

Ohio Municipal League Tax Seminar

Municipal Income Tax: History and Uniformity



J. Donald Mottley

Taft Stettinius & Hollister LLP

July 12, 2012

Taft/

Cincinnati / Cleveland / Columbus / Dayton / Indianapolis / N. Kentucky / Phoenix / www.taftlaw.com

Milestones in the History of Municipal Income Tax



Municipal income taxes began outside of Ohio

- Florence and other Italian cities: 1400s
- Philadelphia: 1932 (Sterling Act), 1939 (tax imposed)



Ohio History: Municipalities enacting income tax

1. Toledo was first: 1946
2. Columbus: 1947
3. Springfield and Youngstown: 1948
4. Dayton and Warren: 1949
5. Cleveland (leading to CCA): 1966



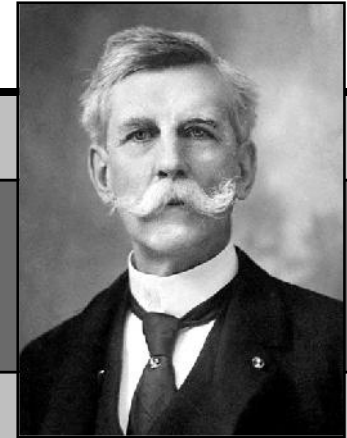
RITA formed: 1971



Taft/

Why Isn't Ohio Municipal Income Tax More Uniform?

“A page of history is worth a volume of logic”
– *Justice Oliver Wendell Holmes, Jr.*



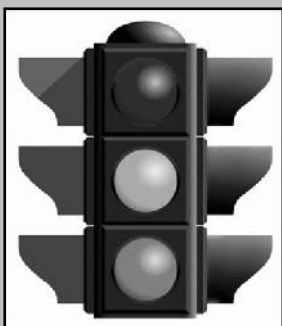
- Ohio's municipal income tax is older than Ohio's MIT uniformity statute
 - Home rule amendments to Ohio Constitution: 1913
 - First Ohio municipal income tax: Toledo, 1947
 - First uniformity statute (O.R.C. Ch. 718.): 1957

Taft/

Cincinnati / Cleveland / Columbus / Dayton / Indianapolis / N. Kentucky / Phoenix / www.taftlaw.com

History of Uniformity Law

- Early version covered only a few topics:
 - Only one rate per municipality
 - Rate over 1% requires voter approval
 - Apportionment statute for business income
 - Some required and prohibited exclusions from taxable income – Examples



- Permitted exclusion: earnings of persons under 18
- Prohibited exclusion: earnings of persons over 18

Taft/

Important Cases Prior to 1990: Resident vs. Non-Resident Scope of Taxation

Non-residents

- Only income earned in the municipality is taxable there (*Angell v. City of Toledo*, 153 Ohio St. 179, 91 N.E.2d 250 (1959))
 - May only tax **compensation** or **net income from business or profession**
 - Discretion limited to permitted variations in these two categories

Residents

- Home jurisdiction may tax any income, regardless of type or where earned, unless prohibited by statute (*Thompson v. City of Cincinnati*, 2 Ohio St.2d 292, 208 N.E.2d 747 (1965))
 - Local option: whether to allow credit for tax paid in municipality where earned, and how much credit to allow
 - Rationale allows local option for credits generally

Taft/

History of Uniformity Law Prior to 1990: Minor, Reactive Changes

- **Legislator taxation:** Columbus tried to tax legislator's and the Lt. Governor's pay; the General Assembly made it taxable only at the official's residence (1967)
- **Intangibles tax:** Grandfathering statute provides for limited non-uniformity
 - **1985:** with repeal of Ohio intangible tax, municipalities could (for the first time) tax “intangibles” income (such as interest) of their residents
 - **1988:** in response to taxpayer complaints about municipalities taxing investment income, the General Assembly prohibited any additional municipalities from taxing intangibles, but grandfathered in those who did already (if they got voter approval during a one-time opportunity)

