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We keep track of Ohio tax developments on a regular basis. This article includes developments between October 2008 and April 2009, as well as an update on Ohio's CAT, interesting sales and use tax cases, continuing developments on the now repealed tangible personal property tax, and a local income tax decision on option income.

I. COMMERCIAL ACTIVITY TAX

Since its enactment on June 1, 2005, the Ohio commercial activity tax has been under attack by taxpayers. In the March 2009 issue of the *State Tax Return,* we reported on the first nexus challenge to the CAT. Now the Supreme Court of Ohio has agreed to review the court of appeals' decision that the CAT is an unconstitutional tax on food.

A. Judicial Developments

1. *Ohio Grocers Association, et. al., v. Wilkins*, 2008-Ohio-4420 (Sept. 2, 2008) UPDATE

On September 2, 2008, the court of appeals held that Ohio's commercial activity tax ("CAT") violated the Ohio Constitution's prohibition on excise taxes on the sale of food. On February 4, 2009, the Ohio Supreme Court agreed to hear the Ohio Department of Taxation's appeal of the court of appeals' decision. In the interim, the Department has advised taxpayers that they should continue to file all applicable CAT returns and make all applicable CAT payments.[1] However, taxpayers may file protective refund claims for CAT paid. Refund claims must be filed within four years of the date of the illegal or erroneous payment of CAT. Refund claims should be filed on Form CAT-REF, which is available on the Department's web site at www.tax.ohio.gov.

[1] *Ohio Department of Taxation Information Release CAT 2008-02* (Revised Feb. 2009).

II. SALES AND USE TAX

Sales tax developments covered in this article are as follows:

- The court of appeals' rejection of DIRECTV's constitutional challenge to the sales tax on satellite broadcasting services;
- *A tax commissioner's opinion finding that consulting and managed services provided by a technology firm were personal services not subject to sales and use tax;*
- *The Board of Tax Appeals' decisions holding that:*
    1. Swimming pools used in a water park are business fixtures that are subject to sales tax;
    2. *A taxpayer could not claim the sales tax bad-debt deduction because the taxpayer had not paid the sales tax on the bad-debt amounts in a preceding tax period; and*
    3. *Individuals were personally liable for sales tax not paid by the corporation.*

A. Judicial Developments

1. *DIRECTV, Inc. v. Levin,* 2009-Ohio-636 (Ct. App. 2009).

In this case, the Tenth District Court of Appeals rejected a constitutional challenge to the imposition of sales tax on retail sales of satellite broadcasting services.

Facts

In 2003 the Ohio General Assembly amended Ohio sales tax law to include satellite broadcasting services as a taxable service. Cable television services, however, are not subject to Ohio sales tax. DIRECTV challenged this disparity in taxation, claiming it violated the Commerce Clause of the United States Constitution.

The trial court, on motions for summary judgment, concluded that "the tax scheme was discriminatory in effect and impermissibly burdened satellite providers by increasing the net costs to television consumers for satellite service in comparison to cable service." The tax commissioner appealed to the court of appeals.

The Court of Appeals Found No Violation of the Commerce Clause.

After an extensive review of United States Supreme Court Commerce Clause precedent, the court concluded that "[the Commerce Clause] protects interstate commerce and the interstate market for products, but does not protect the particular structure or methods of operation in the retail market."

Therefore, there is no Commerce Clause violation if the differential tax treatment "results solely from differences between the nature of their businesses, not from the location of their activities."

The court found that this case involved two different modes of interstate business. Both modes of business, cable and satellite, obtain most of their programming outside Ohio and distribute it to Ohio consumers. Thus, the court stated:

> The tax distinction between satellite and cable providers does not discriminate against interstate commerce as a whole, but places a burden against one form of delivering pay television to consumers, and the burden would fall equally on a satellite provider headquartered in Ohio, having all program content, satellite uplink, account services, and customers in-state.

Since at best the sales tax on satellite broadcasting services discriminated *between different forms* of interstate commerce, there was no Commerce Clause violation.

B. Administrative Developments

1. Ohio Department of Taxation, Opinion of the Tax Commissioner, No. 08-0006 (July 22, 2008).

The tax commissioner considered whether a technology firm that provides consulting and managed services is subject to Ohio sales and use tax. At issue is whether the services qualified as "personal or professional services" or taxable "computer services" under Ohio law.

