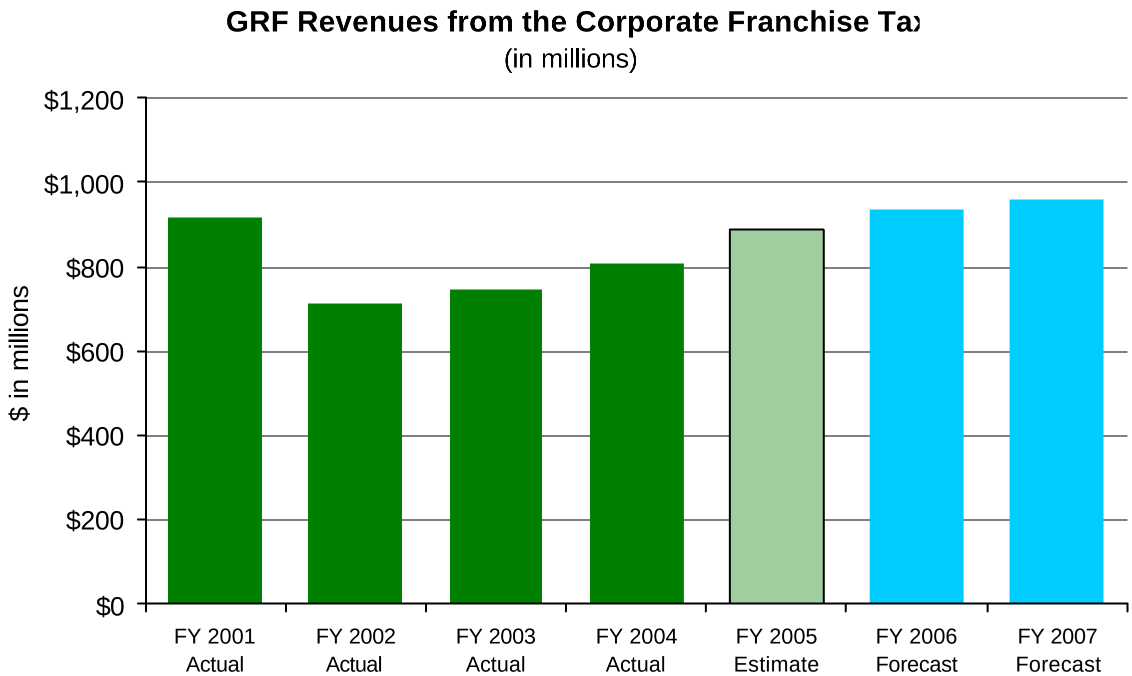
Corporate Franchise Tax



	FY 2001 Actual	FY 2002 Actual	FY 2003 Actual	FY 2004 Actual	FY 2005 Estimate	FY 2006 Forecast	FY 2007 Forecast
Revenue	$915.3	$712.3	$747.2	$809.2	$888.2	$933.5	$958.0
Growth	-5.6%	-22.2%	4.9%	8.3%	9.8%	5.1%	2.6%

The corporate franchise tax (CFT) is levied on corporations doing business in Ohio. The franchise tax has two bases: the net worth base (generally determined as net book value of assets minus the net carrying value of liability) and the net income base (generally, the Ohio portion of federal taxable income with exclusions and additions as required by statute). Differing tax rates apply to each tax base. The corporate taxpayer calculates its Ohio tax liability under the two bases and pays the higher of the two tax liabilities. Different rules apply to financial institutions, "qualifying" holding companies, and certain "high-technology" startup companies.

Between FY 1999 and FY 2002, CFT revenue growth was negative as a result of Am. Sub. H.B. 215 (122nd General Assembly), and the last economic recession. H.B. 215 decreased the net worth tax rate from 5.82 mills to 4 mills, and capped the net worth tax liability at $150,000 for each corporation. Corporate net profits plunged during the economic downturn. The full impact of the net worth tax changes decreased the cushioning effect the net worth tax base has had on franchise tax revenues when Ohio entered the last recession. Also, more and more new firms are taking advantage of alternative forms of business organization (such as limited liability company) that are not generally subject to the corporate franchise tax. This limits revenue growth from the taxation of business income. Instead, this net business income is taxed under the personal income tax from pass-through entities, which has helped contribute to increased volatility in that tax.

Am. Sub. H.B. 95 (125th General Assembly) enacted significant franchise tax changes pertaining to the allocation and apportionment of the income of multistate corporations to Ohio. The corporation franchise tax liability for interstate corporations is based on the portion of their net income or net worth that is allocated or apportioned to Ohio. Prior to H.B. 95, a company would allocate certain types of statutory-listed income whether or not the income was part of the company's active trade or business. H.B. 95 adopted the distinction between "business" and "nonbusiness" income used by many other states in the Uniform Division of Income for Tax Purposes Act (UDITPA).[9] Generally, "business" income will be apportioned to Ohio according to the same three-factor formula, and "nonbusiness" income may be entirely allocated either to Ohio or to another state. These changes expanded the corporation franchise net income tax base and increased growth of CFT revenues in FY 2005.

LSC derives its forecasts of baseline CFT revenues primarily from projections of U.S. corporate profits. Also, a regression of Ohio net income tax liability against actual profits from nonfinancial firms was used in the forecast. Forecasted net income tax liability estimates were supplemented with estimates of tax liability from the net worth tax and from financial institutions to develop baseline CFT revenues for FY 2006 and FY 2007. Finally, some adjustments were made for tax changes in the last few years.

Translating a corporate profits forecast into a franchise tax forecast is not straightforward because of the dual base of the franchise tax (net worth or net income), the fact that corporations often have taxable years that do not coincide with calendar years, and corporations' decisions on the timing and use of statutory tax credits. Other peculiarities of the franchise tax such as the net operating loss deduction, and annual changes in federal and state tax law make forecasting this tax challenging. Particularly, Ohio "decoupled" from two federal tax legislation changes regarding the "bonus depreciation" (Am. Sub. S.B. 261, 124th General Assembly) and "qualifying IRS section

[9] UDITPA defines "business income" as income, including gains or loss, arising from transactions and activities in the regular course of the taxpayer's trade or business, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts for the taxpayer's regular trade or business operations. "Nonbusiness income" means all income other than business income and may include, but is not limited to, compensation, rents and royalties from real or tangible property, capital gains, interest, dividends and distributions, patent and copyright royalties, and lottery winnings, prizes, and awards.

179 expenses" (Am. Sub. H.B. 95, 125th General Assembly) to reduce the impact of those federal laws on CFT revenues.

Corporate franchise tax revenues in a fiscal year generally reflect the previous calendar year corporate profits. Corporate franchise tax revenues grew in FY 2003 and FY 2004 from high growth rates in corporate profits in CY 2002 and CY 2003. Legislated changes from Am. Sub. H.B. 95 will help improve revenue growth in FY 2005. Then, corporate franchise tax revenue growth will decrease in FY 2006 and FY 2007 as expected corporate profits growth declines in CY 2005 and CY 2006. Forecasted estimates of corporate profits from Global Insight (a national forecasting firm) and the Governor's Council of Economic Advisers were the basis for the franchise tax forecast.

Growth in corporate franchise tax revenues and corporate profits