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Effects, Problems, and Solutions of Central Collection of Municipal Income Taxes

John W. Cook

With the advent of the municipal income tax, cities have been forced to search for various methods to efficiently administer their taxing enactments. In this article, Dr. John W. Cook examines Cleveland, Ohio's efforts to solve this problem. Cleveland's ordinance is particularly worthy of study inasmuch as it contains a somewhat unique provision which provides for the sharing of taxes collected from nonresidents with the city of residence if certain requirements are met. Because of this provision, various Cleveland area municipalities decided to participate in the taxing program, and in a joint endeavor sought an effective method of collecting the taxes and administering the program. Their solution was central collection. Dr. Cook — after examining the effects, problems, and solutions of central collection — concludes that if the Cleveland area participants take full advantage of their new system, they will be able to collect and administer an income tax at a relatively low cost, with minimal effort and expense for the taxpayers.

I. INTRODUCTION

 ON NOVEMBER 28, 1966, the Cleveland City Council passed an income tax ordinance,¹ making Cleveland the last of the larger Ohio cities to adopt a municipal income tax. Largely a post-World War II phenomenon, cities in seven different States now

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levy income taxes, including such Ohio cities as Toledo, Cincinnati, Columbus, Dayton, Youngstown, Akron, and now Cleveland. Along with a municipal sales tax, the municipal income tax is the only broad-based, relatively productive, nonproperty source of taxation. Since Ohio municipalities are preempted from levying a sales tax,² they have turned to an in-

come tax to meet the rising demands for and the higher cost of goods

¹ Cleveland, Ohio, Ordinance 2393-66, Nov. 28, 1966 [this ordinance will be published sometime in the future in CLEVELAND, OHIO, CODIFIED ORDINANCES tit. 15, chs. 1-27] [hereinafter cited as CLEVELAND ORDINANCES].

² See *Haefner v. City of Youngstown*, 147 Ohio St. 58, 68 N.E.2d 64 (1946).

and services.

The municipal income tax in Ohio and other States exhibits certain patterns of uniformity. Among these are the following:³

1. Relatively low, flat rates (from ½ to 2 percent generally) applying to the gross salaries, wages, and commissions of employees and to the net profits of incorporated and unincorporated businesses;
2. Applicability to all residents, regardless of where income is earned, and to all nonresidents on income earned within the taxing municipality;
3. Applicability to all businesses (unless specifically exempt) on profits fairly allocable to the taxing municipality. Resident, unincorporated businesses pay on total net profit, regardless of where earned;
4. Credit and reciprocal provisions to obviate double taxation of the same income by two or more taxing municipalities;
5. Withholding requirements for all employers within or doing business within the taxing municipality. Generally, the tax withheld accounts for 70 to 80 percent of the total tax revenues;
6. Relatively low costs of collection in the larger cities and in instances of joint collection by two or more municipalities;
7. Income tax forms and filing requirements similar to those of the federal government;
8. Problems of collecting from itinerant employees, small businesses, and self-employed individuals; and
9. Relatively high costs of compliance incurred by employers, especially where business is conducted in several contiguous taxing municipalities, thus creating the necessity of allocating withholdings from itinerant employees to each municipality.

The foregoing patterns readily illustrate significant problems for both tax collector and taxpayer. Both want fair and uniform compliance, with maximum tax receipts at minimum costs. How-

³Very little has been written on the municipal income tax. For a general treatment, see R. SIGAFOOS, *THE MUNICIPAL INCOME TAX: ITS HISTORY AND PROBLEMS* (1955). For the only available detailed treatment of municipal income tax administration, see J. COOK, *THE ADMINISTRATION OF THE EARNED INCOME TAX* (1964). See also Tillman, *Actual Problems Involved in Setting Up Local Tax Administration*, in *INCOME TAX ADMINISTRATION* 319 (1948); James, *The Administration of the Earned Income Tax in the Township of Mt. Lebanon* (Ph. D. Dissertation, University of Pittsburgh, 1958).

ever, this is often not the case, particularly where adjoining or substantially contiguous municipalities administer the tax individually. In such instances each taxpayer is required to file returns and withhold for every municipality in which he is doing business. To require the usage of separate return forms, separate payroll records, separate allocations, separate taxing offices, and separate income tax administrators often results in the absurdity of incurring costs of 50 cents or more to pay a dollar in tax.

