SQUIRE PATTON BOGGS

MAJOR CHANGES ENACTED TO OHIO'S MUNICIPAL INCOME TAX SYSTEM

On December 19, 2014, Ohio Governor John Kasich signed into law Substitute House Bill 5 ("HB 5"). The provisions of HB 5 take effect for municipal income taxable years that begin on or after January 1, 2016, and they significantly modify Ohio municipal income tax law. HB 5 seeks to make uniform both the income tax base of each Ohio municipal corporation and the administration of each municipal corporation's income tax. It requires each municipal corporation that imposes an income tax to amend its income tax ordinances by January 1, 2016 so that those ordinances conform to Ohio Revised Code Chapter 718 (the Chapter of the Ohio Revised Code that governs municipal income taxation), as amended by HB 5. This alert summarizes the significant modifications to Ohio Revised Code Chapter 718 made by HB 5.

Computation of Taxable Income

HB 5 enacts a uniform definition of taxable income for municipal income tax purposes. Prior to HB 5, each municipal corporation could, within the constraints of Ohio Revised Code Chapter 718, choose the items of taxable income on which it would levy its tax. Under HB 5, taxable income for individuals means (i) compensation shown on IRS Form W-2, Box 5, with certain adjustments, (ii) net profit from business activities shown on IRS Form 1040, Schedule C, E, or F, less any net operating loss carryforward available to the individual, (iii) the individual's distributive share of net profit from a pass-through entity, less any net operating loss carryforward available to the individual, and (iv) prizes and winnings from lotteries, gambling, and similar activities. For corporations and pass-through entities, taxable income means adjusted federal taxable income, less any net operating loss carryforward. Prior to the enactment of HB 5, a municipal corporation had to choose whether it would tax a pass-through entity or its members. Under HB 5, a municipal corporation must tax a pass-through entity as if it were a corporation, although a municipal corporation may tax an individual resident on his or her distributive share of a pass-through entity's net profits, after allowance of a credit for taxes paid by the pass-through entity to other municipal corporations.

HB 5 also adds to the exemptions from municipal income tax many items that are not currently exempt under Ohio Revised Code Chapter 718 but that are commonly exempt under the codified income tax ordinances of most municipal corporations. These include items such as Social Security benefits, retirement benefits, pensions, disability benefits, unemployment compensation, sickness, accident or liability insurance proceeds, alimony and child support, personal injury or property damage compensation, dues and contributions received by labor unions, lodges, or religious, educational, charitable, fraternal, or literary institutions, income of estates (unless trade or business income), gains from involuntary conversions, and interest on federal bonds.

This uniform definition of taxable income will necessitate changes for those municipal corporations that currently have a tax base that differs from the HB 5 definition of taxable income. For example, municipal corporations that currently tax the cancellation of indebtedness income of an individual may no longer do so for taxable years that begin on or after January 1, 2016, unless the cancellation of indebtedness income is part of the individual's net profit from the operation of a trade or business (including the distributive share of net profit from a pass-through entity). Cancellation of indebtedness income that does not arise from a trade or business is not within the HB 5 definition of "taxable income" for an individual and is therefore no longer eligible for taxation by a municipal corporation. By contrast, although lottery and other gambling winnings are within the HB 5 definition of "taxable income," a municipal corporation may elect to exclude lottery or gambling winnings, or any other type of taxable income, from its taxable income base. The Ohio Supreme Court held in *Gesler v. Worthington Income Tax Board of Appeals*, Slip Opinion No. 2013-Ohio-4986, that the Ohio General Assembly may limit the types of income on which municipal corporations can levy an income tax, but the General Assembly cannot compel municipal corporations to tax specific items of income.

Moreover, municipal corporations that did not presently allow a carryover and deduction of net operating losses must do so for taxable years beginning on or after January 1, 2016. HB 5 requires that each municipal corporation allow the carryover of excess net operating losses for a maximum of five taxable years after the taxable year in which the net operating loss is incurred. For individuals, net operating losses from one trade or business may be offset against the net profit of another trade or business, including the distributive share of net profit from a pass-through entity. Net operating losses may not, however, be offset against an individual's qualifying wages. For municipal corporations that imposed an income tax before 2016, the maximum amount of the net operating loss carryforward that a taxpayer in such a municipal corporation may deduct in taxable years beginning in 2018 through 2022 is limited to 50% of the net operating loss carryover.