Facts

The taxpayer ("Taxpayer") is a technology consulting firm that offers a range of professional services. All of Taxpayer's clients participate in a technology assessment. To conduct the assessment, Taxpayer sends a team of consultants to the client's facility to interview staff and management and assess the technical infrastructure. Once the assessment is complete, Taxpayer reports on the assessment and makes suggestions to improve efficiency.

Because many of Taxpayer's clients lack the internal resources to make the recommended changes, Taxpayer also offers ongoing consulting services and support in the form of managed service. Managed service agreements ("MSAs") typically include remote monitoring, vendor management, and access to Taxpayer's consultants via a help desk. Under MSAs, clients typically pay fixed monthly fees.

Taxpayer requests an opinion from the tax commissioner regarding whether its services are subject to sales and use tax in Ohio.

The Commissioner Found Taxpayer's Services Were Personal or Professional.

Services are not subject to sales and use tax in Ohio unless a specific provision lists them as taxable. "Computer services" are taxable under Ohio law. "Computer services" means "providing services consisting of specifying computer hardware configurations and evaluating technical processing characteristics, computer programming, and training of computer programmers and operators, provided in conjunction with and to support the sale, lease, or operation of taxable computer equipment or systems."

R.C. 5739.01(Y)(1)(b). However, "computer services . . . shall not include personal or professional services." R.C. 5739.01(Y)(1)(d). "Personal or professional services" include analyzing business policies and procedures; identifying management information needs; analyzing computer hardware or software needs; designing policies, procedures, and custom software for collecting business information; developing policies and procedures that document how business events and transactions are to be authorized, executed, and controlled; testing business procedures; and training personnel in business procedure applications. R.C. 5739.01(Y)(2).

The commissioner concluded that Taxpayer's consulting and managed services are personal or professional services under R.C. 5739.01(Y)(2). Therefore, the services are not subject to sales or use tax in Ohio. However, the commissioner cautioned that any deviation from the facts presented in this area of rapidly changing technology and services could change the answer provided.

2. *Goofy Golf II, Inc. v. Levin*, BTA No. 2007-A-199 (Nov. 4, 2008).

The Board of Tax Appeals was asked to determine whether pools used at a water park were subject to use tax. The decision centered on whether the pools were real property or personal property under Ohio law.

Facts

Goofy Golf II, Inc. ("Goofy Golf"), operates a water park. The Department assessed use tax on Goofy Golf's purchases of materials for the construction and installation of several pools. Goofy Golf objected, arguing that the pools were not subject to tax because they were incorporated into real property. The tax commissioner agreed that two in-ground pools had become real property and were not subject to use tax. However, the tax commissioner concluded that the rest of the pools at issue were business structures and subject to use tax.

Goofy Golf also argued that because sales tax was erroneously remitted by the contractor on purchases of materials and supplies, Goofy Golf was entitled to a credit for the tax already paid. The tax commissioner denied the objection, finding that Goofy Golf was not the consumer in such transactions.

Goofy Golf appealed the decision to the Board of Tax Appeals.

The Board Concluded That the Credit Issue Was Not Properly Raised.

In its brief**,** Goofy Golf claimed that its contractor paid sales tax on purchases of materials and supplies for the pools and then charged Goofy Golf sales tax. As a result, Goofy Golf argued that it was entitled to have its assessment reduced by such amounts. The Board found that it was unable to consider Goofy Golf's credit argument because it failed to raise the issue in its notice of appeal.

The Board Further Concluded That the Pools Were Business Fixtures.

Goofy Golf contended that the pools were real property under R.C. 5701.02(A)–(E), while the commissioner argued that the pools were business fixtures under R.C. 5701.01(A) and (B). The Board noted that R.C. 5701.02 requires it to inquire into the specific characteristics of the property in question to determine whether it is real property. Moreover, an item is considered real property under R.C. 5701.02(E) if: (1) the property is attached or affixed to the land; (2) the attachment is a permanent fabrication or construction other than a building; and (3) the property increases or enhances utilization or enjoyment of the land.