At the date of this writing, over 45 municipalities in the Cleveland metropolitan area have passed an income tax ordinance. Of this number, 34 have joined the City of Cleveland in a program of joint collection and administration. The purpose of this paper is to analyze this joint endeavor in terms of its effects on compliance and administration, the problems it creates for administrators and taxpayers, and the solutions it contains for local income taxation. To be sure, the significance of these solutions extends beyond the municipal income tax itself, for they provide some insight into the questions of whether local governments can tax efficiently and productively, and whether they can cooperate to solve problems which otherwise might ultimately be dealt with at higher governmental levels.

II. CENTRAL COLLECTION — IN GENERAL AND IN CLEVELAND

A number of central collection arrangements are in effect throughout the Commonwealth of Pennsylvania and have proven to be the most effective and least costly means of administration.⁴ Such arrangements are being utilized by municipalities and school districts in densely populated multijurisdictional areas, in county-wide areas, and in intercounty regional areas. The joint collection device has also proven to be the answer for the small- and medium-sized Pennsylvania jurisdictions that were not collecting the income tax effectively due to size limitations.

Central collection, although a general practice in Pennsylvania, has not been characteristic of municipal income tax administration in any other State. Its enactment in the Cleveland metropolitan area marked a significant departure from the general practice in Ohio. No other Ohio city, with the exception of Toledo,⁵ has en-

⁴ See J. COOK, *supra* note 3, at 14-17.

⁵ Toledo has a reciprocity arrangement with the small neighboring city of Maumee, agreeing to retain only 50 percent of the tax collected from nonresidents who live in

acted ordinance provisions agreeing to share the tax collected from nonresidents with the city of residence. The Cleveland ordinance provides that between two jurisdictions with similar tax and reciprocal provisions, the jurisdiction of employment receives 75 percent of the tax bill and the jurisdiction of residence receives 25 percent.⁶ This provision led to enactments of income tax ordinances by virtually every municipality in the Cleveland area.

Would each city administer and collect its own tax? Would employers and businesses be required to file returns with each jurisdiction in which they were doing business? How would the basic 75-25 percent reciprocity-sharing plan be effected? How would employers withhold taxes from employees working in various taxing cities? These and other perplexing questions indicated that the Cleveland area did not have the typical income tax administrative problems. Having created the most complex local income taxing system known anywhere, the various cities searched for a practical solution for taxpayers and for themselves. That solution was central collection. The ensuing discussion analyzes its effects, problems, and solutions.

III. EFFECTS OF CENTRAL COLLECTION

The effects of central collection are many and varied, including those on administrative procedures and costs, collection, taxpayer compliance, audit, public relations, and the like. The most important of these for Cleveland may be summarized under the headings of audit and compliance. Other effects will appear under the discussion of solutions of central collection.

A. On Audit

The participating municipalities in the Cleveland Central Collection Agency have all signed an administrative contract (*The Agreement*)⁷ which provides for administrative authority, uniformity of ordinances and regulations, responsibility of participants, audit, cost allocation, distribution of money, cancellation, and exchange of information between participating municipalities. Arti-

jurisdictions which impose the income tax and grant the same benefit to their nonresident labor force.

⁶ CLEVELAND ORDINANCES tit. 15, ch. 19, §§ 115.1901-02.

⁷ The full title of this unpublished document is: Agreement for Central Collection of Municipal Income Tax Between Various Municipal Corporations [hereinafter cited as *The Agreement*].

cle III of *The Agreement* calls for the mutual supply and exchange of all information or assistance, including income tax information and records, which the various municipalities shall deem necessary to implement their income tax ordinances. This provision should facilitate audit of the returns of taxpayers who owe taxes to more than one municipality and enable the central collection agency to keep track of taxpayers living in one municipality and working in another.

It is anticipated that the central collection agency will maintain a central staff to audit returns applicable to all participating municipalities on a selective and random sample basis. However, article V(B) of *The Agreement* provides that "the Agency Administrator shall cause a special detailed independent audit to be made of any or all tax returns and all remittances received in the administration of the tax laws of any Participant upon request of the Administrator of such Participant." Thus, each municipality may require an audit of any returns which were not audited or which it feels were improperly or incompletely audited.