Finally, HB 5 now specifically exempts pensions from "taxable income" but continues to allow municipal corporations to tax the nonqualified deferred compensation, including supplemental executive retirement plan income, earned or received by individuals. Municipal corporations that wish to tax nonqualified deferred compensation to its full extent should make clear in their codified income tax ordinances that "pensions" do not include nonqualified deferred compensation, including supplemental executive retirement plans, for purposes of the municipal corporation's income tax.

Residency and Casual Entrants

HB 5 allows municipal corporations to treat an individual as a resident for municipal income tax purposes only if the individual is domiciled in the municipal corporation. HB 5 sets forth the 25 factors that may be used to guide the determination of whether an individual is domiciled in a municipal corporation. A municipal corporation may tax all the taxable income of a resident individual, but it may tax only the compensation of a nonresident individual earned in the municipal corporation (subject to the limitations on taxation of casual entrants, discussed below) and the net profits from business activities that are apportioned to the municipal corporation.

HB 5 also increases from 12 to 20 the number of days during a calendar year a nonresident individual may work in a municipal corporation before that individual is subject to the municipal corporation's income tax on the wages or nonwage compensation earned in the municipal corporation. If the individual works for an employer that has less than $500,000 in annual revenue, that individual's wages are subject to withholding and tax only in the municipal corporation where the individual's employer has its sole, fixed location. HB 5 provides that an individual spends a day working in a municipal corporation only if that individual spends more time working that day in that municipal corporation than in any other municipality. Thus, under HB 5 an individual may work in no more than one municipal corporation on any given day for purposes of the 20-day casual entrant rule.

Under current law, the casual entrant rule does not apply to professional athletes, professional entertainers, a promoter of professional entertainment or sports events, and the employees of such promoters. HB 5 extends the 20-day casual entrant rule to such promoters and their employees, but it provides that the 20-day casual entrant rule continues not to apply to professional athletes and professional entertainers. HB 5 also adds public figures to the list of individuals to whom the 20-day casual entrant rule does not apply. This means that professional athletes, professional entertainers, and public figures are subject to a municipal corporation's income tax on compensation earned in the municipal corporation, regardless of whether such an individual spent fewer than 20 days during the calendar year in the municipal corporation. For this purpose, a professional athlete is a person paid to perform services in a professional athletic event, a professional entertainer is a person paid on a per-event basis to perform services in the professional performing arts, and a public figure is a person of prominence who is paid on a per-event basis to perform services such as making speeches or public appearances.

Apportionment of Net Profits

As is the case under current law, HB 5 provides that net profits of a business are apportioned to a municipal corporation under an equally weighted three factor formula consisting of a property factor, a payroll factor, and a sales factor. HB 5 makes certain modifications to these factors, including (i) specifying the locations for which compensation is paid for purposes of inclusion in the payroll factor, (ii) assigning income from services to the municipality in which the services were performed for purposes of calculating the sales factor, and (iii) including in the property factor the value of rented or leased tangible personal property. HB 5 retains, however, the "throwback rule" for determining the sales factor – i.e., sales of goods are assigned to a municipal corporation if the goods are shipped from the municipal corporation and the business, through its own employees, does not regularly solicit sales at the location where the goods are delivered.

HB 5 also expands the ability to use an alternative method of apportionment rather than the three-factor apportionment formula. Under current law, an alternative apportionment method may be used, pursuant to regulations adopted by the municipality's tax administrator, if the three-factor formula does not produce an equitable result. Thus, under current law, a taxpayer may use an alternative method of apportionment only if the taxpayer obtains permission from the municipal income tax administrator in advance of filing the affected municipal income tax return.

