as a deduction or exclusion in computing federal or Ohio adjusted gross income, active-duty military pay and allowances from the state income tax regardless of whether the serviceperson is serving in a declared combat zone.[13] The exemption does not apply to pay and allowances received for active duty service while stationed in Ohio. The exemption also applies to school district income taxes that use the same tax base as the state income tax. All military pay and allowances currently are exempted from municipal income taxes.

The proposed exemption reduces the income tax base, resulting in a reduction in income tax revenue. The revenue loss from the proposed exemption depends on the amount of military pay exempted. This amount depends on the number of active duty military personnel taking the exemption and their distribution across ranks and service years. The revenue loss was estimated using 5,672 active duty Ohio residents reported by the U.S. Department of Defense public affairs office. Some of the Ohioans on active duty may be stationed in Ohio and would not be eligible for the exemption. LSC does not have information on this subset of Ohio residents on active duty. The estimated revenue loss was calculated using basic pay only. Other types of pay that are currently taxable (special pay, incentive pay, bonuses, and certain other payments) were not included in the estimates. If the Ohio taxpayers on active duty are assumed to have the same distribution across ranks as the military as a whole, receive basic pay only, and their basic pay is assumed to be at the minimum for that rank, the estimated state income tax revenue loss is $2.4 million. If basic pay is assumed to be at the maximum for each rank, the estimated revenue loss is $4.0 million.[14] The Department of Taxation contacted branches separately to obtain data on the number of active duty personnel listing Ohio as home of record. Based on the information obtained, the Department estimates that 40,266 Ohioans were on active duty outside Ohio during 2005. Using the Department of Taxation's estimated number of active duty Ohioans and adjusting for the estimated percentage serving in a combat zone yields an estimated revenue loss of between $17.4 million (assuming basic pay at the minimum for each rank) and $28.5 million (assuming basic pay at the maximum for each rank).

The local government fund freeze for FYs 2006 and 2007 would result in the GRF experiencing the full revenue loss in FY 2007. In subsequent years, the revenue loss would be shared by the GRF and the local government funds according to the Revised Code distribution of income tax receipts. The Revised Code distribution of receipts from the income tax is as

[13] The Internal Revenue Service Armed Forces' Tax Guide contains a table listing items included and excluded from FAGI. The items in Table 1 (attached) are included in FAGI, unless the pay is for service in a combat zone. The items in Table 2 (attached) are excluded whether the item is furnished in-kind or is a reimbursement or allowance.

[14] The bill specifies that the exemption is available for taxable years beginning on or after January 1, 2005. It is possible that taxpayers filing amended 2005 returns could increase the estimated revenue loss for FY 2007.

follows: 89.5% to the GRF, 5.7% to the Library and Local Government Support Fund, 4.2% to the Local Government Fund, and 0.6% to the Local Government Revenue Assistance Fund. The income tax rate reductions scheduled for tax years 2006 through 2009 will act to reduce any revenue losses from the exemption. The number of active duty Ohio residents and their pay will influence the revenue loss. A larger number of active duty Ohio residents will increase the revenue loss and a smaller number will decrease the revenue loss. Pay increases will increase the revenue loss.

<u>Fiscal impact of the military pay exemption on school districts</u>

The exemption would also reduce the tax base for some school district income taxes. The revenue loss would depend on the school districts in which the active duty military personnel reside, the school district income tax rate for that district, and the value of exemption claimed. If the individual were in a district without a school district income tax, there would be no revenue loss due to that individual's exemption. If all Ohio active duty military personnel were in districts without a school district income tax, then there would be no statewide revenue loss. If all Ohio active duty military personnel were from school districts that levy a school district income tax at the current maximum rate of 2%,[15] then the statewide revenue loss would be $2.3 million assuming basic pay at the minimum for each rank and $3.1 million assuming basic pay at the maximum for each rank. At the average tax rate of 1%, the revenue loss would range from $1.1 million to $1.6 million. As with the state income tax, the revenue loss will be influenced by the number of active duty Ohio residents and their pay. Using the Department of Taxation's estimated number of active duty Ohioans yields an estimated $16.0 million to $22.3 million revenue loss at the 2% tax rate.

The Department of Taxation reports that the FAGI of taxpayers in school districts with a school district income tax is approximately 9% of statewide FAGI and that the (weighted) average school district income tax rate is 0.8%. This percentage and tax rate yield an estimated statewide school district income tax revenue loss of $82,000 to $114,000 assuming 5,672 active duty Ohioans and $578,000 to $803,000 using the Department's estimate of the number of active duty Ohioans.

[15] There is no rate limit. The only stipulation by law is that the rate must be in increments of a quarter percent (0.25%). Currently, the minimum rate levied by a district is 0.50%, the maximum rate is 2.00%, the median rate is 1.00%, and the most frequently charged rate is 1.00%.

Table 1: Items Included in FAGI

Category	Items	Category	Items
Basic Pay	Active duty Attendance at a designated service school Back wages CONUS COLA Drills Reserve training Training duty	**Bonuses**	Career status Enlistment Officer Overseas extension Reenlistment
		Incentive Pay	Submarine Flight Hazardous pay High/low altitude
Special Pay	Aviation career incentives Career sea Diving duty Foreign duty Foreign language proficiency Hardship duty Hostile fire or imminent danger Medical or dental officers Nuclear-qualified officers Optometry Pharmacy Special duty assignment pay Veterinarian	**Other Payments**	Accrued leave High deployment per diem Personal money allowances paid to high-ranking officers Student loan repayment from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone

Table 2: Items Excluded from FAGI

Living Allowances	Basic allowance for housing Basic allowance for subsistence Housing and cost-of-living allowances abroad Overseas housing allowance
Moving Allowances	Dislocation Military base realignment and closure benefit Move-in housing Moving household and personal items Moving trailers or mobile homes Storage Temporary lodging and temporary lodging expenses
Travel Allowances	Annual round trip for dependent students Leave between consecutive overseas tours Reassignment in a dependent restricted status Transportation for taxpayer and dependents during ship overhaul or inactivation Per diem
Combat Zone Pay	Compensation for active service while in a combat zone or a qualified hazardous duty area
Family Allowances	Certain educational expenses for dependents Emergencies Evacuation to a place of safety Separation
Death Allowances	Burial services Death gratuity payments to eligible survivors Travel of dependents to burial site
In-kind Military Benefits	Dependent-care assistance program Legal assistance Medical/dental care Commissary/exchange discounts Space-available travel on government aircraft
Other Payments	Defense counseling Disability, including payments received for injuries incurred as a direct result of a terrorist or military action Group-term life insurance Professional education ROTC educational and subsistence allowances Survivor and retirement protection plan premiums Uniform allowances Uniforms furnished to enlisted personnel

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