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State and Local Taxes Affect Deferred Compensation Packages

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On February 4th, the Ohio Supreme Court ruled that the City of Cleveland may statutorily and constitutionally tax stock option income that a Florida resident received upon exercise in 2014 and 2015 on stock options granted to her by a Cleveland employer back in 2007.

The taxpayer worked for a Cleveland employer starting in 1980. In 2007, she was granted stock options that would expire within ten years if not exercised. In 2009, she retired from the company, left Ohio, and moved to Florida. In 2014 and 2015 she exercised the stock options. Her former employer withheld Cleveland municipal income tax on the exercise of the options. She sought refunds from the City of Cleveland, arguing that she was not a resident of Cleveland during the tax years in which the options were exercised (2014 and 2015) and the stock option income was intangible income not subject to the City of Cleveland municipal income tax in the hands of a nonresident under the applicable ordinances.

The Ohio Supreme Court ruled that the stock option income constituted "wages" from a Cleveland employer within the meaning of the City of Cleveland ordinance. As such, the stock option income was taxable by the City of Cleveland under the ordinance, notwithstanding that the retiree had not lived or worked in Cleveland for five years when the options were exercised.

Additionally, the Ohio Supreme Court held that there was no constitutional violation. Since the retiree had worked in Cleveland when the options were granted, there was a constitutionally sufficient connection to Cleveland to justify taxing the income.

One justice dissented, focusing on the five year gap in time between when the retiree lived and worked in Cleveland and when the tax was imposed. In the dissenting justice's view, the five year gap in time resulted in an insufficient connection between Cleveland and the retiree such that imposing the tax offended traditional notions of fair play and substantial justice, producing a Due Process Clause violation.

There are two lessons from the case for employers. First, state and local tax considerations should be taken into account when drafting deferred compensation packages for employees close to retirement, especially ones planning to retire out-of-state. Additionally, employers should be mindful that states and localities often require withholding on at least certain types of payments made to former employees of the company, even ones that handed in their ID cards and left the company many years ago.

The case is *Willacy v. Cleveland Bd. Of Income Tax Rev*., Ohio Supreme Court Slip Opinion No. 2020-Ohio-314 (February 4, 2020).