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What Effect Does The William Macdonald/Shaker Heights Decision Have On Employer Municipal Income Tax Withholding Against SERP Benefits Going Forward?

Earlier this year, the Ohio Supreme Court in the William MacDonald v Shaker Heights decision resolved the remaining procedural point relating to the main issue of the income taxation of certain non-qualified supplemental retirement compensation arrangements (SERPs) under the Shaker Heights ordinance. Shaker Heights is the municipality in which the employee lived in that case. The Shaker Heights income tax ordinance had provided an exemption for “pensions” but did not define the term. The Ohio Board of Tax Appeals and the 10th District Court of Appeals (Franklin County) concluded that the SERP arrangement in that case is within the pension exemption found in the Shaker Heights tax ordinance.

Employees who filed refund claims for prior open years should contact Shaker Heights regarding the status of their claims. For 2012, employees who filed a Shaker Heights income tax return have until April 15, 2016 to file a refund claim. If any refund claims were rejected by RITA, proper procedural steps had to be taken to assure that the claim remained valid.

The resolution of the Shaker Heights litigation is not the end of this saga. First, a similar issue continues to be disputed in other municipalities. Second, a statutory provision enacted in 2014 by the Ohio legislature was thought to provide uniformity by adding an income tax exemption for “pensions” throughout all Ohio municipalities. However, such statute does not resolve the issue.

In short, unless it is clear for the specific municipality at issue, employers should continue to withhold municipal income taxes with respect to nonqualified deferred compensation arrangements as such amounts are considered “earned,” consistent with FICA tax withholding. Any challenges or tax refund claims will likely be initiated by employees.

The following highlights remaining points of interest after the William MacDonald/Shaker Heights decision:

1. Pending Cleveland Matter. A pending Board of Tax Appeals also involves William MacDonald and his employer (National City) on the same facts but with respect to the Cleveland ordinance. Cleveland is where the employer was located, who withheld Cleveland municipal income taxes. At issue here is whether the SERP benefit was income under the Cleveland ordinance in effect where the employee worked (Cleveland) requiring the employer to withhold Cleveland income tax. (William E. MacDonald, III et al. v. Cleveland Income Tax Board of Review et al., BTA No. 2009-K-1130). This case had been suspended pending resolution of the Shaker Heights matter and was activated on August 20 with a scheduled hearing date of November 4, 2015.

Like the Shaker Heights ordinance, the Cleveland income tax ordinance also contains an exemption for pensions but the adopted Cleveland rules and regulations define pension as limited to distributions reported on a Form 1099R and excludes nonqualified

deferred compensation. Other Ohio municipalities also have rules and regulations (rather than the ordinance) that would exclude nonqualified deferred compensation. An issue in the Cleveland BTA matter is whether the rules and regulations can limit the application of the pension exemption.

Employees who have paid a Cleveland tax on SERP arrangements should file protective refund claims. For taxes paid/collected in 2012, employees should file a refund claim by the end of 2015. For those employees who (a) worked in Cleveland, (b) had Cleveland taxes collected, (c) lived in a different municipality, and (d) did not file a Cleveland income tax return, Cleveland might take the position that refund claims must be filed by the third anniversary after the time that the employer issued a form W-2 for 2012, which would have been in January 2013.

2. Scenarios for pre-2016 Years. For pre-2016 years, the ordinance and related rules and regulations for each applicable municipalities must be reviewed. As in the William MacDonald case, the issue can surface both for the municipality which is the employee's place of employment (with respect to the employer's tax withholding) and the employee's place of residence (with respect to any additional municipal income tax liability).

Depending on the wording of the ordinance and the facts, various scenarios can arise regarding municipal income taxation of SERPS:

- a. A municipal income tax ordinance has a pension exemption, but no definition is provided and the facts can be presented so the SERP is treated as a pension eligible for exemption. (Shaker Heights—William MacDonald decision).
- b. A municipal income tax ordinance has a pension exemption, but no definition is provided and a court holds that a SERP is not a pension eligible for the exemption. (Middletown-Wardrop decision).

- c. A municipal income tax ordinance has a pension exemption, and the municipal rules and regulations contain a definition that limits the exemption to qualified plans (Cleveland CCA—William MacDonald pending BTA matter).

- d. A municipal income tax ordinance has no pension exemption but the tax return instructions state that pensions are exempt. (Columbus and the 2015 Nationwide Insurance decision—no pension exemption).

- e. A municipal income tax ordinance was not amended to adopt the 2004 Ohio statutory changes to link municipal taxation of deferred compensation to the FICA Section 3121(v) approach. In this limited situation, the result could be that neither employer tax withholding nor employee taxation on any SERP (or other nonqualified deferred compensation is required. (Columbus and the 2015 Nationwide Insurance decision--no employer withholding required).

- f. A municipal income tax ordinance limits the pension exemption to qualified plans.

Consideration would need to be given to each municipality where an employee works and resides to understand whether protective refund claims should be filed.

3. Alternative Positions. The employees in the Shaker Heights and Columbus decisions presented alternative positions that did not need to be addressed because such employees won on other grounds. These alternative positions will surface in the Cleveland pending matter, which (if successful) could provide further defenses against municipal income taxation.

4. 2016 and Future Years—Ohio Statutory Provision. During 2014, the Ohio Revised Code was amended (through HB 5) to add a pension exemption to municipal income taxation throughout Ohio. The new exemption is effective for 2016 and future years. As a

political resolution, the term pension was left undefined and subject to interpretation by the courts.

Revisions to municipal ordinances will incorporate the 2014 state legislation but is expected to define pension as limited to qualified plan arrangements and not include nonqualified deferred compensation (e.g., SERPs). While the 2014 statutory addition was initially considered to create uniformity and perhaps a true exemption, the initial step will likely lead to the opposite in having the local ordinance specifically state that nonqualified deferred compensation arrangements (including SERPs) are not exempt from municipal income taxation. This can lead to further controversy without an immediate resolution.

To repeat, unless clear, employers should continue to withhold municipal income taxes with respect to nonqualified deferred compensation arrangements. Any challenges and tax refund claims will likely be initiated by employees.

FOR MORE INFORMATION

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