Taft/

Reactive Changes in the 1990s

- Exempt certain election poll worker compensation and transit authority employee compensation from municipal taxation (1996)
- Allow stock option exemption (1997)
- Exempt national guard/reserve compensation (1998)
- Public utilities exempt, then not, then exempt again (1998)
 - Supreme Court reversed earlier case law that had exempted utilities from municipal income tax in the Cincinnati Bell case
 - General Assembly restored the exemption



Taft/

JEDDs and JEDZ

- At first JEDDs (providing for municipal income tax within part of a township's unincorporated area) were permitted only in a charter county (then, only Summit County) – 1992
- JEDDs permitted in non-charter counties – 1995
- JEDZ permitted (joint municipal agreements governing territory within one of the municipalities) – 1995
- Recent AG's opinion: JEDD agreement may exempt income from municipal income taxation within the JEDD that municipalities generally may not exempt from their tax (OAG 2011-007)
 - Allows a type of non-uniformity that may be essential to economic development!

Municipal Income Tax Uniformity: First Proposals in the **1990s**

- Ohio CPAs report urging greater uniformity: 1994
- Proposed HB 803: 1998
 - Uniform base, but not rate
 - Required larger municipalities (those with >\$10 million in municipal income tax revenue) to grant 100% reciprocity credit for municipal tax paid by their residents to another city where the resident worked, but left credit optional for smaller municipalities
 - Created a board to standardize tax forms
 - Provided uniform interest, penalty, and estimated payment rules
 - Required advance, mailed notice of audits



- Bill did not get beyond a first hearing, even though the sponsor was then Chair of the House Ways & Means Committee, E. J. Thomas

Taft/

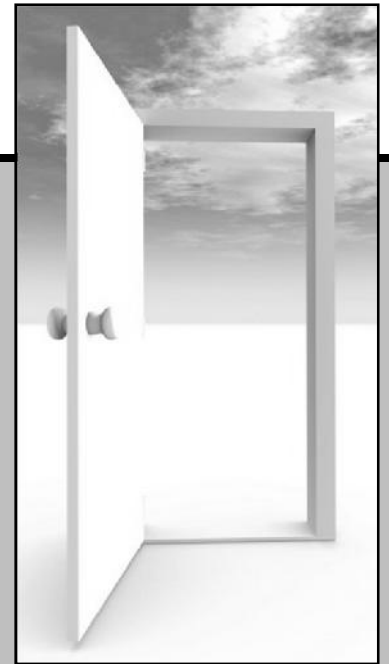
Uniformity Statute Changes in 2000:

“Here’s where I came in . . .”

House Bill 477: Significant uniformity (but no central collection) for non-utility taxpayers

House Bill 483: Central collection and uniformity for utilities newly subject to taxation

- Intended to be, in part, an experiment with central collection for business taxpayers
- Also a way to ease the compliance burden on taxpayers newly subject to municipal tax (due to de-regulation) and who did business in a large number of jurisdictions
- Both worked out in consultation with municipal and private sector representatives



Taft/

HB 477 Changes

- 12-day rule, excluding athletes and entertainers
- Municipal ordinances, rules, and forms available online
- Uniform estimated payment percentages and due dates
- No tax returns due before Federal due dates (but can allow later)
- Municipalities must declare whether pass-through entities are taxed at owner or entity level
- Credit for pass-through entity tax paid elsewhere (similar to credit for tax paid on W-2 income elsewhere)
- Consolidated returns must be accepted
- \$150 minimum withholding threshold for nonresident employers
- Generic returns must be accepted
- Automatic extensions where Federal extension requested
- Local board of appeals and appeals procedures
- Parsonage allowance exemption