It is important to note that the presence of the central collection agency audit staff does not preclude audits by the administrator or other designated official in each participating municipality. In fact, a return may be audited by both. In case of disagreement, *The Agreement* provides a uniformity criterion.⁸

B. On Compliance

The most essential element in compliance is the proper and timely filing of return forms and payment of taxes due. The central collection agency has provided uniform central collection forms with spaces for allocation to place of work and place of residence for each of the participating municipalities. These include employer quarterly withholding forms, employee quarterly estimate forms (for employees whose tax is not withheld), and business quarterly estimate forms. The taxpayer must make his own work and residence allocations in the proper columns on the central collection forms. At the time of this writing, final return forms have not been designed and distributed.⁹

In recognition of the relationship of taxpayer appeal channels to compliance with the tax laws, the ordinance of each participating

⁸ Text accompanying note 10 *infra*.

⁹ [ED. NOTE: Final return forms have subsequently been designed and distributed. 2 CCH STATE TAX CAS. REP. ¶¶ 71-409-21 (Ohio 1968).]

municipality provides for a board of review which adopts its own procedural rules, records its own transactions, approves the rules and regulations issued by the administrator of the municipality, and hears and passes on appeals from any decision or ruling of such administrator.¹⁰ In an attempt to encourage uniformity of boards of review decisions, article IV(A) of *The Agreement* states:

It shall be the prerogative of the Boards of Review of each of the parties hereto to make rulings and to decide appeals on all questions arising in their respective jurisdictions. However, the parties agree to the extent practicable to consider any prior decision on file with the Agency Administrator on similar questions rendered by the Board of Review of any party.

Taxpayer compliance is also affected by the following language in article I(D)(3) of *The Agreement* with respect to delinquent taxpayers: "Any account which is delinquent for a period of one year shall be forwarded to the Participant in which the delinquent taxpayer resides or has his principal office. Thereafter, it shall be the responsibility of each Participant to collect such delinquent accounts." Since the central collection agency will not process any accounts delinquent for more than 1 year, the participating municipalities must develop a collection process to assure maximum collection from their own delinquents.

Taxpayer compliance is always dependent on and tempered by rulings and administrative determinations. As noted above, article IV(A) of *The Agreement* encourages uniformity of boards of review rulings and appeal decisions. To further assure such uniformity, article IV(B) provides:

Copies of all rulings and opinions of any Administrator or Board of Review shall be filed with the Agency Administrator. The Agency Administrator shall have the right to request a rehearing before any Board of Review that renders a decision which he deems incompatible with the operation of the central collection facility.

One can imagine the confusion and complexity for taxpayers who must deal with various adjoining municipalities having essentially identical ordinances but with varying and contradictory rulings and administrative determinations. Articles IV(A) and (B) attempt to avoid this situation.

Experience in Ohio, and other States, has shown that most of the evasion and avoidance of municipal income taxes is attributable to the self-employed and itinerant individuals whose tax is not with-

¹⁰ See, e.g., CLEVELAND ORDINANCES tit. 15, ch. 25, §§ 115.2501-03.

held. In order to solve this problem, article III(A) of *The Agreement* sets forth certain responsibilities of participating municipalities to ensure compliance by these groups. Under *The Agreement*, each participant is: (1) to furnish all information or assistance necessary to the successful operation of the central collection facility; (2) to furnish, on an annual basis, to the agency administrator a census of all employers and self-employed persons within each jurisdiction; and (3) to interchange necessary income tax information and records in writing to the extent available.

The annual census of employers and self-employed persons is an exceptionally valuable tool for guaranteeing maximum compliance. If each jurisdiction properly compiles and updates its census, a check can be run with the central collection agency's master file of taxpayers to ascertain who has not filed a return.

IV. PROBLEMS OF CENTRAL COLLECTION

The Cleveland Central Collection Agency, as well as those in Pennsylvania, is not without its share of problems. Some of these should not have arisen in the first place while others are an inherent part of what is essentially an unusually complex local income taxing structure.

A. *Taxpayer Problems of Allocation and Compliance*

With each of over 45 municipalities in the Cleveland metropolitan area having an income tax ordinance which taxes nonresident employees on income earned for services performed within its jurisdiction, employers must devise some reasonably accurate means of keeping track of the time spent by their employees in each municipality. This is an especially difficult and time-consuming task for such businesses as cab companies, utilities, and businesses with salesmen and other itinerant employees. Of course, the task would be even more complex without central collection, since the participating municipalities can agree on reasonable allocation methods and formulas which probably would not be forthcoming if they collected individually.

