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Ohio’s Commercial Activity Tax

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Ohio's Commercial Activity Tax (the "CAT") became effective July 1, 2005.The CAT is a business privilege tax measured by gross receipts on commercial activities.With limited exceptions(1),all companies (regardless of the actual form of the entity) doing business in Ohio with gross receipts in excess of $150,000 per annum are subject to the CAT.The amount of tax payable under the CAT will be phased in over a five-year period.

Although the CAT applies to nearly all businesses, this Advisory will focus on the effects of the CAT with respect to commercial real estate.

Gross receipts are broadly defined to include, among other things, all rents and other charges (such as "CAM" charges) received by a property owner from its tenants(2).In some instances, gross receipts received outside of Ohio that are subsequently brought into Ohio within one year of receipt also will be included in "Ohio" gross receipts(3).However, businesses who act as an agent in managing the property of unrelated persons may exclude from their gross receipts amounts received in their capacity as agent in excess of their management fee, commission, or other remuneration(4).

Property owners who receive gross receipts in excess of $150,000 will have to pay a tax on the amount received(5).Affected property owners must register with the State of Ohio by November 15, 2005 and pay a registration fee of $15 (electronic registration) or $20 (paper registration)(6).These property owners are required to file a return by February 10, 2006 for the period July 1, 2005 through December 31, 2005.The minimum tax payable is $150.The CAT phases in between July 1, 2005 and April 2009, with the tax initially being 0.06% of gross receipts over $1,000,000, increasing periodically over this time period to 0.26% of gross receipts over $1,000,000(7).

The good news for many property owners (particularly commercial property owners) is that they may be allowed to "pass through" the CAT to their tenants if permitted by their leases(8).Many commercial leases specifically provide that the landlord may "pass through" to the tenant taxes on "rents" if the tax is not an income or franchise tax.Depending on market conditions, however, even if the lease permits the pass through, a property owner may find it imprudent to pass these charges on in an effort to keep its property and rents competitive.

The bad news for many property owners is that, for purposes of determining the amount of tax payable pursuant to the CAT, gross receipts from commonly owned properties must be aggregated(9).For example, if two or more "different" entities are commonly controlled (i.e. 50% or more of the value of their ownership interests are owned or controlled, directly or constructively, through related interests, by common owners) then the gross receipts of the commonly controlled

entities will be aggregated(10).There is a comparable result if a single entity owns multiple properties.In addition, depending on how a business files its CAT return, intra-company transactions may also give rise to liability under the CAT(11).

From the perspective of a tenant of property, each tenant should review its lease and look closely at billings received on and after July 1, 2005 to determine whether the CAT is a proper pass through.Further, when negotiating a new lease or the extension of an existing lease, a prospective tenant should factor in the potential for an "extra" cost for the pass through share ofthe CAT, since an owner of a small building, apartment or shopping center may not be subject to the CAT because its gross receipts from all businesses and properties are under $150,000; whereas a property owner who directly or together with its affiliates has gross receipts in excess of $150,000 will be subject to the CAT, which it may pass on to its tenants.

If the CAT is not paid by a business, then, in addition to being liable for interest and penalties, the State has the right to revoke the entity's right to do business in Ohio(12).Until this right is reinstated by the State, the revocation could affect the ability of entities to obtain loans and enforce leases and also could result in a breach of loan covenants.

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(1) Several types of businesses are excluded from the CAT, including non-profit entities, financial institutions, and insurance companies.
(2) "Except as otherwise provided in divisions (F)(2), (3), (4) and (5) of this section, ‘gross receipts' means the total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person..."Ohio Revised Code §5751.01(F).
(3) See Ohio Revised Code §5751.013.
(4) Ohio Revised Code §5751.01(F)(2)(l).
(5) Pursuant to Ohio Revised Code §5751.01(F)(4), the amount "received" is determined on the same basis as the taxpayer uses for federal income tax purposes (i.e., accrual or cash basis).Certain, limited deductions are permitted to be made from gross receipts.
(6) Forms are available at www.tax.ohio.gov.Online registration may be effected at www.obg.ohio.gov.
(7) See Ohio Revised Code §5751.031.
(8) Ohio Revised Code §5751.02(B) prohibits a person from billing or invoicing the tax to another person unless it is part of a charge that the person is entitled to recover as part of a legal contract.
(9) Ohio Revised Code §5751.012(A).
(10) Ohio Revised Code §5751.012(A).
(11) Compare Ohio Revised Code §5751.012(C), which prohibits a combined taxpayer from excluding taxable gross receipts between members with Ohio Revised Code §5751.011(C)(1), which permits a consolidated elected taxpayer to exclude such gross receipts.
(12) Ohio Revised Code §5751.11.