Members Brief

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Municipal Taxation: Nonresident Income

Ohio municipalities may, pursuant to their constitutionally granted home rule authority, levy taxes on the income of both residents and nonresidents. But both the Constitution's due process clause and state law limit the extent to which municipalities may tax the income of nonresidents. This brief explores these constitutional and statutory limitations.

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Introduction

Cities and villages in Ohio may levy income taxes without an affirmative grant of authority from the state, pursuant to their home rule authority granted in Article XVIII of the Ohio Constitution. This authority includes the power to tax not only the income of their residents, but also the income of nonresidents. Yet, this power is not unlimited. Both the Ohio and United States constitutions, as well as state restrictions enacted pursuant to the Ohio Constitution, limit the extent to which a municipality may tax a nonresident's income.

This brief discusses these limitations, which have the general effect of limiting a municipality to only taxing income that a nonresident earns in that municipality. However, this brief first addresses the threshold question of under what circumstances a taxpayer may be considered a resident of a municipality.

Who is a resident?

Since a municipality may tax any income received by its residents, but is limited in taxing the income of nonresidents, the question of whether a taxpayer is a resident or nonresident is essential in determining the extent of an individual's tax liability. Until H.B. 5 of the 130th General Assembly, which took effect in 2015, each municipality adopted its own standard for making this residency determination. Many municipalities employed common law determinations of domicile that used various factors indicating where a person intended to stay (e.g., where the person maintained a home, registered to vote, or registered a motor vehicle).

H.B. 5 codified 25 of these common law factors and provided a standard that all municipalities must use to determine whether or not someone qualifies as a resident. An individual is presumed to reside in a municipal corporation if a municipal tax administrator reasonably concludes that the individual is domiciled in that municipality or if the individual was domiciled in the municipality on the last day of the preceding taxable year. The individual may rebut this presumption by showing by a preponderance of the evidence that they were not domiciled in the municipality. In making this determination, only the 25 specifically listed factors may be considered. Some examples include: where the individual owns a home or is registered to vote, or the location of banks, businesses, and health care establishments frequented by an individual.[1]

Contrast with state residency standards

The standards for determining municipal residency are different from the standards for determining whether an individual is a resident of Ohio for state income tax purposes. An individual is generally considered a resident of Ohio if he or she has more than 213 annual "contact periods" with the state, i.e., an overnight stay that results in the resident spending a portion of two consecutive days in the state.[2] In contrast, an individual's contact periods in a municipality may be considered when determining residency, but it is only one of the 25 municipal domicile standards.[3] The difference between the state and municipal residency standards potentially leads to a situation in which an individual, for income tax purposes, may qualify as the resident of an Ohio municipality but not as a resident of the state.

Due process and the taxation of nonresidents

One of the first constitutional issues to arise after Toledo levied the first municipal income tax in 1946 was whether the city could tax the income that nonresidents earned in the city. Nonresidents initiated a challenge against Toledo's tax on the basis that federal and state due process protections prohibited the city from taxing their income.[4]

The Ohio Supreme Court ruled that due process did not bar Toledo from taxing the income of nonresidents earned in the city. The Court articulated that the "test of whether a tax law violates the due process clause is whether it bears some fiscal relation to the protections, opportunities, and benefits given by the state, or, in other words, whether the state has given

[1] R.C. 718.01(J) and 718.012.

[2] R.C. 5747.24. In addition, an individual must meet a few other requirements, such as not holding a state-issued driver's license or ID and not receiving in-state tuition.

[3] R.C. 718.012(B)(18).

[4] U.S. Constitution, amend. XIV, § 1; Ohio Constitution, Article I, Section 16.

anything for which it can ask a return." According to the Court, the nonresidents did receive certain benefits from the municipality in which they worked – namely fire and police protection.[5]

While court precedent consistently establishes that municipalities may tax nonresidents working within the municipality, courts have generally found that a municipality may not tax a nonresident's income that is not earned in that municipality. Indeed, the Ohio Supreme Court has held that a municipal corporation taxing nonresident income violates constitutional due process if there is no "fiscal relation" between the tax and the protections, opportunities, and benefits provided by the taxing municipality to the nonresident.[6] Several cases have applied this principle to instances where a municipal corporation sought to tax a nonresident on income not earned in the municipality.[7]

Recent cases have applied a two-prong test to determine whether a municipality may tax a nonresident's income. The first prong requires that a minimum connection exist between a municipality and the income it seeks to tax. In other words, does the nonresident engage in some income-producing activity that may be linked to the municipality? For example, the Ohio Supreme Court has held that a nonresident professional athlete playing a game in Cleveland is sufficient to subject that athlete to Cleveland's income tax.[8] In another instance, a Florida resident with no current connections to Cleveland was nevertheless subject to its income tax on the basis of stock options the Floridian earned while working in Cleveland nearly a decade prior.[9]

The second prong requires the presence of a rational relationship between the income taxed by the municipality and the income-producing activity within that municipality. Specifically, employee compensation must be allocated to the place where the employee performed the work. For example, in the professional athlete case, the Ohio Supreme Court, while acknowledging Cleveland's authority to tax the nonresident athlete's income, rejected the manner by which the city determined how much of the athlete's income it could tax. The Court found that Cleveland's approach effectively taxed income that was actually earned and thus taxable in other jurisdictions.[10]

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[5] *Angell v. Toledo*, 153 Ohio St. 179, 185 (1950).