Taft/

HB 483 Changes

- Technical change to 12-day rule
- Provision affecting deregulated the net profits tax for electric companies only (later extended to telephone companies)
 - Central filing and collection via a single State-wide return
 - State fee (1 ½ % after first two years) for collection expenses
 - Uniform tax base, applying that municipality's tax rate
 - Uniform 3-factor apportionment, applied in 2 stages
 - Alternative apportionment permitted
 - Uniform 5-year NOL carry-forward
 - Uniform penalties, interest, and refund procedures
 - Appeal rights as with other State-administered taxes
 - Municipality may not appeal apportionment beyond Commissioner

Taft/

Changes in MIT Uniformity Statute Since 2000: Zaino Commission Changes



- Zaino Commission Report and HB 95: 2003
 - Further uniformity provisions
 - Modified some provisions of HB 477
 - Central filing and payment through Ohio Business Gateway as an alternative to central collection (net profits and withholding taxes only)
 - Right of appeal to Board of Tax Appeals
 - Some areas left to local option as a result of negotiations
 - Ex. NOLs – 5 years recommended, but statute leaves to local option
 - Stock options and deferred comp: local option due to divisions in business community

Taft/

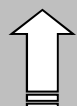
Zaino Commission (HB 95) Changes

- Uniform payroll withholding and net profits tax bases with 3 local options
 - NOLs
 - Non-qualified deferred compensation (opt out)
 - Stock options (opt in)
- Sole proprietors taxed on Schedule C, E, or F income; other entities on “adjusted federal taxable income”
- Apportionment of net profits:
 - *Before*: books and records preferred, use 3-factor if books and records do not lead to equitable result
 - *After*: 3-factor apportionment preferred, use other apportionment method if this does not lead to an equitable result
- Eliminated \$150 minimum withholding threshold from HB 477
- Federally disregarded entities (generally, single-member LLCs) are also disregarded for municipal income tax purposes

Taft/

Net Profits Tax Base After HB 95

$$\text{“Net Profit”} \times \text{Apportionment Factor} \times \text{Rate} - \text{Credits} = \text{Tax Liability}$$



- **Consolidated Return Issue:**
 - Pre vs. post consolidation
- **Alternative apportionment**



- **Uniform rate *but* credits allowed at discretion of municipality**
- **Municipality may also allow reduction for NOLs**



Taft/

Changes in MIT Uniformity Statute Since 2000: Mostly Reactive Changes

- Some “Reactive” changes in MIT uniformity statute since 2000
 - S Corporation “uniformity with grandfathering” in response to the 2001 Tetlak case, similar to what was done with intangible income (2003 & 2003)
 - Exemption for WPAFB non-resident employees from Riverside’s income tax (2007)
 - Limit taxation of Supreme Court justices and appellate judges (2009)



Tetlak house

Taft/

Changes in MIT Uniformity Statute Since 2000: Policy-Driven Changes

- Some policy-driven changes since 2000
 - Marathon/Findlay amendment, to offset unintended consequences of disregarded entity changes in 2003 (2004)
 - Cincinnati amendment providing for add-back to corporation's municipal income of deduction for stock options not taxed (2004)
 - Optional deductions for HSA contributions and self-employed health insurance (2007)
 - Requiring 90 days (previously 75 days) prior to election to place municipal tax issue on the ballot
 - Exclusion of contractor's income from "privatized" state services (2011)

Taft/

So, Why Isn't Municipal Income Tax *More Uniform*?

- Many laws and practices evolved before there was a uniformity statute
- Some issues have been deliberately made non-uniform in past uniformity statutes and “reactive” changes:
 - Rates (and no one seriously challenges this)
 - Taxation of S Corporations, other pass-through entities, and intangible income
 - Deferred compensation
 - Earnings of minors
 - Credits (including “reciprocity” credits)
 - Net operating loss deduction



Taft/

So, Why Isn't Municipal Income Tax *More Uniform*?

