Income Tax - Information Release*

IT 1996-01 – Federal Law Preempting State Taxation of Retirement Plan Income

Introduction

The purpose of this information release is to address federal law preempting state income taxation of certain types of retirement plan income. This federal statute, 4 U.S.C. §114, was enacted in 1996 and amended in 2006.

The full text 4 U.S.C. §114 can be found here: https://www.law.cornell.edu/uscode/text/4/114
The full text of current R.C. 5747.06 can be found at: http://codes.ohio.gov/orc/5747.06
The full text of current R.C. 5747.20 can be found at: http://codes.ohio.gov/orc/5747.20

Observations/ Law

Division (a) of 4 U.S.C. §114 prohibits a state from imposing an income tax on "retirement income" of an individual who is neither a resident of nor a domiciliary of such state, as determined under the laws of such state when the income is received. Under Ohio law, domicile and residency are one and the same. See R.C. 5747.01(I)(1) and 5747.24.

Division (b) of 4 U.S.C. §114 defines “retirement income.” The following list is generalized summary of those items included in 4 U.S.C. §114(b):

- Money purchase pensions
- Simplified Employee Pension Plans (SEP)
- Individual Retirement Accounts (IRA)
- Annuity Funded Plans
- Qualified Deferred Compensation Accounts
- Government Pensions
- Union Retirement Plans
- Any plan, program, or arrangement either:
  - Described in IRC §3121(v)(2)(C), or
  - That 1) is in writing, 2) provides for retirement payments in recognition of prior service to be made to a retired partner, and 3) is in effect immediately before retirement begins

* An information release does not create legal obligations by its own force. Only an administrative rule can “confer the force of law on a requirement.” See Progressive Plastics, Inc. v. Testa, 133 Ohio St.3d 490, 2012-Ohio-4759.
If the income from that plan, program or arrangement is:
  o Paid in a series of substantially equal periodic payments (at least annually) for the life or life expectancy of the recipient or the joint lives or joint life expectancy of the recipient and the recipient's beneficiary; or
  o Paid in a series of substantially equal periodic payments (at least annually) for at least 10 years; or
  o A payment after termination of the recipient’s employment from a plan, program or arrangement related to said employment and maintained solely for the purpose of providing retirement benefits for employees in excess of any limitation on contributions or benefits imposed by the Internal Revenue Code.

While this list is provided for taxpayer ease, for the exact items included in the federal definition of “retirement income” please refer to the link above.

Generally, Ohio levies an annual tax on a taxpayer’s Ohio adjusted gross income less exemptions. R.C. 5747.02(A)(3) and (4). Ohio law allows a nonresident credit to nonresident taxpayers who otherwise file an Ohio income tax return. R.C. 5747.05(A). The credit is calculated as the tax otherwise due times the ratio of income that is not allocable or apportionable to the taxpayer’s Ohio adjusted gross income and business income.

Ohio law requires every employer to withhold from its employee’s compensation an amount that reasonably estimates the amount of state income tax and school district income tax that the employee owes for the taxable year. R.C. 5747.06. Ohio income tax law defines compensation as “remuneration paid to an employee for personal services.” R.C. 5747.01(D). However, Ohio law does not define “employee.” When a term is not defined under Ohio income tax law, it “has the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes.” See R.C. 5747.01.

Permissive withholding is also available from certain “retirement systems” if the recipient of retirement benefits requests that their retirement system withhold Ohio income tax on his/her behalf. See R.C. 5747.071.

**Guidance**

**Income Tax.** Based upon this federal preemption, Ohio cannot allocate or apportion the retirement income of a nonresident to Ohio. Such nonresidents who file an Ohio income tax return should calculate their nonresident credit by including in the numerator any retirement income earned while a nonresident.

This preemption applies only to “retirement income” as defined 4 U.S.C. §114. Thus, certain deferred bonus or stock option plans are not subject to this preemption. Instead, those amounts should be allocated or apportioned to Ohio, as appropriate. See R.C. 5747.20 and 5747.21. In most of these cases, the payor will be the employer (rather than a separate pension plan trust), and the payment will be subject to federal income tax withholding and will be reported on IRS form W-2.

**Withholding Tax.** In most situations, individuals receiving retirement plan payment are no longer employees of the organization. Thus, in most cases payments of retirement benefits will not be subject to Ohio income tax withholding, regardless of the recipient’s residency status. One exception is that a recipient of benefits from the Ohio public employee’s retirement system (OPERS), state teacher’s retirement system (STRS), school employee’s retirement system (SERS), Ohio police and fire pension fund, state highway patrol retirement
system, and any municipal retirement system can request those plans to withhold income tax from their benefits. See R.C. 5747.071.

Nevertheless, the administrator of a retirement plan is required to withhold Ohio income and school district income tax from distributions if all the following apply:

- The payor is an employer;
- The payor maintains an office or transacts business within Ohio; and
- The payor is making payment of compensation to an employee

Please note, while an employer is not required to withhold income tax on retirement benefits, the employer is required to withholding income tax on compensation paid the employee. See R.C. 5747.06. As such, amounts paid by an employer to an employee that are not preempted under 4 U.S.C. §114 (e.g. bonuses, nonqualified deferred compensation, and stock options) are generally compensation and thus subject to withholding.

In those situations where such payments are reported on the IRS form W-2, such payments to nonresidents will be subject to Ohio individual income tax withholding only if the five above-listed requirements are present.

Questions?

Taxpayers may visit www.tax.ohio.gov. Questions may be submitted by clicking on the “Contact” link found at the top right of the page and then choosing the “Email Us” option. Taxpayers with additional questions regarding this subject may contact Individual Income Taxpayer Services at 1-800-282-1780.