Applying the three requirements above, the Board found that the pools were business fixtures, not real property structures. The Board concluded that the pools were attached to the land. However, to be considered a structure, an item must "have such relationship to the land or improvements already constructed thereon as to be necessary or beneficial to its enjoyment, independent of the business presently carried on." *Zangerle v. Standard Oil*, 144 Ohio St. 506 (1945); *see also Funtime, Inc. v. Wilkins*, 105 Ohio St. 3d 74 (2004). Examples of realty fixtures include bridges, trestles, dams, silos, fences, and walls. The Board found that the pools at issue did not enhance the utilization of the land. As opposed to standard in-ground pools, they are specialty attractions that are unique to the water park business and would be of no benefit to any other user of the land.

Based on all of the above, the Board concluded that the pools are business fixtures and constitute real property. Therefore, the Board affirmed the tax commissioner's conclusion that the pools were subject to use tax.

3. *Hartville Ready-Mix, Inc. v. Wilkins*, BTA No. 2006-H-462 (Oct. 21, 2008).

The Board of Tax Appeals was asked to determine whether a taxpayer was permitted to deduct bad debts from its sales tax assessment.

Facts

Hartville Ready-Mix, Inc. ("Hartville"), produces and supplies pre-mixed concrete. After Hartville filed several late monthly sales tax returns, the tax commissioner conducted an audit and determined that Hartville had collected but failed to remit sales tax. Hartville filed a petition for reassessment, requesting that the tax commissioner reduce the amount owed by the amount of bad debt. The tax commissioner found that "[b]ad debts resulting from most of the charges made during this period were not eligible for deduction from the sales tax returns filed during this period." Hartville appealed to the Board of Tax Appeals.

The Board Concluded That Hartville Could Not Deduct Bad Debts.

Before the Board, Hartville argued that the tax commissioner erred in refusing to allow it to deduct bad debts from the total tax assessed. Under R.C. 5739.121, taxes must be paid on bad-debt amounts in a preceding tax period before a deduction can be claimed. Hartville did not dispute that sales tax was collected but not remitted during the period at issue. Therefore, Hartville could not have paid the tax on the bad-debt amount that it argued it was entitled to deduct. Moreover, Ohio law requires any amount deducted for bad debts to have been charged off as uncollectible on the vendor's books. Hartville's spreadsheets described the debts as "not written off." For both of these reasons, the Board affirmed the tax commissioner's disallowance of bad-debt deductions.

4. Sales Tax Personal Liability Cases

In two recent cases, the Board of Tax Appeals was asked to determine whether individuals affiliated with Ohio corporations were personally liable for sales tax assessed against the corporations. The outcome in both cases turned on whether the individuals were responsible parties under Revised Code § 5739.33.

(a) *Fetchet v. Levin, BTA No. 2007-T-751 (Feb. 10, 2009).*

Facts

Ann & Andy's, Inc. ("Ann & Andy's"), is an Ohio corporation that operates as a bar and restaurant. Ann & Andy's failed to file sales tax returns from January 1995 through May 1996 and did not remit the amount of sales tax due. As a result, the tax commissioner issued assessments. Because the assessments were never paid, the tax commissioner assessed Laurence Fetchet personally as a responsible party. Fetchet argued in his notice of appeal that the assessment was in error because he was not a responsible party during the periods at issue.

The Board Held That Fetchet Could Not Be Held Derivatively Liable.

Under R.C. 5739.33, certain individuals may be held personally liable for a vendor's failure to file sales tax returns or remit sales tax. That section is intended to "hold those officers or employees who were in charge of the operations of a defaulting corporation personally liable for unpaid sales tax if such persons filed returns or paid taxes, or controlled or supervised others who performed those tasks, or had responsibility for such tasks." *Spithogianis v. Limbach*, 53 Ohio St. 3d 55, 57 (1990). In other words, only those persons who have a specific connection with the preparation and filing of tax reports and the remittance of tax can be held personally liable.

Applying these rules, the Board determined that Fetchet could not be held personally responsible for the assessments. During the relevant periods, he was not an employee. Instead, he stocked shelves, filled in as bartender, cleaned, and ran errands to help his father, who was the president of the corporation. Fetchet was not an officer of the corporation, had no ownership interest, and had no authority to sign checks. Moreover, Fetchet did not become responsible for filing tax returns and remitting sales tax until the end of 1996—after the assessment period. Based on all of these facts, the Board determined that Fetchet was not among the class of persons who could be held personally liable for corporate sales tax. Therefore, the tax commissioner's final determination was reversed.

(b) *Mick v. Wilkins,* BTA No. 2007-H-126 (Jan. 27, 2009).