(Continued)

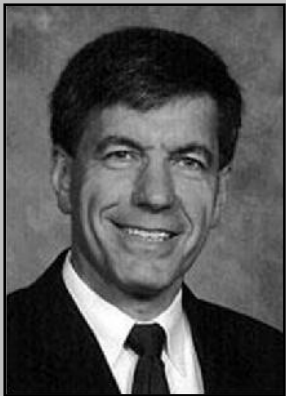
- Some non-uniformity affects only residents and has not been of concern in the past, such as --
 - Retirement income
 - Lottery winnings (how about gambling winnings?)
- Some non-uniformity exists because the concern was not raised during prior uniformity discussions or was not easily resolved, such as --
 - Minimum amounts due and minimum refund
 - Changes made in HB 95 that went beyond HB 477
- Some non-uniformity remains because the uniformity statute is not clear enough (ex. combined returns)



Taft/

MIT Reform in the Kasich Administration: 2010 and 2011


- CPAs report in 2010 on Ohio's budget problems: Proposed more uniformity and consideration of central collection (either mandatory state-wide or expanded use of collaborative collection agencies such as RITA and CCA)



- Commissioner Testa in 2011: Reviewing MIT changes, including possibly state-level collection
 - Off the table: uniformity of rates or of credits (including reciprocity credits)
 - On the table for discussion: everything else

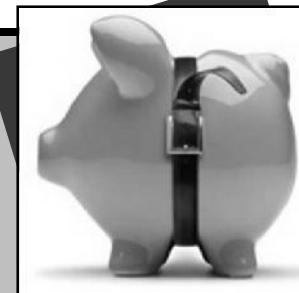
Taft/

MIT Reform in the Kasich Administration: 2012

- Administration has not formally proposed either central collection or more uniformity
 - Department of Taxation has concluded that Central Collection is feasible and might be less expensive
 - Ohio Business Gateway would be used as it is now for payroll and net profits taxes under uniform collection
 -  Lt. Gov. Taylor's "Common Sense Initiative" on regulatory reform is the primary forum through which the Administration will address this issue
- Legislative efforts now focused on uniformity
 - Central collection is "off the table" in current uniformity discussions, although many groups (such as the CPAs) still favor it in the long run

Taft/

Would Central Collection be Less Expensive?



- ***Not necessarily!*** The business case for central collection is not very strong –
 - State analysis of simpler situations (ex. Municipal income tax, which applies only to resident individuals) is not a good basis for estimating the cost of statewide collection of a more complex tax
 - States conclusion that it could administer the whole State for less than what it costs RITA to administer 40% of it does not make sense; it is more likely that they have left some necessary services out of the analysis
 - HB 483 and OBG experience shows that the State is not always as responsive as it should be

Taft/

Should We Have Greater Uniformity?

Yes

for several reasons:

- Improved compliance
- Reduced compliance burden and cost for taxpayers and municipalities
- Make Ohio more competitive in the eyes of businesses and business location services
- Easier to develop systems that many taxpayers (and many municipalities) can use, leading to efficiencies
- Some non-uniformity is not deliberate

Taft/

A Framework for Greater MIT Uniformity

- Making compliance easier
 - Make MIT statute sufficiently uniform that all businesses could (if they wish) use the OBG for net profits and payroll tax returns
 - Major obstacle: uniformity for combined returns
 - OBG currently can handle most of the other known differences among municipalities! So, changes in these areas would be made for other reasons



Taft/

A Framework for Greater MIT Uniformity *(Continued)*

- Make it feasible for tax software companies to add Ohio municipal tax software to their Federal and State tax packages for both individual and business returns
 - Need to explore what is required for this
- Balance contractor concerns over compliance costs with municipalities desire to prevent tax evasion



Taft/

Cincinnati / Cleveland / Columbus / Dayton / Indianapolis / N. Kentucky / Phoenix / www.taftlaw.com

