Ohio Tax Talk: One Step Closer To Telework Income Tax Clarity

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On Sept. 26, Ohio's Cuyahoga County Court of Common Pleas held in Morsy v. Dumas that the city of Cleveland, Ohio, must reimburse all local income tax withholdings or payments collected on Manal Morsy's income while she was working remotely from her home in Blue Bell, Pennsylvania. Cleveland appealed the decision. On Nov. 2, Ohio's Eighth District Court of Appeals granted a stay and abeyance, effectively placing a hold on the appeal until a similar case, Schaad v. Alder, is decided at the Ohio Supreme Court level.

Remote work policies are a significant area of contention as states and localities attempt to clarify withholding tax obligations in a post-COVID work environment.[1] The initial ruling in Morsy is significant as it demonstrates a victory for employees when it comes to telecommuting during the COVID-19 pandemic.[2]

Background

During the COVID-19 pandemic, many states, including Ohio, enacted legislation that offered employers an alternative to the existing income tax withholding mandate, which required employers to withhold municipal income taxes based on an employee's principal place of work.[3]

In an effort to reduce the compliance burden for employers when computing income tax withholding at a time when the majority of their workforce was working from home, Ohio enacted Section 19 of H.B. 197, which allowed employers to withhold municipal income taxes for remote employees as if they were working at the employer's location during the COVID-19 emergency declaration.

Although H.B. 197 allowed employers by and large to treat any municipal income tax withholding as they would have prior the pandemic, the result was often that remote employees were subject to a higher municipal income tax, since a majority of employers are located in and around higher-tax-rate municipalities such as Cleveland or Cincinnati.

Summary

The plaintiff in the case, Morsy, was employed as a senior executive at the Cleveland-based biotech company, Athersys Inc. Prior to the pandemic, Morsy commuted, residing in Cleveland Monday through Friday, and returning to her home in Blue Bell on the weekends. She was considered a resident of Blue Bell for income tax purposes.

Prior to the pandemic, Morsy's employer withheld city of Cleveland income taxes from her pay. Morsy would then apply for and receive municipal income tax refunds from Cleveland for the days she worked in Pennsylvania.

Pursuant to H.B. 197, Morsy's employer continued to withhold income taxes as if she was working in Cleveland during the pandemic. When she applied for a refund of income taxes paid to Cleveland during that time, her request was denied.

In her initial complaint, Morsy called on the court to declare H.B. 197 unconstitutional, as it allowed Cleveland to tax income from workers who do not reside in the city's jurisdiction. The Court of Common Pleas, when granting Morsy summary judgment, found that H.B. 197 is constitutional on its face, but was unconstitutional when applied to assess income tax against a nonresident for wages earned on work performed outside the state.

Observing that "an employee enjoys the protections, opportunities and benefits" of a taxing authority where they are physically present, the court concluded that Cleveland did not establish a basis for jurisdiction to tax Morsy on income generated by work performed at her home in Pennsylvania. Thus, she was entitled to a refund.[4]

Implications

Morsy, like Schaad and a handful of other Ohio cases, were filed by the Buckeye Institute, an independent research and educational institution that has filed several teleworking cases alleging violations of the Ohio and U.S. Constitutions.[5][5] Although the ruling in Morsy was relatively narrow in that it only applies to those residents working out of state, Ohioans should get clarification on this topic in the upcoming months.

In Schaad, the Buckeye institute asserted a broader facial challenge to H.B. 197 on constitutional grounds of due process. This case is currently pending before the Ohio Supreme Court.

The most distinguishing aspect of Morsy was the interstate nature of the dispute. As previously stated, Morsy was a resident of Blue Bell, Pennsylvania, and had initially requested a refund from the city of Cleveland for her municipal withholding taxes. Schaad, on the other hand, is a resident of Blue Ash, Ohio.

In its Morsy ruling, the court distinguished the two cases by stating: While the Ohio General Assembly has jurisdiction over Ohio residents and authority to deal with exigencies of the pandemic, it cannot create jurisdiction to levy a tax on the income of persons who are not residents of Ohio, and that was earned for work performed outside of the State of Ohio.[6]

Therefore, in its ruling, the court emphasized that Morsy was not required to exhaust her administrative remedies prior to filing her lawsuit.

