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## Finally! An Answer to Local Taxation of Non-Qualified SERP Benefits in Ohio

By Brad Smith

Qualified retirement plan benefits paid by pension or 401k plans have always been exempt from local taxes in Ohio. Non-qualified retirement plans (often referred to as “Supplemental Executive Retirement Plans” or “SERPs”) are often designed to enhance retirement benefits for executives over and above the benefits provided through the qualified plans offered by the employer. Over the last several years there has been disagreement between cities in Ohio and SERP eligible executives over whether benefits paid by SERPs are retirement plan benefits, exempt from local taxes, or deferred compensation benefits, subject to local taxes when such benefits become vested using FICA and Medicare (“FICA”) taxation rules.

SERP participants have alleged that SERPs are retirement benefits which should be exempt from local taxes just like qualified retirement plan benefits. Cities have argued that non-qualified SERPs are taxable compensation to the executive. The disagreement rose into the public eye in 2015 in the case of MacDonald vs. Shaker Heights when the Ohio Supreme Court ruled in favor of MacDonald. The local tax ordinance in that case did not exclude SERPs and further, did not specifically define “pension benefits” which were exempt from local taxation. After this ruling many cities amended their tax ordinance to define pensions as benefits paid only by a qualified retirement plan. Many taxpayers have argued these Ohio cities should not be able to tax retirement benefits....whether paid by a qualified or non-qualified plan. But there has been little or no guidance from Ohio on the issue.....until recently.

### What’s New in 2020?

Ohio House Bill 166 amended ORC 718 and clarifies the definitions of “pension” and “retirement benefit plan”. This prevents cities from defining such terms in their tax ordinances to require taxation of non-qualified pensions and retirement benefits. All pensions and benefits paid out of a retirement benefit plan are

exempt from local taxes if the benefits meet the following criteria:

- The benefits are provided by the Employer and not through a deferral of wages by the employee;
- The benefit payments must be due after or at termination of employment; and
- The plan is designed to deliver the benefits because of retirement or disability

HB166 does not define “retirement”; therefore, it will be up to plan documents to define what constitutes a retirement. Retirement definitions vary from plan to plan, but it is typically defined by age and/or years of service. Wage continuation, severance payments and payments of accrued vacation are specifically not included in retirement plan benefits.

Thus, whether paid by a qualified or non-qualified plan, if these criteria are met, the benefits are retirement plan benefits exempt from local taxes in Ohio. Eligibility for the exemption in SERPs is going to be a facts and circumstances analysis comparing the plan design to the criteria above and intent of the plan. The new rules were made effective January 1, 2020. SERP benefits taxed by municipalities prior to 2020 are not refundable. However, eligible SERP benefits which become vested on or after January 1, 2020, even if they have accrued over a long career, are exempt from local taxes.

### Taxation Timing

SERPs are subject to FICA taxes under special rules....the present value of the benefit is generally taxed when the benefit becomes vested, even if this is prior to payment. There is an exception for non-account balance plans which benefits cannot be determined until retirement. Ohio local taxes follow the FICA rules for tax timing. HB166 did not change these tax timing

rules. However, if the benefits qualify as “pension” and “retirement benefit plans” under HB 166, the benefits are exempt from local tax if vested on or after January 1, 2020. Starting in 2020, collection and remittance of city income taxes for an eligible SERP is no longer necessary, assuming it meets the facts and circumstances analysis.

Questions? Contact the Findley consultant you normally work with, or Brad Smith at [brad.smith@findley.com](mailto:brad.smith@findley.com), or [419.327.4414](tel:419.327.4414)

## Ineligible Benefits

Examples of executive benefits that would be ineligible for the local income tax exclusion:

- Benefits provided through elective deferrals on the part of the employee
- Any payment of benefits prior to termination of service, retirement or disability
- Benefits delivered through long term incentive plans, such as phantom stock plans, which do not promise benefits because of retirement or disability
- Benefits under a plan which provides a participant with an election to be paid prior to retirement or disability, even if the participant did not make the election
- Severance payments, payments made for accrued personal or vacation time, and wage continuation payments.

## Outcomes

As a result of HB 166, the taxation of SERPs by Ohio municipalities has been resolved. Properly designed SERP benefits will be exempt from income tax by Ohio municipalities, just like qualified retirement plan benefits.

Many employers currently have a SERP; those plans should be evaluated to determine if it meets the exemption criteria. Employers should stop reporting and withholding local wages and taxes starting in 2020 if they deem the plan(s) to be a “retirement benefit plan”.

Some school districts within Ohio have their own income tax. There are no changes to the taxation of school district income tax as a result of HB166. School District Income taxes follow Ohio taxing guidelines rather than FICA, so participants would be taxed when benefits are paid.