Facts

Steven Mick was a 50 percent shareholder in Allied Communications, Inc. ("Allied"), and also served as its secretary and vice president from October 1999 to October 2000. During that same period, Mick's business partner was Allied's other 50 percent shareholder and its president and treasurer. Mick managed sales and operations, including employees and daily functions. Mick generally did not file tax returns or sign checks, but he did so when his business partner was not available. After his business partner resigned in October 2000, Mick became Allied's sole shareholder and president until it went out of business in March or April 2001.

The tax commissioner determined that Mick was a responsible party. As a result, he could be held derivatively liable for Allied's sales tax assessments. Mick appealed to the Board of Tax Appeals.

The Board Held That Mick Could Be Held Derivatively Liable.

The Supreme Court of Ohio has determined that officers or employees can be held personally responsible for a tax assessment under R.C. 5739.33 only when they have "control or supervision of or are charged with the responsibility of filing returns or making payments." *Kihm v. Lindley,* 70 Ohio St. 2d 76 (1980). The Supreme Court has further expanded on that interpretation by holding that a responsible officer or employee is one who has knowledge of the statutory duty to file taxes and the authority to write checks. *See Lenart v. Lindley*, 61 Ohio St. 2d 110 (1980).

With respect to October 2000 through April 2001, the Board found that Mick could not dispute that he was president and sole shareholder of Allied. Therefore, the Board concluded that he was a responsible party and could be held liable under R.C. 5739.33 for all sales tax assessments due for that period.

With respect to October 1999 through October 2000, Mick argued that he could not be held liable because he strictly handled operations while his partner handled fiscal matters. The Board disagreed, finding that Mick had enough supervision and control over the filing of sales tax returns and check signing to be deemed a responsible party. In fact, he signed numerous monthly tax returns and checks. As a result, the Board held Mick liable for the tax assessments due for October 1999 through October 2000.

III. PERSONAL PROPERTY TAX

Although Ohio personal property taxpayers made their last personal property tax payments on September 22, 2008, litigation continues. The Supreme Court of Ohio recently found that a company's personal property tax refund claim was not barred although it was based on removing fictitious assets reported on its Ohio personal property tax return. Further, the Ohio Board of Tax Appeals considered whether the tax commissioner's determination of a retailer's inventory was wrong because the tax commissioner failed to consider markdown allowances.

A. Judicial Developments

1. *HealthSouth Corporation v. Levin,* 2009-Ohio-584 (Feb. 17, 2009)

The Supreme Court of Ohio found that HealthSouth's personal property tax refund claim was not barred although it was based on removing fictitious assets reported on its Ohio personal property tax return. However, the court remanded the case to the Board of Tax Appeals to determine whether HealthSouth provided sufficient evidence justifying the reduction in the true value of its tangible personal property.

Facts

In March 2003, the Securities and Exchange Commission filed suit against HealthSouth and its chairman, asserting that HealthSouth had deliberately overstated its earnings. In response, HealthSouth's board of directors appointed a special audit review committee ("Committee") to examine HealthSouth's corporate accounting. The Committee found more than $2.7 billion in false or unsupported entries in the accounting system. The Committee also found more than $1 billion in fictitious assets used to conceal the entries. Some of these fictitious assets were included on Ohio personal property tax returns filed for tax year 2002.

HealthSouth filed an application for final assessment and refund of personal property tax overpaid. In support of its claim, HealthSouth provided spreadsheets prepared by an outside representative. HealthSouth stated that these spreadsheets established that it removed the fictitious assets from its books. The tax commissioner denied HealthSouth's refund claim because it did not provide "detailed journal entries" showing that HealthSouth wrote off the fictitious assets. HealthSouth appealed to the Board of Tax Appeals, which reversed the tax commissioner without addressing the tax commissioner's objections to the sufficiency of HealthSouth's evidence. The tax commissioner appealed to the Supreme Court of Ohio.

Supreme Court Holds That Good Faith Is Not a Condition to Receiving a Refund of Personal Property Tax.

The court found that the Ohio property tax statutes do not condition a taxpayer's right to the correction of an assessment or a refund of taxes on whether the taxpayer completed the original personal property tax return in good faith. In addition, the court found that R.C. 5711.26 required the tax commissioner to issue a final assessment certificate when a taxpayer timely requests same. Thus, the tax commissioner cannot refuse to correct an assessment unless the reason for refusal is listed in R.C. 5711.26.

