

## Publications

### State and Local Tax Alert: Ohio Tax Reform Bill Introduced – House Bill No. 59

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**CLIENT ALERT** | 2.15.2013

**Editors' Note:** Since Vorys posted the following tax alert, at least one blog has referred to it. That blog mischaracterizes the context of the alert and the terms and phrases quoted. The alert is a technical review of tax legislation and an attempt to simplify complex tax concepts. It is not a commentary on how that legislation fits into the overall Ohio tax reform being proposed.

### Ohio Sales and Use Tax Focus – Ten Steps to Revelation

#### Introduction

Ohio Governor John Kasich's FY 2014-2015 biennial budget bill was introduced this week. Weighing 22 pounds in print, covering over 4,200 pages and containing almost 130,000 lines of text, the bill does not lack in length or ambition. Within the bill, there are significant Ohio tax reform proposals. We present and order our overview and summary of the major sales and use components of this bill in ten steps that we hope lead you to a quick and efficient understanding.

#### Unprecedented Broadening of the Tax Base

The governor proposes to expand the sales and use tax base to a breadth never attempted by any state in history. That's ambitious. This tax expansion will hit Ohio businesses most directly and hardest although individual consumers will bear the brunt of these new taxes in the form of higher prices for the things they typically buy and use. All businesses should analyze the bill carefully, both from a perspective of sales and purchases. Estimating the tax impact on your business as well as the added compliance cost and responsibilities will give you the best chance to determine a business appropriate response. In estimating the tax impact, keep in mind that the bill lowers the state tax rate from 5.5% to 5.0%.

## Tax Base Overview

Ohio currently imposes tax on sales and uses of all tangible personal property not otherwise exempt and on sales of approximately twenty specifically enumerated and defined services. At the outset, sales and use of real property, intangible property and non-enumerated services are not part of the definition of sale or use and therefore no exemption needs to be applied to avoid the tax on the purchase or use of these types of "things."

### Step One: Services

The bill abandons the approach of defining and listing specific services that may be taxed. Instead, it expands the definition of sale to include all services. The term "services" is defined as "any act performed for another for a fee, retainer, commission or other consideration." There are several notable exclusions from this expansive definition including: medical and healthcare services; educational services; adult and child day care services; funeral services; and services of an employee rendered to his/her employer.

This shift makes virtually any act performed (outside an employer/employee relationship) by any person, business, enterprise, joint venture, partnership, etc... for another in exchange for something of value a service that is subject to sales or use tax. Yes, this means ALL non-excluded services. If you can think of or describe an act rendered for a fee that is not expressly excluded, it's a taxable service under the bill. Many services never before taxed would be under the proposed tax reform such as accounting, engineering, legal, banking, business consulting, advertising (space and time), transportation, public utility, software engineering, and management services. Also, services that had been taxed only in part by virtue of definitional limits like some repair, installation and employment services, will now be taxed fully unless an exemption applies. The definition limits are gone.

This type of broadening of the sales and use tax base to services has been attempted by only a handful of states. Each time, the effort failed for political, economic, practical, compliance and/or enforcement reasons.

### Step Two: Commercial Real Estate Rents

Interestingly, in addition to the exclusions listed above, the bill also excludes from the definition of services the rental of apartments, condominiums and houses to those using them as a primary domicile. The implication of this exclusion is that rental of commercial real estate is intended to be a taxable service. Yes, you read that correctly. Rental of commercial real estate in the bill is defined as a sale of services subject to sales tax. This also raises the question of whether outright sales of title to residential and commercial real estate are intended to remain in the definition of services as they are not excluded. At the very least, some clarification is needed.

### Step Three: Credit Processing Fee/Bank Merchants Fee

The fees vendors pay credit card issuers for the benefit and convenience of allowing customers to pay with credit cards will be a taxable service under the bill. All merchants understand the big bite out of sales receipts this fee means. That cost just got more expensive by the amount of sales and use tax.

**Step Four: No Resale Exemption For Services**

For sales of tangible personal property, there are tax exemptions for items purchased and resold either in the same form as received or when assembled or manufactured into a new item for sale. However, under the bill, services are prohibited and can never qualify for resale.

