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NEWSLETTER

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Ohio Supreme Court holds that 0.5% fee forcibly collected by the Ohio Department of Taxation from Ohio Cities is Unconstitutional

Frank J. Reed Jr., Frost Brown Todd LLC

On November 5, 2020, the Ohio Supreme Court issued a decision (4-1-2) that upheld the centralized collection of municipal net profits tax, but held that 0.5% fee forcibly collected by the Ohio Department of Taxation without the consent of the cities was unconstitutional. *City of Athens v. Jeff McClain, Tax Commissioner*, 2020-Ohio-5146. November 5, 2020. Special thanks to the Ohio Municipal League which filed an *amicus* brief in support of the cities in Ohio. The decision was written by Justice Michael Donnelly, and joined by Chief Justice Maureen O'Connor, Justice Patrick Fischer, and Justice Melody Stewart. Justice Sharon Kennedy would have found both the centralized collection and the 0.5% fee unconstitutional. Justice Judith French and Justice Patrick DeWine would have found both items constitutional. The case has been remanded to the Franklin County Court of Common Pleas, and will now proceed before Judge Karen Phipps, where the case began.

Background of Municipal Net Profits Tax

There are many Ohio municipalities which impose a tax on income earned within their boundaries. When that tax is applied to businesses, it is known as a "net-profits" tax. The cities of Athens, Akron, and Elyria, and numerous other cities and villages, all of which impose a net-profits tax, challenged the Ohio General Assembly's enactment of H.B. 49 (the budget bill which was passed July 1, 2017), and that permitted the "centralized collection" and administration of those taxes as well as a law that allowed the state to retain 0.5 percent of the collected taxes as a fee or a tax to defray the cost the state of Ohio incurred in performing centralized collection and administration.

The cities asserted that the legislation violated a City's Home-Rule authority granted under the Ohio Constitution and exceeded the Ohio General Assembly's constitutional power to limit the power of municipalities to levy taxes.

History of Municipal Net Profits Taxation

The City of Toledo enacted the first municipal income tax in Ohio in 1946. Ohio Legal Center Institute, *Ohio Taxation,* Chapter 17, at 316 (1967). According to the Tax Foundation, 649 Ohio municipalities currently impose income taxes. (https://taxfoundation.org/local-income-taxes-2019, (accessed July 24, 2020) https://perma.cc/6HWJ-PEEX].

In 1957, the General Assembly first exercised its power to limit municipal income taxation by enacting Ohio Revised Code Chapter 718. Chapter 718 mandated a uniform tax rate, required municipalities to get voter approval before they could impose a higher rate, and immunized certain income from municipal taxation. Over the years, R.C. Chapter 718 has been expanded to make municipal taxation more uniform, with the goal of making it easier for taxpayers to comply.

In 2014, the Ohio General Assembly enacted 2014 Sub. H.B. No. 5 ("H.B. 5"), which purported to establish statewide uniformity of municipal income taxes by explicitly preempting municipalities from imposing an income tax unless they adopted, by ordinance or resolution, the provisions of R.C. Chapter 718 and levied the tax in accordance with those provisions.

The Enactment of Centralized collection and administration

In 2017, the General Assembly enacted 2017 Am. Sub. H.B. No. 49 ("H.B. 49"), which added new sections to R.C. Chapter 718—R.C. 718.80 through 718.95—and those sections provide for a centralized administration of municipal net-profits taxes. R.C. 718.80 authorizes municipal net-profits taxpayers to "elect to be subject to" those newly enacted sections "in lieu of the provisions set forth in the remainder of R.C. Chapter 718."

If a city or village fails to comply with these requirements, the law provides that the Tax Commissioner must notify the state director of budget and management, who is required to withhold 50 percent of the amount due to that municipality "until the municipal corporation complies." R.C. 718.80(C)(3).

H.B. 49 made the centralized-administration option available with respect to "taxable years beginning on or after January 1, 2018." *Id.* at uncodified Section 803.100(A). So, this "skim" has occurred in calendar year 2018, 2019, and 2020.

C. History of Litigation

The lawsuits originated from an action for declaratory and injunctive relief that was filed in the Franklin County Court of Common Pleas on November 16, 2017, by more than 100 municipalities, led by the law firm of Frost Brown Todd LLC. The City of Athens was the lead plaintiff. A second set of Northeast Ohio municipalities, represented by the law firm of Walter Haverfield, also filed suit and the city of Elyria served as the lead plaintiff for the second set of plaintiffs.

In February 2018, the trial court held a two-day preliminary-injunction hearing, and shortly thereafter, the Court entered an Order that denied the injunctive relief sought by the cities.

The plaintiffs appealed to the Tenth District Court of Appeals, located in Franklin County. The Court (in a 2 to 1 decision) upheld the trial Court's determination that the law implementing centralized collection and the 0.5% fee did not violate the Ohio Constitution.

Analysis by the Ohio Supreme Court

The Court examined:

Article XVIII, Section 3 of the Ohio Constitution (the "Home Rule Amendment") which provides that "municipalities shall have authority to exercise all powers of local self-government and to adopt and enforce within their limits such local police, sanitary and other similar regulations, as are not in conflict with general laws."

Article XVIII, Section 7 which states that "any municipality may frame and adopt or amend a charter for its government and may, subject to the provision of section 3 of this article, exercise thereunder all powers of local self-government."

Article XVIII, Section 13 which confers on the General Assembly the authority to pass laws to "limit the power of municipalities to levy taxes and incur debts for local purposes."

And, Article XIII, Section 6 of the Constitution which provides that the General Assembly has the authority to "restrict [municipalities'] power of taxation, assessment, borrowing money, contracting debts and loaning their credit, so as to prevent the abuse of such power."

The Ohio Supreme Court observed that during the first 85 years of home rule, the Court held that if the General Assembly had enacted a tax of a particular type, the state occupied the field as to that type of tax and thereby implicitly preempted a similar municipal tax. In 1998, Ohio Supreme Court overruled the doctrine of implied preemption and held that a state tax law does not preempt municipal power unless it does so expressly. *Cincinnati Bell*, 81 Ohio St.3d 599, 693 N.E.2d 212.

After examining the specific language of the statute, the Court held, "The General Assembly's authority to limit the power of municipalities to tax allows it to broadly preempt municipal income taxes and to require that such taxes be imposed in strict accordance with the terms dictated by legislation passed by the General Assembly." Further, the Court held "because Article XVIII, Section 13 permits the General Assembly to limit the municipalities' power to levy taxes, the General Assembly can require municipalities to enact legislation that accomplishes this aim." 2019-Ohio-277, 119 N.E.3d 469, at ¶ 51.

The 0.5 percent fee is not Constitutional

The Court also held, however, that whether the 0.5 percent retention is viewed as a "fee" or as a "tax," the General Assembly had no authority to impose it. The Court held that by allowing the state to retain a portion of the tax proceeds to defray its expenses cannot be seen as a legitimate exercise of the General Assembly's power to limit or restrict municipal taxation. And, as such, the Court held, "imposing a regulatory fee measured by a percentage of municipal-tax proceeds is not an authorized act of limitation under Article XVIII, Section 13, or a valid restriction under Article XIII, Section 6."

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