The court rejected the tax commissioner's request to find that equity required a finding that HealthSouth's conduct precluded it from receiving a refund. In effect, the tax commissioner asked the court to find that HealthSouth was estopped from seeking a refund because of its conduct. The court refused, citing long-standing precedent in Ohio that estoppel does not apply to tax matters. In addition, the court found that this case did not "fit the standard pattern of estoppel based on fraud." Here, HealthSouth's shareholders, not Ohio, were primarily harmed. If the state were allowed to deny the refund, the shareholders would be further harmed.

The court criticized the Board for failing to properly evaluate the evidence and to set forth in its decision the evidence that substantiated HealthSouth's reduction in the true value of its property. Thus, the Court returned the case to the Board ordering it to complete its fact finding based on the existing record.

B. Administrative Developments

1. *Rich's Department Stores, Inc. v. Wilkins*, BTA No. 2005-T-1609 (Feb. 3, 2009).

The Board of Tax Appeals was asked to consider whether the tax commissioner erroneously determined the true value of a retailer's inventory for personal property tax purposes by failing to consider vendor markdown allowances when determining cost.

Facts

Rich's Department Stores, Inc. ("Rich's"), was a national chain of retail department stores that operated under the name "Lazarus." To account for its retail inventory values, Rich's used the "retail inventory method" ("RIM") of accounting. RIM is based on the notion that the cost value of inventory bears the same relationship to retail value as the original cost bore to the original retail value. In other words, the purchase markup figured when the inventory is placed in stock may be applied to the inventory value at retail to reduce it to cost. RIM "basically consists of taking the retail sales price of the merchandise in stock and deducting therefrom the percentage markup by departments." *R.H. Macy Co., Inc. v. Schneider*, 176 Ohio St. 94, 97 (1964).

Rich's referred to its percentage markup as "margin performance." "Margin performance" was essentially the profit margin Rich's made on its merchandise. Whenever Rich's purchased merchandise from a vendor, the two agreed upon a margin performance that was expected for the merchandise over a given period. There was an understanding that the retail price of merchandise may undergo some adjustment.

Rich's used two basic types of markdowns to adjust retail price. The first type, point-of-sale markdowns, are temporary. The second type, hardmarks, are permanent and often done in a series. Essentially, hardmarks are used when an item can no longer be sold at its then current price because sales are slow. While some hardmarks are anticipated, the merchandise sale rate may be slower than expected. As a result, Rich's would sometimes attempt to move merchandise by applying additional hardmarks. These hardmarks reduce the margin percentage.

Throughout each selling season, Rich's would communicate with vendors to discuss their performance. When the margin performance dropped below the anticipated percentage, Rich's would negotiate a monetary contribution from the vendor. To maintain positive business relationships, vendors usually agreed to the contributions, known as "vendor markdown allowances" ("MDAs"). These MDAs were not a cash amount paid to Rich's, but a credit to be applied to future purchases from the vendors.

In response to Rich's request for a final assessment and partial refund, the tax commissioner issued 34 final assessment certificates against Rich's for unpaid personal property tax. The commissioner had found that MDAs are in the nature of a contribution to margin—an increase in Rich's profit rather than a reduction in the cost of goods. Rich's filed an appeal with the Board of Tax Appeals.

The Board Concluded That Vendor Markdown Allowances Should Have Been Considered When Calculating Inventory Value.

Under the now repealed personal property tax,[2] every taxpayer who engaged in business within the State of Ohio was required to file an annual personal property tax return with the county auditor of each county where property used in the business was located.

There were several issues on appeal. First, the Board had to determine whether MDAs reduce cost and, thus, the true value of inventory or whether they reduce the amount of hardmarks applied to retail. The Board agreed with Rich's, finding that MDAs are common in the retail business and are treated by retailers as a reduction in the cost of goods. "Cost," for purposes of personal property tax, is not actual cost but inventory value. *Higbee Co. v. Evatt*, 140 Ohio St. 325, 329 (1945). This method automatically recognizes a decline in inventory value due to the impaired value of merchandise. Treating MDAs as a reduction in cost is supported by the Financial Accounting Standards Board, which oversees the development of accounting practices.

[2] The final personal property tax payments were due September 22, 2008. The Ohio Department of Taxation, September 19, 2008, news release.