**Step Five: No Significant In-Puts Exemption for Service Providers**

For vendors that manufacture or process tangible personal property for sale, purchases of equipment used in the manufacturing and processing activity usually is exempt. This is true regardless of whether sales tax applies to the sale of the property they make. For example, a wholesaler gets a resale exemption when it buys a widget (but for service providers, see Step Four). The idea is that the ultimate consumer is the targeted taxpayer and the price of the thing sold will include amounts to recover the price paid for equipment used in making the item. Thus, this exemption avoids double taxation, or pyramiding the tax. For sellers of services, however, the bill provides no such exemption. Thus, a custom software engineer that uses a computer to design software for sale must pay sales tax on the purchase of that computer. Moreover, if the engineer subcontracts a portion of that project to another engineer, the service charge invoiced by the subcontractor is subject to sales tax and the price charged by original contractor to the software purchaser is taxable including the increased amount on account of the subcontracted services and the sales tax thereon. Taking into account the prohibition of applying the resale tax exemption (Step Four) and the lack of tax exemption for things used by service providers in rendering services, the tax on tax pyramiding effect will be extraordinarily heavy.

**Step Six: More Broadening: Digital Goods**

The bill will tax sales and uses of digital products which means electronically transferred digital audiovisual work, digital audio work and digital books...think iTunes, pay-per-view movies, cell phone games and mobile apps.

**Step Seven: Even More Base Broadening: Intangible Property**

The definition of sale and use<sup>1</sup> will be expanded under the proposed budget to include intangible property. Sales or uses of trademarks, copyrights, patents, franchises and licenses will be taxable. It is unclear from the bill whether any resale type exemption can apply to sales of intangible property.

We know of no other state that has ever attempted to expand its sales and use tax base to include intangible property. On its face, it would impose tax on sales of stock, bonds, commercial paper, money markets, mutual funds and business investments of all kinds. Although taxing sales and purchases of these latter types of financial instruments may not have been well conceived or intended, that is how the bill reads.

**Step Eight: Siting**

Despite the unprecedented broadening of the tax base, the bill offers almost no guidance to sellers or purchasers on where to situs transactions involving services or intangible property. To be sure, current law provides some guidance on siting services (no such luck for intangible property). However, the guidance

in those statutes is very vague and was tailored to the specifically enumerated services currently taxed. For many of the new services to be taxed, situsing them based on current language of "where the consumer receives the service" is not adequate guidance. It is overly vague. For example, where are accounting services received when: (1) the client is a multinational company; (2) with U.S. headquarters in Cleveland; (3) that hires an accounting firm with offices in ten cities (two of which are in Ohio); (4) to work on a multistate tax project when the services will entail administrative defense and compliance work in twenty states (including Ohio) related to operating divisions located in those twenty states; (5) all of which culminates in annual reports, state tax returns and memoranda delivered to both corporate counsel in Cleveland and to divisional tax directors in each state? It's a nightmare. It's a nightmare for both the vendor of services (sales tax), the consumer in reviewing invoices and the consumer in use tax audits. The current situsing statutes are not adequate, but there was no attempt to conform them for new taxable services or intangible property. Moreover, in Ohio each county has varying amounts of add-on rates. Thus, this situsing inquiry must be done county by county within Ohio.

**Step Nine: Related Party Transactions**

The bill provides no exemption for sales transactions between members of an affiliated group. Such affiliated members will be treated as strangers for purposes of Ohio sales and use tax. Now, apply this concept to information already covered on the expansion of the base to services and intangible property. The rendition of administrative, tax, legal, marketing, advertising, billing, and purchasing services among affiliates (perhaps under the umbrella of a "management services fee") will be taxable. Charges among affiliates for the use of trademarks, patents, franchises, licenses and copyrights also will be taxed. Charges for rental of commercial real estate among affiliates also will be taxed. These results will hit businesses with Ohio headquarters particularly hard.

**Step Ten: Compliance - Vendors and Consumers**

As explained in the preceding nine steps, significant sales and use tax changes have been proposed. They will have drastic tax effects on each business in Ohio in the form of new taxes to pay and/or collect. Each business should review its accounts receivable base to make very certain that it understands the potential sales tax collection responsibilities that may be imposed. Point of sale/point of purchase software may need updated or replaced. Contracts may need to be reviewed and customer budgets considered. Invoicing systems may need replaced. This is true for the sale and purchase side of your business. You will need to review invoices and accounts payable to make sure the correct amount of sales tax is being collected by the vendor or use tax is being remitted. For direct pay permit holders or users of use tax software systems, new compliance protocols should be considered.

**Conclusion**

OK, take a deep breath. What you have read may scare you. However, the good news is that the bill is just that, a bill. It is not clear whether it will become law in its current form. In fact, it likely will change. However, each business should monitor the bill and start internal reviews for effects on both compliance and budgets. Your business may want to become involved in the legislative review process.

We will be following the bill closely. Vorys has the experience you may need to analyze the bill and help you chart your course in assessing its effects on your business. If you have questions or concerns about Ohio

sales or use tax matters, please contact one of our state and local tax attorneys listed.

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<sup>1</sup>In its current form, the bill only redefines sale to include intangible property and not the term "use" for use tax purposes. We feel this was oversight that will be corrected in later versions of the bill.