Under HB 5, a taxpayer may request an alternative apportionment method, and a municipality may require the use of an alternative method, if the three-factor formula does not "fairly represent the extent of the taxpayer's business activity" in the municipal corporation. The taxpayer's request to use an alternative apportionment method must be made in writing and submitted along with the taxpayer's annual income tax return, amended return, or appeal of a written determination. The taxpayer may use the alternative apportionment method on the tax return that is filed with the written request to use an alternative apportionment method, and the taxpayer's request is considered accepted unless the municipal income tax administrator issues a denial of the request within the three-year statute of limitations for assessment of municipal income tax. The alternative apportionment method must involve one or more of the following: (1) separate accounting; (2) the exclusion or modification of one or more of the three factors; or (3) the inclusion of one or more different factors.

Withholding of Tax and Filing of Returns

Under HB 5, each employer must withhold and remit municipal income tax on its employees' qualifying wages pursuant to a uniform schedule. If during the preceding annual period the amount of the employer's municipal income tax withholding did not exceed $2,399, and in no month during the preceding calendar quarter did the withholding exceed $200, the employer must remit the withheld municipal income tax on a quarterly basis by the 15th day following the end of the quarter. If the employer's total municipal income tax withholding during the preceding annual period exceeded $2,399, or the withholding exceeded $200 during any month in the preceding calendar quarter, the employer must remit its municipal income tax withholdings on a monthly basis by the 15th day of the month that follows the month for which the withholding was made. Finally, a municipal corporation may require semi-monthly remittance if the employer's municipal income tax withholding for the preceding annual period exceeded $11,999 or if the withholding for any month in the preceding calendar quarter exceeded $1,000. Failure to remit the withheld municipal income taxes can result in a penalty equal to 50% of the unremitted tax, with interest accruing on the unpaid balance at a rate equal to the federal short-term rate plus 5%.

HB 5 also requires all municipal income taxpayers to file an annual municipal income tax return by the same due date as the taxpayer's annual federal income tax return, with an automatic extension of the municipal income tax return due date to same extended due date of the taxpayer's federal income tax return. A municipal income tax return is not required if the taxpayer's municipal income tax credit exceeds the municipal income tax owed. Prior to HB 5, a municipal corporation did not have to obligate all taxpayers to file an annual return.

HB 5 requires each municipal corporation to collect estimated taxes from each taxpayer whose annual income tax liability, less amounts withheld by the taxpayer's employer, is at least $200.

Prior to HB 5, each municipal corporation could choose whether to collect estimated taxes. The estimated tax payments must be made by the 15th day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year (April 15, June 15, September 15, and December 15 for calendar year taxpayers), and the estimated tax payment for each quarter must equal at least 22.5% of the taxpayer's estimated annual tax liability. A municipal corporation may not assess interest or penalties for the underpayment of estimated income tax if the taxpayer either: (1) paid at least 90% of the amount owed for the current taxable year; (2) paid an amount equal to 100% of the taxpayer's municipal income tax liability for the preceding taxable year; or (3) was not domiciled in the municipal corporation on January 1 of the calendar year that includes the first day of the taxpayer's taxable year as a resident of the municipal corporation.

Finally, HB 5 requires a municipal corporation to allow an affiliated group of corporations to file a municipal consolidated income tax return if (i) the affiliated group filed a federal consolidated income tax return for the taxable year, (ii) at least one member of the affiliated group is subject to the municipal corporation's tax, and (iii) the affiliated group shows good cause for filing the municipal consolidated return. A municipal income tax administrator may require an affiliated group to file a consolidated municipal income tax return if the administrator determines, by a preponderance of the evidence, that intercompany transactions are not at arm's length and result in distortions in net profits by shifting income or expenses to or from the municipality. The consolidated municipal income tax return of an affiliated group must be prepared in the same manner as the group's federal consolidated income tax return, and the group's municipal net profit is determined in the same way a single corporation calculates its adjusted federal taxable income for municipal income tax purposes. HB 5 makes clear that each member of an affiliated group is jointly and severally liable for the tax, interest, or penalties with respect to a consolidated municipal income tax return.

Conclusion

HB 5 enacted many additional changes to Ohio Revised Code Chapter 718 that are beyond the scope of this alert. If you have any questions regarding HB 5, including the amendments that must be made to a municipal corporation's existing codified income tax ordinances before January 1, 2016, please contact the Squire Patton Boggs lawyer with whom you work.