A concomitant problem with allocation which also affects compliance is the proper completion of the central collection forms which requires an allocation between work and residence columns. Here the employer must ascertain the residences of all his employees, their place or places of work, and whether these various municipalities have an income tax. For example, if John Doe works 50

percent of his time in Cleveland and 50 percent in Euclid and if he lives in Shaker Heights, his employer must allocate 25 percent of his tax to Shaker Heights and divide the remaining 75 percent equally between Cleveland and Euclid. If Doe lived in a nontaxing municipality, Cleveland and Euclid would equally divide 100 percent of his tax instead of 75 percent. One can appreciate the employer's difficulties in properly completing the central collection form with a number of John Doe's.

B. *Jurisdictional Problems*

If XYZ Company does business in Cleveland and has employees who live in Euclid but work in cities other than Cleveland and Euclid, Euclid, in the absence of central collection, would have no jurisdiction to compel XYZ Company to withhold tax money from its residents working in such other cities.¹¹ However, since Euclid and Cleveland collect jointly, can XYZ Company be compelled to withhold taxes from its Euclid residents because of central collection? In other words, does the central collection contract create jurisdiction for withholding purposes, where, in the absence of the contract, no such jurisdiction exists? Louis A. Boxleitner, in an address to the Tenth Annual Cleveland Regional Tax Institute, answered this question in the negative and noted that an administrative contract does not carry with it jurisdiction.¹² However, the apparent position of the Cleveland Central Collection Agency is that the central collection contract does create jurisdiction. Since the question has not been answered either administratively or by the Ohio courts, there are no affirmative guidelines to follow at this point other than to seek the advice of legal counsel.

Another jurisdictional problem is whether the central collection contract affects the "doing business" test for purposes of determining jurisdiction to tax. Boxleitner posed the question this way: "Does Central Collection carry with it jurisdiction for Cleveland to impose its tax on a nonresident business entity?"¹³ Again he answered negatively, pointing out that an administrative contract does not create legal taxing jurisdiction. If a firm is doing

¹¹ XYZ Company does no business in Euclid, therefore Euclid must require the employees involved to file returns and pay the tax. See CLEVELAND ORDINANCES tit. 15, ch. 13, § 115.1302; Cleveland, Ohio, Administrator's Tax Bulletin No. 1, art. I (Dec. 30, 1966).

¹² Boxleitner, *Jurisdiction, Reciprocity and Credits*, in LECTURE OUTLINES FOR THE TENTH ANNUAL CLEVELAND REGIONAL TAX INSTITUTE 93-97 (1967).

¹³ *Id.* at 95.

business in East Cleveland but not in Cleveland, the fact that both collect jointly does not subject the firm to Cleveland's tax. Again, since this question has also not been dealt with either administratively or by the courts, advice of legal counsel should be obtained if controversy arises.

C. Municipalities Not in Central Collection

A number of municipalities in the Cleveland metropolitan area have not joined central collection; instead each has decided to collect and administer its own tax.¹⁴ This has created a number of problems which would not exist if they all were in the central collection system. For example, one problem is where to file returns and remit withholdings for employees who work in central collection cities and live in noncentral collection cities and vice versa. The noncentral collection cities have demanded that their residents file returns with them, regardless of the fact that they work in a central collection city. Since the residents' employers will withhold and remit the entirety of the tax to the central collection agency, any returns the employees file with their cities of residence will amount to overpayment and create the need for refund claims, proof of payment for proper credits, and so on. The central collection cities, on the other hand, are following the Cleveland Administrator's Tax Bulletin No. 1 by directing that their employers and taxpayers pay the tax in full to the city of employment, followed by notification in writing to the respective cities that the full amount is being paid to that city.¹⁵ Under this approach, taxes of residents of central collection cities who work in noncentral collection cities would be paid in full directly to the noncentral collection cities. Even though this approach appears to conform with the basic theory of the various ordinances, it is uncertain how the problem will be resolved.

Another problem with noncentral collection cities is the determination and payment of reciprocity credits. Even though these cities are not in central collection, all but one of them¹⁶ have the basic reciprocity provisions in their ordinances whereby a taxpayer's municipality of employment receives 75 percent of his tax bill

¹⁴ These municipalities include: Brooklyn, Brookpark, North Royalton, Parma, Parma Heights, and Rocky River.

¹⁵ Cleveland, Ohio, Administrator's Tax Bulletin No. 1, art. VI (Dec. 30, 1966).