[6] *McConnell v. Columbus*, 172 Ohio St. 95, 99-100 (1961).

[7] See, e.g., *Vonkaenel v. New Philadelphia*, No. 2000AP 04 0041, 2001 Ohio App. LEXIS 285 (5th Dist. January 23, 2001) (holding that New Philadelphia's tax ordinance was unconstitutional to the extent it imposed an income tax on the portion of UPS drivers' salaries that were attributable to work performed outside the city, as a violation of the due process clause); *Miley v. City of Cambridge*, No. 96 CA 44, 1997 Ohio App. LEXIS 3243 (5th Dist. June 25, 1997) (same, city ordinance unconstitutional because it taxed nonresidents for work outside the city if the employer's principal place of work was in the city).

[8] *Hillenmeyer v. Cleveland Bd. of Income Tax Review*, 144 Ohio St.3d 165 (2015).

[9] *Willacy v. Cleveland Bd. of Income Tax Review*, 2020-Ohio-314. The stock options were made available to the former employee while she was employed in Cleveland, but were not exercised by her and thus not taxable until she retired and was living in Florida.

[10] *Hillenmeyer*, 144 Ohio St.3d at 176.

The major implication of these due process cases is that nearly all of the municipal corporations that currently levy an income tax extend the tax to the income of nonresidents earned in the municipality. State law does not limit the taxation of nonresidents in this manner, and even acknowledges the authority of municipal corporations to tax such income.[11] However, one consequence is that an individual may be subject to municipal income tax on the same income in two separate municipalities – where the income was earned and where the individual resides. Municipal corporations and the state have adopted various mechanisms to deal with this "double taxation" effect.

Municipal credits

Many municipal corporations mitigate the double taxation effect by granting their residents a full or partial tax credit for income taxed by another municipality. But these credits are not required under state law, so not every municipal corporation offers one.[12] According to the city of Columbus, 381 jurisdictions that levy a municipal income tax currently offer a credit to residents that fully offsets tax remitted to another taxing jurisdiction, while dozens more offer credits that partially offsets another jurisdiction's tax.[13]

Casual entrant rule

In addition to credits granted by municipalities, the state has enacted limitations on a municipality's ability to tax nonresidents who work in the municipality for fewer than 20 days in a year, often referred to as occasional or casual entrants. The general rule is as follows: an individual is essentially exempt from tax in any nonresident municipality in which the individual works for 20 or fewer days in a year. If the individual ultimately works for more than 20 days in the municipality, the individual's employer must begin withholding that municipality's tax on the 21st day.

During the first 20 days, the employer withholds income tax for the municipality, if any, where the employee's principal place of work is located.[14] The rule is slightly modified for employers with less than $500,000 in annual gross revenue. These smaller employers are authorized to withhold income tax for the principal place of work municipality for all nonresident employees, even if an employee works more than 20 days in another taxing municipality.[15] Tax withheld to a principal place of work municipality is generally exempt from taxation by the municipality where the work was actually performed.[16]

Though the casual entrant rule deals with employer withholding obligations, it may result in an employee paying more tax to a nonresident municipality than would otherwise be allowed

[11] R.C. 718.01(A)(1)(c).

[12] See R.C. 718.04(D).

[13] "Tax Municipalities," City of Columbus, Office of the City Auditor, Income Tax Division, available at https://www.columbus.gov/IncomeTaxDivision/TaxMunicipalities/.

[14] R.C. 718.011(C).

[15] R.C. 718.01(TT) and 718.011(E).

[16] R.C. 718.01(C)(16)(a).

under the due process requirements described above. Current law, for instance, contemplates that an employee may request a refund for tax withheld to the employee's principal place of work municipality pursuant to the casual entrant rule on the basis that the employee did not work in that municipality on those days. If such a refund is granted, that income is no longer exempt from tax by the municipality where the work is actually performed.[17] In other words, while an employee may be entitled to a refund of such withholdings on the basis of due process, claiming the refund will result in the possible elimination of the exemption previously enjoyed in the municipality where the work was performed.

The casual entrant rule does not apply to compensation earned by nonresident professional athletes, professional entertainers, or public figures. The manner of taxing their income is left to municipalities, but must still comply with the due process requirements described above.[18]

Employer agreements

A municipality may eschew applying all or part of the casual entrant rule if it enters into an agreement with a particular employer on how the employer will withhold tax from its nonresident employees performing work in the municipality.[19] Sometimes, municipalities will build a requirement to enter into one of these agreements into bid proposals for municipal projects.[20]

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[17] R.C. 718.01(C)(16)(d).

[18] R.C. 718.011(B)(1)(d). See *Hillenmeyer v. Cleveland Bd. of Income Tax Review*, 144 Ohio St.3d 165 (2015) (invalidating Cleveland's method of determining the nonresident income of professional athletes subject to the city's income tax).

[19] R.C. 718.011(F).

[20] See, e.g., City of Canton Water Department, "Request for Proposals: Emergency Profiling and Street Paving," p. 17 (submission deadline of January 29, 2020), available at https://www.bidnet.com/bneattachments?/607006116.pdf (requiring successful bidder to enter into an employee withholding agreement with the city of Canton).