

Ohio Supreme Court: SERP excluded from municipal income tax



Michael G. Riley | Thursday, October 12, 2017

After years of litigation, a former National City executive has prevailed in a hard fought tax dispute with the city of Cleveland. On Sept. 26, 2017, the Ohio Supreme Court decided *MacDonald v. Cleveland Income Tax Bd. of Review*. The case provides that a Supplemental Executive Retirement Plan (SERP) must be excluded from the Cleveland municipal income tax as a “pension” benefit. The ruling buttresses a 2014 Franklin County Court of Appeals decision that reached the same result in a dispute between the same taxpayer and the city of Shaker Heights. The cases could have implications for taxpayers with SERP income across the state.

BACKGROUND

THE SERP INCOME

The taxpayer, William MacDonald III, retired from National City Corporation in 2006 after working there for 38 years and serving as a top executive during his later years. MacDonald earned the income at issue through his participation in National City’s SERP. The SERP is not a deferral of current wages or segregated funds that National City set aside. Rather, the SERP is an unfunded promise to pay MacDonald about 60 percent of his income during his top earning years through an annuity. At the time of his retirement, the SERP had a present value of about \$9.1 million.

The SERP is a “nonqualified deferred compensation plan” under the Internal Revenue Code that does not benefit from the favorable tax treatment for qualified plans such as a 401(k). Even though MacDonald’s

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SERP is an annuity and federal income tax is paid as payments are received, MacDonald's W-2 for 2006 listed the entire \$9.1 million present value of the SERP for purposes of reporting and paying federal Medicare tax. In this context, many municipalities use the present value amount reported for Medicare tax purposes to similarly accelerate the imposition of their local income tax on the entire present value of the SERP in the year of retirement.

THE LEGAL BATTLE

MacDonald's cases addressed whether Cleveland or Shaker Heights could impose their municipal income taxes on the entire present value of his SERP at the time of his retirement. Both cities attempted to impose tax on MacDonald's SERP income, Shaker Heights as his residence municipality and Cleveland because he worked there.

At issue was whether the SERP income is a "pension" benefit excluded from the municipal income tax by ordinance. Cleveland Tax Ordinance 191.0901(d) excludes "pension" benefits from the Cleveland municipal income tax. Several cities such as Shaker Heights and others also have similar pension benefit exclusions from the municipal income tax on their books.

The first line of cases with Shaker Heights went up through the Ohio Board of Tax Appeals and then to the Franklin County Court of Appeals. The Court of Appeals ruled in 2014 that the SERP was an excluded pension benefit. The case then went up to the Ohio Supreme Court on an ancillary procedural issue, but the substantive tax issue had to wait for another day as the Ohio Supreme Court declined to address it. That day finally came last month when the Ohio Supreme Court ruled in MacDonald's case with Cleveland that his SERP is excluded from Cleveland's income tax.

THE COURT'S OPINION

In an opinion that Justice Pat DeWine authored, the state's high court looked to the dictionary definition of "pension" as "a fixed sum paid regularly to a person" upon retirement. The court determined that SERP income is indeed an excluded pension benefit because it is paid to MacDonald regularly as a fixed sum upon retirement.

The court also rejected several legal arguments that the city of Cleveland advanced. The court first rejected the notion that the SERP income was subject to municipal income tax as compensation for services rendered. The court rejected this argument, finding that the city's argument would, in essence, render the pension benefit exclusion meaningless and delete that section from the Internal Revenue Code.

Next, the court addressed whether local rules and regulations in effect for the 2006 tax could justify Cleveland's imposition of the tax. While the court recognized that the regulations would have taxed the SERP benefit, the court ruled that Cleveland ordinances trumped the regulations. The Cleveland City Council did not ratify the regulations and the court found that the Cleveland Tax Administrator exceeded his authority in adopting them. The regulations were therefore invalid as applied to this situation and did not justify the tax.

Third, the court addressed another provision of the Cleveland ordinances that expressly provided for taxing "qualifying wages" including "non-qualifying deferred compensation" such as a SERP. The court recognized that this provision imposed tax on the SERP, but found it to be in conflict with the pension benefit exclusion. After determining that the pension benefit exclusion is the more specifically applicable law, the court found that the "pension" benefit exclusion prevailed over the "qualifying wages" provision. In addition, the court ruled that state law did not justify imposing the municipal income tax on the SERP

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and summarily rejected several other arguments that Cleveland advanced.

IMPACT FOR OHIO TAXPAYERS

The Ohio Supreme Court's decision in *MacDonald v. Cleveland Bd. of Review* is technically limited to Cleveland's municipal income tax, but has other ramifications as a practical matter. Taxpayers and municipalities alike have been watching the MacDonald cases to protect their interests. With the court battles now finally resolved, there could be legislative action in response. Either at the state level or through each city's municipal income tax codes, you could see taxing bodies accept or reject the Ohio Supreme Court's ruling. Taxpayers should be cognizant of this changing environment and consult with their tax professionals to keep pace with the current taxing codes where they live and work.



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