

SNOWBIRDS CAN'T ESCAPE TAXATION OF DEFERRED COMPENSATION

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The Ohio Supreme Court recently considered the issue of whether stock options, earned in Cleveland, Ohio but exercised after their holder had retired to Florida, can be taxed by Cleveland upon their exercise, despite the holder's no longer working or living in the city. *Willacy v. Cleveland Bd. of Income Tax Rev.*, Slip Opinion No. 2020-Ohio-314 (February 4, 2020). The options were issued to Hazel Willacy as part of her compensation during her employment by Sherwin-Williams Company in Cleveland from 1980 until her retirement in 2009. Willacy exercised the options in 2014 and 2015, years during which she no longer lived or worked in Cleveland. For each exercise of options, Sherwin-Williams withheld 2% of the proceeds to satisfy Willacy's municipal income tax obligation. Willacy sought refunds of the tax paid, but was denied by Cleveland's income tax administrator, whose decision was upheld by the Cleveland Board of Income Tax Review, then by the Ohio Board of Tax Appeals ("BTA"). Willacy's appeal from the BTA to the Tenth District Court of Appeals was then transferred to the Ohio Supreme Court.

Willacy's primary argument was that Cleveland's tax laws violate the Due Process Clause of the U.S. Constitution and the Due Course of Law Clause of the Ohio Constitution. She also argued that the income from her exercise of the options constitutes "intangible income" rather than qualifying wages, and as such it is exempt from income taxation under Ohio law and Cleveland municipal law.

Intangible Income

In support of her argument that the options income should be classified as intangible income, Willacy relied on a statement from the Sixth District Court of Appeals in *Hickey v.*

Toledo, 143 Ohio App.3d 781, 787 (6th Dist. 2001) that a “stock option is intangible property.” The Ohio Supreme Court, however, noted that Willacy ignored the Sixth District court’s further statement in *Hickey* that “when stock options are received by an employee as compensation, they may be properly taxed as compensation.” *Id.* As Willacy did receive the options as compensation, the Ohio Supreme Court concluded that they may be taxed as such. The Ohio Supreme Court rejected a further argument by Willacy that the profit from the options must be classified as intangible income because of her status as a non-resident retiree at the time of exercise. In the Ohio Supreme Court’s view, the change of a taxpayer’s status and residency between the time of earning the options and exercising them does not alter the classification of this income.

Constitutional Due Process Claims

The Ohio Supreme Court addressed the federal due process and Ohio due course of law claims together, relying on caselaw applying the federal Due Process Clause. In responding to Willacy’s claim that Cleveland’s taxation of the income in question violates her due process rights, the Ohio Supreme Court applied the established two-part test that requires: (1) a “minimum connection” between the taxing authority “and the person, property or transaction it seeks to tax,” *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954); and (2) “the presence of a rational relationship between the income taxed by the jurisdiction and the income-producing activity or property within that jurisdiction,” *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978). According to the Ohio Supreme Court, the first prong is satisfied by the fact that the options were awarded as compensation for work performed in Cleveland, notwithstanding the later exercise date following an appreciation of the options’ value. The Ohio Supreme Court also found the second prong to be satisfied. This prong relates to whether the income in question is fairly attributable to the taxing jurisdiction. The Ohio Supreme Court discusses the decision of *Hillenmeyer v. Cleveland Bd. of Rev.*, 144 Ohio St.3d 165 (2015), 2015-Ohio-1623, in which Cleveland’s method for taxing nonresident professional athletes was found to violate due process because it imposed the tax on “compensation earned while [the taxpayer] was working outside Cleveland.” *Id.* at ¶ 49. In Willacy’s case, by contrast, the stock option income is considered to be compensation for work performed entirely within Cleveland. Therefore, the second prong is also satisfied.

The Ohio Supreme Court rejected Willacy’s arguments that she received the income in a different tax year than that in which the work activities took place, and that the stock options and her activity of managing her investments both were in Florida, not Cleveland, Ohio, during the relevant years. The Ohio Supreme Court held that these arguments rely on the misclassification of the income as “intangible income” rather than “qualifying wages,” a position which the Ohio Supreme Court has already rejected. The Ohio Supreme Court also rejected Willacy’s suggestion that the earnings are not attributable to her Cleveland-based work because much of the increase in value occurred after she moved to Florida. In the Ohio Supreme Court’s view, the subsequent change in value has no bearing on the options’ classification as compensation for work performed in Cleveland.

Conclusion

The Ohio Supreme Court’s holding in *Willacy* is not surprising given the wording of the

Cleveland municipal ordinance and previous Ohio decisions on the taxation of deferred compensation. A municipality has the legal right to tax deferred income (e.g., stock options) as qualifying wages regardless of the taxpayer's residence and work status at the time he or she ends the deferral and receives cash, as long as the deferred compensation was earned for work performed in the municipality. It is worth keeping in mind, however, that municipalities may not impose tax on income that was not earned within the municipality, even if the employer paying the income is located therein. In *Wardrop v. Middletown Income Tax Review Bd.*, 2008-Ohio-5298, ¶ 29, the Twelfth District Court of Appeals held that the taxpayers "were entitled to apportion [their] income, for municipal tax purposes, based on the number of days they worked within the city," and the use of a five year average to allocate their income was considered reasonable in the absence of specific guidance from the municipality.

In *Hillenmeyer*, the "games played" method of allocating a professional athlete's income to Cleveland was held to violate the second prong of the due process clause test because it did not reasonably associate the amount of compensation taxed with the work the athlete performed within the city. The court held that the "duty-days" method was the proper apportionment method because the resulting percentage was based on all work for which compensation was earned in the relevant year, rather than just professional football games played in and outside of the city. *Hillenmeyer* at ¶ 49.

Nonresidents with stock option income from their years working in an Ohio municipality should consider whether a tax return position or refund would be available for time they spent working outside the Ohio municipality.

If you would like to further discuss the *Willacy* decision or any other state and local tax matter, please contact Richard Farrin, Debora McGraw or one of our other ZHF professionals.

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