¹⁶ The city ordinance of Brookpark, Ohio does not contain the basic reciprocity provision.

and his municipality of residence receives 25 percent. Sections 115.1901-03 of the Cleveland ordinance, and similar provisions in the other ordinances, provide for payment or assignment of reciprocity credits and claims based on evidence and proof. These various sections, however, do not designate the proper form and procedures for such assignment or payment, nor do they indicate what shall constitute adequate evidence or proof. Since the full amount of the tax will generally be paid to the city of employment, it is not clear how the 25 percent belonging to the city of residence is to be paid. "Satisfactory evidence," "acknowledgment of liability by a nonresident to his city of residence," "assignment of refund claims" — all of this wording appears in the various ordinances, but the actual procedure to put the reciprocity provisions into effect has not been delineated.

The central collection cities have solved this problem by collecting and administering their income taxes jointly. Article VII (B) of *The Agreement* provides for payment by the central collection agency of reciprocity credits and monies to the participating municipalities on or before 120 days after the close of any given calendar quarter. Just how and when such credits will be acknowledged and paid between central and noncentral collection cities is yet to be resolved.

D. Problems of Uniformity of Ordinances and Regulations

One of the prerequisites to successful joint collection of municipal income taxes is that the ordinances, rules, and regulations of the participating municipalities be as uniform as possible. Article II(A) of *The Agreement* attempts to ensure such uniformity: "In order to ensure the successful administration and operation of a central collection facility the contracting parties shall attempt to enact uniform provisions in their respective income tax ordinances and adopt uniform rules and regulations in furtherance thereof." However, uniformity is not completely assured, since article II(C) provides that any participant failing to meet the uniformity criterion shall pay the additional cost of administrative procedures necessary to put the deviating provision(s) into effect.

E. Public and Taxpayer Information

One of the marks of a good tax law is that it be understood by those who are subject to it. The public should have up-to-date information concerning such things as: rates, forms to be filed, fil-

ing dates, rules, and regulations. The municipal income tax law in Cleveland and surrounding cities has certainly been deficient in this regard. At the date of this writing, no final return forms and no rules and regulations have been issued by the central collection agency.¹⁷ With so many municipalities passing income tax ordinances, taxpayers have had trouble keeping up to date on what cities have the tax. The various new enactments had different effective dates; for example, some began January 1, 1967, others began April 1, and still others began July 1. In addition, it is difficult to find out from some of the suburban communities just when their tax became effective. Then there are the cities not in central collection. While most of the municipalities with new enactments have noted their intention to join central collection, a few have not made up their mind or have decided to go it alone. Time itself should solve most of these problems, but the confusion that now exists is unfavorably affecting the first year's administration and collection, not to mention public opinion.

V. SOLUTIONS OF CENTRAL COLLECTION

The above problems notwithstanding, central collection in the Cleveland metropolitan area can simplify and improve municipal income tax administration and compliance. As opposed to having over 45 contiguous municipalities administering separate income taxes, central collection provides the following solutions through local government cooperation:

1. One set of forms and procedures, and one place to pay money;
2. Uniformity of ordinances and regulations;
3. Uniformity of boards of review decisions on appeals and rulings;
4. Improved compliance and minimal evasion through cooperation and exchange of information;
5. Economy through joint effort. In my study of Pennsylvania municipal income taxation, a sample of 330 municipal income taxing offices revealed that a majority of those with costs of collection under 4 percent were central collection agencies. Some central collection agencies experienced costs of collections under 2 percent. Costs of single city collection offices often exceeded 10 percent.¹⁸

¹⁷ [ED. NOTE: The forms are now completed. See note 9 *supra*.]

¹⁸ J. COOK, *supra* note 3, at 77.

6. Simplification and delineation of workings and relationship as to tax reciprocity. Article II(B) of *The Agreement* states: "Each of the Participants hereto recognize the reciprocal provisions of the other Participants' ordinances as referred to herein and agree to respect and follow such reciprocal provisions"; and
7. Simplification of an inherently complex local taxing structure. This includes the following: apportionment formulas, procedures, and agreements acceptable to all participating municipalities; uniform collection procedure; simplification of reporting and remittances; and uniform interpretation and decision procedures.

VI. CONCLUSION

Efficiency is not always the prime desideratum in government. If it were, there would probably be no system of municipal income taxation, assuming that a higher governmental level could collect the income tax more efficiently. However, experience has proven that through a joint effort municipalities can collect and administer an income tax at a relatively low cost, with minimal effort and expense for taxpayers. The municipalities in the Cleveland area that have joined together to collect their income tax are to be commended. There are many problems which must be solved and some which should never have arisen. Whether the full advantages and solutions offered by central collection will be forthcoming will be up to the municipalities themselves. If they want topnotch administration, full compliance, fair and uniform treatment of taxpayers and all at minimum costs, they can have them.