Second, the Board was faced with the question of whether Ohio Administrative Code § 5703-3-17 prohibits Rich's from applying MDAs to reduce its inventory values. The commissioner argued that under § 5703-3-17, reductions to the book value of inventory can be allowed only for "cash discounts," "merchandise shrinkage," and "aggregate net markdowns." The tax commissioner argued that MDAs do not fall into any of these categories. However, the Board disagreed, finding that average inventory value is based on "cost as disclosed by the books of the taxpayer." Once cost is determined on the taxpayer's books, the rule permits additional adjustments for cash discounts, merchandise shrinkage, and aggregate net markdowns. These adjustments are made only after the cost of the inventory is determined. As previously discussed, cost includes MDAs.

Finally, the Board had to determine whether Rich's met its burden of establishing true value. The tax commissioner argued that Rich's MDAs had to be rejected because Rich's estimated them rather than submitting the actual amounts from each store. However, the Board rejected the tax commissioner's position because the cost of inventory is an average based upon the average cost-to-retail ratio. Moreover, the Board found that Rich's did not rely upon a random sampling of MDAs but upon the MDAs actually applied and the cost shown on its books.

Based on all of the above, the Board determined that the tax commissioner's failure to consider MDAs was unreasonable and unlawful. Therefore, Rich's request for a reduction in inventory value was granted.

IV. REAL PROPERTY TAX EXEMPTION

The Supreme Court of Ohio recently held that real property leased to a nonprofit corporation was not exempt from real property tax as property owned by a charitable institution but leased to another charitable institution.

A. Judicial Developments

1. *Northeast Ohio Psychiatric Institute v. Levin,* 2009-Ohio-583 (Feb. 17, 2009).

In this case, the Supreme Court of Ohio affirmed the tax commissioner's and Board of Tax Appeals' denial of charitable exemption for real property leased to an entity that provides behavioral health services to the general public.

Facts

Northeast Ohio Psychiatric Institute ("Northeast") is a nonprofit 501(c)(3) corporation. Its regulations state that its purpose is to "operate in connection with and carry out the exempt purpose of Portage Path Community Mental Health Center ['Portage Path']." Portage Path provides behavioral health services to the public per an agreement with Summit County. That agreement allows Portage Path to be reimbursed for its services as long as it does not deny service to anyone who needs it because of inability to pay and adheres to the county's ability-to-pay guidelines. Patient fees are set on a sliding scale based on financial need. Summit County reimburses most, but not all, unpaid costs. Thirty-five percent of patients are covered by Medicare or Medicaid.

Sixty-eight percent of the property was used by Portage Path. Portage Path's rent was $5,500 per month, but Northeast discounted the rent so that Portage Path did not pay more than 68 percent of the cost to operate the building. Northeast did not discount the rent paid by private tenants leasing space in the building. The rent received for 2002 and 2003 exceeded the cost of operating the building. The tax commissioner and Board of Tax Appeals denied exemption for the real property, and Northeast appealed to the Supreme Court of Ohio.

The Court Affirmed the Denial of Exemption Finding That Northeast Was Not a Charitable Institution.

The first issue faced by the court was whether Northeast was a charitable institution. This issue was critical because property leased by its owner cannot qualify for exemption under R.C. 5709.12(B), since the owner uses the property for leasing, not exclusively for charitable purposes. Since R.C. 5709.12(B) was not applicable, Northeast must qualify for exemption under R.C. 5709.121. That provision allows exemption for property owned by a charitable institution that is leased to another charitable institution which uses the property for charitable purposes. However, to qualify, the property must be owned by a charitable institution.

The court found that whether Northeast was a charitable institution turned on the charitable activities of Northeast and not on the charitable activities of its lessee, Portage Path. In holding that the Board reasonably and lawfully concluded that Northeast's activities did not make it a charitable institution, the court relied on these facts:

- Northeast generated significant revenue through leasing property and providing psychiatric staffing services.

- There was no evidence that Northeast's off-site mental health clinic was operated on a charitable basis.

The court also rejected Northeast's claim that it was a charitable institution because none of its earnings were used for private benefit. That alone, the court found, did not make Northeast a charitable institution.

V. PERSONAL INCOME TAX

The Court of Appeals held that corporate executives were required to pay municipal income tax on profit from stock options and retirement plans.