A Framework for Greater MIT Uniformity *(Continued)*

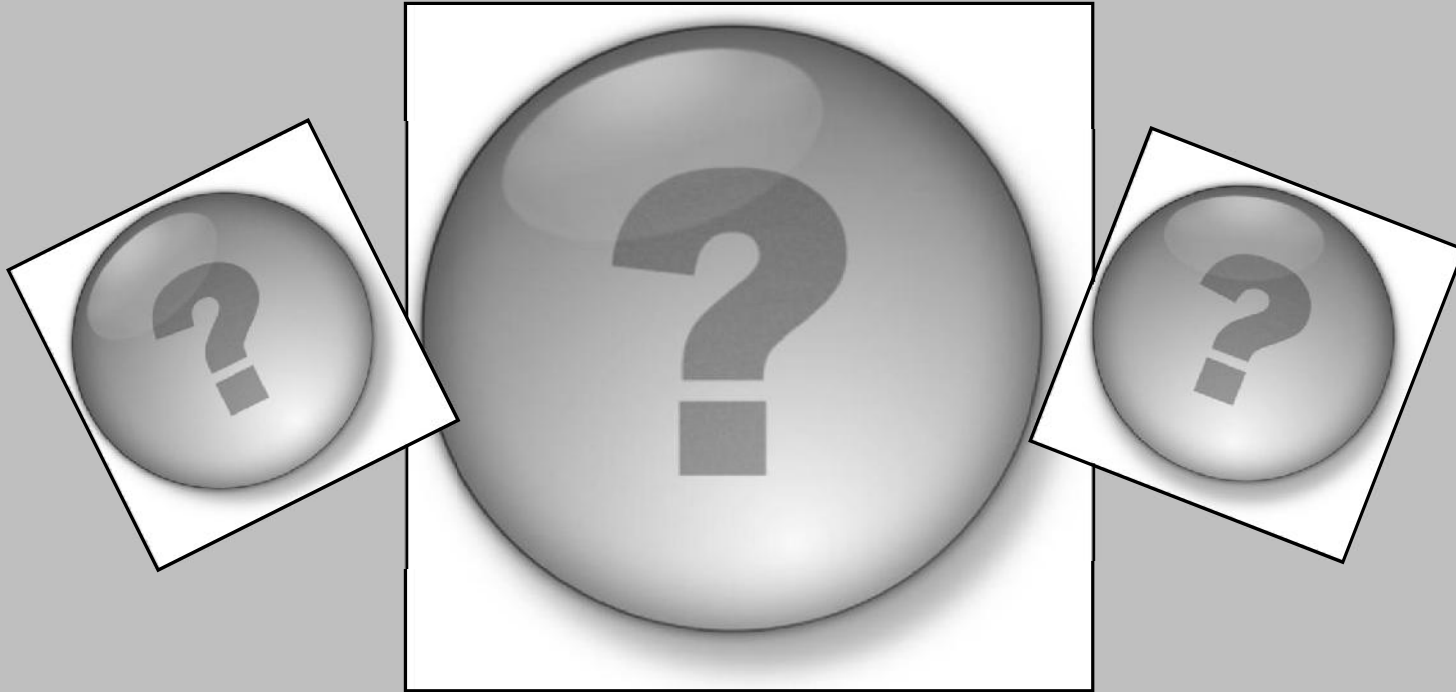
- Triage suggested changes into **four categories**:
 1. Where the benefits of uniformity probably outweigh the benefits of local choice, such as
 - Minimum amounts due and minimum refunds
 - Combined returns
 - Bright line residency?
 2. Where it is essential that local options remain, at a minimum
 - Rates
 - Credits (both reciprocity and economic development)
 - What about deferred compensation and stock options?

A Framework for Greater MIT Uniformity *(Continued)*

3. Where there may be no harm in allowing local options, especially for residents
 - Lottery and other gambling winnings
 - Retirement income

4. Where we should balance lost revenue to local governments against cost and burden of compliance benefits, such as
 - Contractors and traveling employees?
 - NOLs?

Questions? Your thoughts?



J. Donald Mottley

(614) 220-0255 / mottley@taftlaw.com

Taft/

Cincinnati / Cleveland / Columbus / Dayton / Indianapolis / N. Kentucky / Phoenix / www.taftlaw.com