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Ohio HB 5 Reforms Municipal Income Taxation – Impact on Nonresident Compensation and Establishing a Uniform Pension Exemption

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HB 5, which reforms certain aspects of Ohio municipal taxation, passed both the Ohio House and Senate and has been sent to Governor Kasich for his signature. The Ohio Senate made improvements to the House version. Two aspects that we have been following and provided comments on are (A) an expansion of the current 12-day exemption from municipal income tax for nonresidents who travel and perform services in a municipality that is neither their place of residence nor principal place of work (an Outside Municipality) and (B) the development of a uniform municipal tax exemption for “pensions,” as such term is eventually defined by the courts.

This provision applies to Ohio residents who travel between municipalities within Ohio and to Ohio nonresidents who travel from outside Ohio to Ohio municipalities. The following focuses on employees who travel from different states to work in Ohio on a temporary basis and also discusses the new pension exemption. Additional rules apply to Ohio residents who travel between municipalities within Ohio.

The legislation expands and clarifies the current provisions as follows:

1. General Rule. The current 12-day exemption is expanded to allow nonresidents to work in an Outside Municipality for 20 days without municipal taxation. In general, this exemption applies to employees, directors and other independent contractors.

This exemption is **not available** for employees who work at a construction site or other temporary worksite at which

the employer’s total services are expected to last more than twenty days in a calendar year. Switching employees to work at these locations for periods of less than 20 days will not avoid municipal income tax and withholding requirements. Besides construction sites, this includes businesses that provide onsite services to customers that are expected to last beyond 20 days.

Like the current rule, the new 20-day cap is not available to professional athletes, professional entertainers or public figures. A special rule is also stated for persons performing services at a petroleum refinery.

2. How Days Are Counted. The new legislation defines how days are taken into account in determining whether the 20-day cap is met. An employee is considered to have worked a day in a municipality if the employee spends a majority of that day performing services in that municipality. Travel time is considered as working at the employee’s principal place of work (rather than in the Outside Municipality) in the determination of whether the employee works a majority of the time in an Outside Municipality. Accordingly, when an employee spends the majority of a day traveling, that day is not counted even though the only work time for the day might have been in an Ohio municipality.

The method for counting days has some favorable applications:

- a. If an employee stays overnight in a municipality and leaves the following morning, any work performed on the second day in the Outside Municipality will not be counted toward the 20-day

cap if the travel time plus any additional work time in another location on that day exceeds any work time in the initial Outside Municipality. This application can surface when an employee has early meetings on the day of departure.

- b. An employee who travels midday from an Outside Municipality back to her principal place of work and then works well into the night might be able to exclude the day worked in the Outside Municipality from the 20-day maximum.
- c. An employee who works for most of the day at the principal place of work, then travels and resumes work later in the day in the Outside Municipality will likely be able to exclude the day of arrival from the 20-day cap.
- d. Employees who travel among multiple Outside Municipalities during a single day might be able to exclude that day from the 20-day limit. This is because the travel time is treated as if the employee worked at her principal place of work. If the travel time exceeds the work performed in either Outside Municipality, then the majority of work time is deemed to be at the employee's principal place of work.

The proposal on how to count days is similar to (but seems even better than) the approach used under the proposed federal 30-day rule, referenced in (8) below. Further, the new Ohio legislation provides a better approach than how some municipalities currently apply the 12-day exemption. Currently, some municipalities would count any day against the 12-day limit to the extent that an employee performed any services in an Outside Municipality during any portion of a 24-hour day.

3. Tax Withholding. Employers are exempt from withholding municipal taxes against compensation paid to nonresident employees who work in an Outside Municipality within the 20-day exempt threshold. If the employee exceeds the 20-day threshold, the employer is required to commence withholding municipal income taxes for services performed commencing on the 21st day.

Employers are not required to withhold municipal taxes with respect to the initial 20 days, but employers can elect to withhold taxes for the initial 20-day period when that limit is exceeded. Note that the employer might have already collected and deposited taxes to the municipality where its principal place of work is located for wages paid during the first 20 days. Employers might consider coordinating a withholding approach with its employees with respect to the initial 20-day period to avoid the need for filing refund claims.

The bill does not provide guidance on what information employers can rely on to be aware of when the 20-day threshold has been exceeded. Employers will have to develop such procedures. Employers and city administrators can enter agreements on how to administer the withholding requirement.

Thankfully, the Ohio Senate deleted a House provision that would have required employers to file withholding reconciliation returns listing the names, addresses and Social Security numbers of employees who were exempt pursuant to the 20-day exemption.

4. Small Employer Rule. The Senate added a special municipal tax withholding rule for employers located within Ohio with total annual revenue of less than \$500,000. These employers are required to pay all withheld taxes only to the Ohio municipality where the employer's permanent place of business is located. This is a separate exemption and is available when employees (a) either work beyond the 20-day limit or are not eligible for the 20-day exemption and (b) provide services at different Ohio locations.

The new provision provides that the \$500,000 small employer gross revenue calculation is based on either federal income tax principles or GAAP.

5. Inconsistency with State *de minimis* Exemption. There continues to be a disconnect (and even more so now) between the exemption available to nonresidents for Ohio municipal income taxes as compared to Ohio state income tax purposes. One can only hope that the legislative change to expand the Ohio municipal income tax exemption will be adopted eventually at the administrative level by the Ohio Department of Taxation with respect to Ohio state income taxes.

6. Pension Exemption. Consistent with the House version, the Senate bill establishes an exemption for “pensions.” The definition of what constitutes a “pension” is being addressed by the courts (favorably to date), particularly on the issue of whether certain nonqualified retirement benefits (e.g., supplemental executive retirement plans, excess benefit plans) fit within this term. Currently, only some municipalities have an exemption for “pensions,” the breadth of which is being tested in the courts. The legislation creates uniformity throughout the state on an exemption that is currently present primarily in RITA jurisdictions.

The pension exemption is only for municipal income taxes and not for state income taxes.

The same new uniform exemption contains another exemption for retirement benefit payments, payments from annuities, and similar payments made to an employee or to the beneficiary of an employee under a retirement program or plan. These exemptions seem helpful only to qualified plan payments and not to nonqualified deferred compensation distributions. Because Ohio municipal taxation (like FICA taxation) is imposed when nonqualified deferred compensation is earned, there would normally be no municipal taxation when the retirement amount is paid. Accordingly, the inclusion of an exemption for retirement payments does not seem to provide real relief from municipal income taxation.

7. Effective Date and Application to Multi-Year Compensation Awards. HB 5 has an effective date of “for tax years beginning on or after January 1, 2016.” Tax administrators can continue to administer the municipal tax provisions under current law with respect to tax years beginning before January 1, 2016.

A question arises with respect to compensation awards that cover multiple years and whether the current 12-day threshold would apply to determine Outside Municipality-based income for calendar years that relate to services through 2015 and whether the proposed 20-day threshold would apply to determine the Outside Municipality-based income for calendar years commencing 2016. This can surface in the context of (a) stock options that are outstanding for an extended period and (b) restricted stock units or restricted shares that have a multiple year vesting

period that straddles 2016. Arguably, the proposed 20-day threshold applies to the entire compensation arrangement where the income is recognized in 2016 and future years.

8. Federal Proposal. A bill passed by the U.S. House of Representatives and introduced repeatedly in the U.S. Senate would establish a 30-day exemption. The likelihood of the Senate passing this provision has been considered low, but query whether a Republican-led Senate affects that logjam. If the federal bill were to become law, it would automatically create a state tax exemption and might also result in a broader municipal tax exemption.

We hope you find this information useful.

FOR MORE INFORMATION

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