A. Judicial Developments

1. *Wardrop v. City of Middletown Income Tax Review Board*, No. CA2007-09-235 (Ohio App. 12th Dist., Oct. 13, 2008).

The court was asked to determine whether corporate officers were subject to the City of Middletown's personal income tax. The income in question included profit from restricted stock and stock options, as well as payments made to the officers under supplemental retirement plans.

Facts

Richard Wardrop was the chief executive officer and chairman of the board of directors of AK Steel Corporation and AK Steel Holding Company (jointly "AK Steel"). Wardrop resigned in 2003. Afterward, he received a significant amount of compensation from AK Steel as a result of his former employment. The compensation included: (1) $2.3 million in appreciation from restricted shares; (2) $1.6 million in profit from exercised stock options; and (3) $27.8 million in benefits under the terms of the AK Steel Corporate Executive Minimum and Supplemental Retirement Plan ("SERP"). AK Steel withheld and submitted 1.5 percent of Wardrop's total compensation to Middletown as income tax.

John Hritz served as the president of AK Steel. He resigned and left the company in 2003. Hritz also received a significant amount of compensation from AK Steel after his retirement: (1) a lump-sum payment totaling more than $2 million pursuant to an executive severance agreement; (2) $1.5 million in compensation from a management incentive program and a single month's salary; (3) $7.7 million in benefits under the AK Steel SERP; (4) $600,000 in appreciation from restricted shares; and (5) $340,000 in profit from exercised stock options. As with Wardrop, AK Steel withheld and submitted 1.5 percent of Hritz's total compensation to Middletown as income tax.

At all relevant times, Wardrop and Hritz maintained offices in Middletown, Ohio. They did not live in the city. Wardrop and Hritz filed income tax returns with Middletown for tax year 2004. Both sought a refund of a percentage of the income tax they had paid, based on the average number of work days each was physically present in the city over the previous five years. Middletown denied the refund requests. In response, Wardrop filed an amended tax return that reduced the amount of his taxable income by removing the SERP payment and valuing restricted stock and stock options at zero. Hritz also filed amended returns that deducted his SERP benefits, severance payments, and the post-appreciation value of his restricted stock and stock options. Middletown denied both refund requests.

Wardrop and Hritz appealed to the Middletown Income Tax Review Board, which rejected the claim for refunds. The Butler County Court of Common Pleas affirmed, and Wardrop and Hritz appealed to the Ohio Twelfth Appellate District.

The Court Determined Taxpayers Were Liable for Municipal Income Tax.

Wardrop and Hritz ("Taxpayers") raised several issues on appeal. First, they argued that Middletown could not tax the income they received in 2004 following their 2003 resignations. The court disagreed, finding that the critical issue was when the income was earned, not when it was received. The court noted that compensation earned by a nonresident employee cannot evade municipal taxation simply because it is deferred to a year when the nonresident no longer works in the municipality.

Second, Taxpayers asserted that Middletown could not tax the income earned outside the city. Both spent a substantial amount of time working out of town, so they contended that Middletown was required to apportion their income, for municipal tax purposes, based on the number of days they worked within the city. The court found that the applicable statute taxes nonresidents' income for "work done or services performed or rendered in the City." MCO §890.03(a)(2). In other words, Taxpayers could be taxed only for work performed within the city limits. It did not matter that Taxpayers earned their income as a result of employment with a business located in the city or that they were high-ranking executives. As a result, the court sustained Taxpayers' assignments of error that dealt with taxing income earned outside the city and remanded to the trial court for further proceedings.

Third, Taxpayer argued that income they received under AK Steel's SERP was not subject to income tax because it is a pension plan, not taxable deferred compensation. *See* MCO §890.02(a)(26). The court noted that neither term is defined in the municipal code or regulations. The court also found that the SERP identifies itself as "an unfunded deferred compensation arrangement." As a result, the court held that the SERP payments were not exempt.

Finally, Taxpayers argued that the appreciated value of their restricted stock and stock options was not subject to Middletown's income tax because the income from those investments was realized post-employment. The court disagreed, finding that the stock options and restricted stock were a form of compensation for work performed on behalf of AK Steel during the term of employment. Taxpayers did not sell their restricted stock or exercise their stock options until after they left AK Steel. Nevertheless, the court held that the income was earned while working for AK Steel and was therefore taxable.

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