Cleveland, unsurprisingly, disagrees with the lower court's decision, and on Oct. 19 filed a notice of appeal. On Nov. 2, Ohio's Eighth District Court of Appeals granted a stay and removed the appeal from its active docket pending the Ohio Supreme Court's decision in Schaad. The Supreme Court granted review in Schaad on June 7, and merit briefs have concluded as of Oct. 24.

Although the facts of Schaad are not identical to Morsy, the Supreme Court's decision in Schaad may potentially govern its outcome, or at the very least provide guidance concerning the application of H.B. 197.

Significance

In a partial response to the ongoing litigation over income tax withholding in Ohio, the state's 2021 budget bill partially reversed

H.B. 197, allowing remote workers to file refund claims for income tax withheld by cities in 2021 based on their primary work location; however, the relief does not apply to the 2020 tax year.

Although H.B. 197 was initially intended to ease employers' compliance burdens, in effect, the legislation was seen to unfairly tax those whose employer's offices were located in city centers, but who perform work in more suburban or rural areas, as these cities often apply higher income tax rates when compared to their suburban or rural counterparts.

The city of Cleveland, for example, collects more than $400 million a year from its 2.5% income tax and estimates that pre-COVID-19, 85% of that came from commuters who live outside the city.[7] This ruling, along with the other cases brought by the Buckeye Institute, could impact other Ohio cities like Cincinnati, Toledo or Youngstown, that also employ workers residing outside Ohio. Potentially, out-of-state remote workers may use the Morsy decision to recover income tax withholdings.

In some ways, the outcome of the Morsy and Schaad decisions will have limited impact, as the decisions cover a discreet time frame. However, these decisions may have important ramifications for taxpayers and the Ohio municipal income tax system as a whole.

Tax practitioners know that jurisdiction to tax is an ongoing issue, complicated by a growing mobile —and now remote —workforce. The outcome of these Ohio cases could greatly affect the ability of Ohio municipalities to tax such workers.

This could be a boon to suburban and rural municipalities, while detrimental to major cities. Likewise, if the decision in Morsy is upheld, border cities may be disproportionately affected, as they may face ongoing issues collecting taxes from workers who live across state lines. Ohio, like many states, has a multitude of taxing jurisdictions that will continue to collect taxes.

If these decisions narrow the ability of municipalities to collect income taxes because of due process or other constitutional concerns, a ripple effect may reach taxes beyond the municipal income tax. Likewise, if the courts rule in favor of taxpayers in these cases, suburban and rural areas may become far more aggressive in their efforts to capture income from remote workers.

This, in turn, could complicate matters for employers, who may be forced to implement stringent tracking of employees' activities to ensure proper withholding occurs.

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[1] Morsy v. Dumas, Ohio, Ct. Com. Pl. No. CV 21 946057, Summary judgment granted 09/26/22.
[2] We previously discussed this here: Ohio Tax Talk: Telework Case Shows Tax Grounds Eroding, https://fbtgibbons.com/ohio-tax-talk-telework-case-shows-tax-grounds-eroding.
[3] See O.R.C. 718.011(A).
[4] Morsy v. Dumas, Ohio, at 6.
[5] See Schaad v. Alder, 1st Dist. Hamilton, 2022-Ohio-340; Buckeye Inst. v. Kilgore, 2021-Ohio-4196; Curcio, et al., v. Hufford, et al., Lucas City Court of Common Pleas, Case No. CI-2021-1522; Denison v. Kilgore, Franklin County Court of Common Pleas, Case No. 21-CV-00848. More information can be found at https://www.buckeyeinstitute.org.
[6] Morsy v. Dumas, Ohio, at 6.
[7] Robert Higgs, Ohioans Aren't Close To Getting All The Answers, Despite Court Ruling That Cleveland Must Refund Some Income Taxes Cleveland (2022), https://www.cleveland.com/metro/2022/10/ohioans-arent-close-to-getting-all-the-answers-despite-court-ruling-that-cleveland-must-refund-some-income-taxes.html (last visited Oct 11, 2022).