

**JULY 22, 2019****OHIO MUNICIPAL INCOME TAXES****FINALITY REGARDING THE APPLICATION OF THE PENSION EXEMPTION TO SERPS  
AND CERTAIN SIMILAR ARRANGEMENTS AND EMPLOYER WITHHOLDING  
PURSUANT TO HB 166**

On July 18, 2019, the Ohio budget bill (HB 166) was signed by Governor DeWine. The new law contains a provision that would seem to finally close the door and prohibit municipalities from subjecting certain nonqualified supplemental retirement plans (“SERPs”) to income taxation, even though such arrangements are not qualified retirement plans. This change affects employers by no longer requiring withholding of municipal income taxes against qualifying amounts.

**HOW DID WE GET HERE? WASN'T THIS ISSUE RESOLVED ALREADY?**

The issue of whether SERPs are subject to Ohio municipal income taxation has been addressed in court decisions and, indirectly, in prior legislation. In fact, effective for 2016 and future years, the Ohio Revised Code was amended to state that “pensions” and “retirement benefit payments” are exempt from municipal income taxation throughout Ohio. However, these terms were not defined and municipalities enacted ordinances stating that the pension exemption is limited to qualified plan arrangements and did not include nonqualified deferred arrangements (which includes SERPs).

For more detail regarding the state of affairs before this more recent legislation, See our memo: *What Effect Does The William Macdonald/Shaker Heights Decision Have On Employer Municipal Income Tax Withholding Against SERP Benefits Going Forward* dated September 25, 2015.

<https://www.thompsonhine.com/publications/what-effect-does-the-william-macdonaldshaker-heights-decision-have-on-employer-municipal-income-tax-withholding-against-serp-benefits-going-forward>

The new legislation defines “pension” and “retirement benefit plan” to clarify the issue and prevents Ohio municipalities from defining such terms in a manner to limit the scope of the exemption, but some questions remain.

**WHAT IS COVERED BY THE NEW PENSION EXEMPTION?****Requirements:**

- **Employer provided benefits**
- **Payable on or after termination of service, and**
- **Termination of service is linked to retirement or disability**

Exemption not affected by the following:

- Status of arrangement as qualified plan or a nonqualified plan subject to Section 409A
- Amounts that are considered “qualifying wages” and subject to FICA taxation.

- Fact that the credited benefit is subject to FICA taxes for a year preceding payment of such benefit or for the same year that such benefit is paid.
- Benefits vest in a calendar year preceding the year of payment.
- Payments are made in a lump sum or installments.
- Whether the employer is a for-profit or tax-exempt organization.
- Federal income taxation prior to the year of actual payment (based on vesting date) would seem to not disqualify the exemption.
- Lack of retirement definition in the arrangement might be acceptable. Statute does not provide retirement definition, which might be read narrowly and limited to payments after a specific age or, alternatively, broadly to pick up payments after any termination of employment when cease working.
- Applicable to Ohio residents who earned qualifying amounts in other States and former Ohio residents who earned the benefits in Ohio and relocated to another State.
- Federal source tax exemption ( 4 USC 114) can potentially also be applicable to address amounts that are not covered by the new pension exemption.

Covered. SERPs linked to defined benefit plans that provide employer contributed benefits in excess of the limitations provided by the Internal Revenue Code. Typically, these arrangements are structured as excess benefit plans that provided a benefit in excess of the amount permitted by the contributions limits under the Internal Revenue Code and additional benefits that are pegged to a percentage of the executive's compensation.

Typically (but not always), the FICA taxes and the municipal income taxes with respect to these arrangements are collected and paid close in time to the executive's retirement. Accordingly, for municipal taxes that have not yet been collected, employers would not need to collect municipal income taxes starting in 2020.

The terms "pensions" and "retirement benefit plan" might be sufficiently broad to pick up the following arrangements:

- Employer contributions credited to an account and scheduled to be paid only on or after the employee's termination of service in connection with retirement, regardless of whether the amounts credited are subject to a vesting schedule for services performed.
  - For vested amounts already credited to an account and against which municipal income taxes have already been collected, the new provision is not beneficial.
  - For unvested or future employer contributions credited to an account that are subject to FICA taxation starting in 2020 or future years and scheduled to be paid on or after employment termination in connection with retirement, employers should consider not collecting Ohio municipal income taxes either when the amounts become vested or are paid, and collecting only FICA taxes when the amounts are fully vested.
- Employer contributions credited to an account and scheduled to be paid on employment termination, and such event occurs following retirement. Because the new law does not define "retirement," the question is whether the fact that the arrangement is not initially limited to

retirement payouts but results in retirement payments is qualifying. A practical challenge with this arrangement is that municipal income taxes would ordinarily be collected and deposited when the employer contributions vest, which could be years in advance of payment, and it would be unknown upfront whether employment termination coincides with retirement. Nonetheless, this might be an arrangement covered by the new exemption. If municipal income taxes are not collected when the employer contributed vested amount is credited to an account and the employee terminates employment prior to “retirement,” it would seem that the full payment amount would be subject to municipal income taxes when payment is made and not merely the initial amount credited to the employer’s account.

Not Covered. Employee contributions and elective deferrals are not covered. This means that many common nonqualified account balance plan arrangements through which employees elect to defer their base salary and bonuses do not qualify within the pension exemption, even though the payout occurs following retirement. However, consideration should be given to whether such benefits qualify under the federal source rule exemption (4 USC 114).

Severance payments, payments made for accrued personal or vacation time, and wage continuation payments are not covered.

Employer contributions that are credited to an account that would be payable on a fixed date while the employee is working and the employee elects to have the payout occur following retirement.

SERP distributions that are already in-pay status were subject to municipal income taxes at an earlier date and the new provision does not provide relief.

### **EFFECTIVE DATE.**

The clarified pension exemption is applicable in municipal tax years on or after January 1, 2020.

To properly apply the effective date, determine when Ohio municipal income taxes would be collected under the current provisions and the new pension exemption applies to municipal income taxes required to be collected commencing in 2020. Currently, the timing of collecting municipal income taxes is matched up with when FICA taxes are collected. Through 2019, the current rules continue to apply. When FICA taxes are collected during 2019 with respect to SERPs, municipal income tax payments would also need to be collected, unless the federal source rule should apply (4 USC 114). If the FICA taxes with respect to retirement benefits can be delayed until 2020, the new pension exemption might be applicable for such benefits.

Qualified Plan Benefits. Qualified plan benefits have been exempt from municipal income taxes and remain exempt for 2019 and future years.

### **SUBSTANTIATION.**

Ohio municipalities have tracked W-2 Box 5 reporting to determine whether employers failed to collect municipal income taxes and to subject employees to income taxation.

With a 2020 effective date, there would seem to be sufficient time for municipalities to adjust their review procedures so that amounts shown on a W-2 Box 5 without accompanying municipal income tax collections are not automatically linked to an audit. Procedures might be developed to require employers or employees to substantiate that the benefits are exempt “pension” amounts, as now defined.

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