



## Taxation of Nonresident's Capital Gains from Sale of Ohio Company Violates Due Process

When considering the constitutionality of state tax laws, courts typically conclude that the tax easily satisfies the low Due Process Clause threshold of some minimal connection to the taxing state. Courts often spend little time analyzing due process and focus the bulk of their opinion on whether the tax satisfies the Commerce Clause.

But a recent trend has emerged as courts have taken a closer look at Due Process Clause challenges in other contexts. For instance, in the last several years, the U.S. Supreme Court has concluded that no jurisdiction existed over defendants under the Due Process Clause because the defendants had not purposefully availed themselves of the protection of the forum state's laws.<sup>1</sup>

The Ohio Supreme Court followed that trend in the state tax context recently in *Corrigan v. Testa*,<sup>2</sup> holding that Ohio's attempt to tax a nonresident of Ohio on the capital gains from his sale of an ownership interest in an Ohio limited liability company (LLC) violated the Due Process Clause. The court held that the sale at issue was the transfer of an intangible (LLC ownership interest) by a nonresident from outside Ohio. As a re-

sult, the court held, the taxpayer did not purposefully avail himself of the protections of Ohio law when he sold his membership interest, and Ohio could not tax the taxpayer's capital gain income from the sale.

The court distinguished the taxpayer's capital gains from pass-through income that the taxpayer would receive from the LLC's business operations. The court noted that pass-through income from the LLC's regular business operations would be taxable under Ohio law because the income is directly connected to the LLC's Ohio business operations.

Despite ruling in favor of the taxpayer on his as-applied challenge, the court rejected the taxpayer's argument that the statute should be struck down in its entirety. The court noted that there might be circumstances where a non-Ohio investor selling an ownership interest in an Ohio entity could have a unitary business relationship with the Ohio company whose stock was sold, which could satisfy Due Process Clause requirements for taxing any gain. The court specifically pointed out that the commissioner did not assert that the taxpayer's minimal involvement in management of the company (approximately 100 hours per year of board-level strategic assistance) created a unitary business relationship. In fact, the tax com-

missioner argued that it was "irrelevant" whether the taxpayer and the LLC operated as a unitary business.

This case provides additional support for taxpayers challenging the constitutionality of tax laws, as courts continue to breathe life into the Due Process Clause restraints on state jurisdiction. In addition, the court's decision helps provide support for taxpayers structuring their transactions to ensure favorable tax treatment.

**Background.** Mansfield Plumbing (Mansfield) specialized in selling sanitary ware in all 50 states and maintained its corporate headquarters in Perrysville, Ohio. In November 2000, Connecticut resident Kevin Corrigan purchased a 79% share in Mansfield. As part of his purchase, Corrigan became a "manager" of Mansfield—i.e., a member of the company's board of managers.

Corrigan's duties as a manager included visiting the company's Ohio headquarters to attend board meetings, provide management presentations, and address other matters dedicated to growing Mansfield. He estimated his time spent in these manager duties as "easily a hundred hours per year."

However, Corrigan asserted that his role did not involve active "management" of the Mansfield business but rather "stewardship." Indeed, the court pointed out that the tax commissioner did not assert that Corrigan was "operating or managing the business of Mansfield Plumbing."

In 2004, Corrigan sold his 79% interest in Mansfield as part of a sale of a 100% interest in the company to a Colombian sanitary-ware business hoping to gain a



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foothold in North America. Corrigan's capital gain from the sale was approximately \$27.5 million, and he allocated all of that income outside of Ohio based on his non-Ohio domicile.

In 2009, Ohio assessed tax liability from 2004 of nearly \$675,000 based on the capital gain from the sale, plus \$150,000 in interest. Corrigan paid \$100,000 of the assessment and filed a refund claim in March 2010 with the Ohio tax commissioner.

The tax commissioner denied the refund claim in August 2012, and Corrigan appealed to the Ohio Board of Tax Appeals (BTA). The BTA upheld the commissioner's determination on statutory grounds but declined to reach Corrigan's constitutional arguments, reasoning that it lacked jurisdiction to do so. Corrigan appealed directly to the Ohio Supreme Court.

**Ohio law required apportionment of capital gains based on activities of the business.** During the tax period, Ohio law provided that capital gains—like royalties, rents, and compensation—were considered “nonbusiness income” subject to allocation based on their situs.<sup>3</sup> As a result, capital gains were not generally apportionable and instead were required to be assigned to only one state. Ohio law further provided specifically that capital gains from the sale of intangible personal property were statutorily allocated to the taxpayer's domicile.<sup>4</sup>

However, Ohio law contained an exception for capital gains earned by a pass-through entity investor owning an interest of at least 20% in the entity. Specifically, the statute provided that such capital gains

“shall be apportioned” based on the pass-through entity's apportionment formula for apportionment of “business income.”<sup>5</sup> This statute clearly applied to Corrigan because he owned 79% of Mansfield, and he sold his interest in 2004.

**Due process imposes jurisdictional limitation on states to tax transactions.**

Corrigan argued that the applicability of Ohio law to his majority sale of Mansfield violated the Due Process Clause and the Commerce Clause. As the court explained, the Commerce Clause “reflects structural concerns about the effects of state regulation on the national economy,” while the Due Process Clause “centrally concerns the fundamental fairness of government activity.”<sup>6</sup>

While the court pointed out that taxation restraints imposed by those clauses are “distinct,” they also “partially overlap.” Fundamentally, the court said, the “bedrock principle” underlying both clauses is that “a State may not tax value earned outside its border.”<sup>7</sup> However, the court provided no additional Commerce Clause analysis because it held in favor of Corrigan on due process grounds.

Due process, the court stated, “requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”<sup>8</sup> The court explained that this link must exist between the state and the taxpayer, as well as between the state and the activity subject to tax.

The link between a taxpayer and the state requires that the taxpayer “purposefully availed” himself or herself of the benefits within the taxing state. The link between the activity and the state re-

quires “a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.”<sup>9</sup> For example, in *Allied-Signal*, the U.S. Supreme Court held that New Jersey could not tax a taxpayer's gain from selling its shares of a corporation that operated partly in New Jersey, reasoning that the income was derived from “unrelated business activity” that constitutes “a discrete business enterprise.”<sup>10</sup>

**Apportionment of capital gains by nonresident violates due process.**

The court began its application of due process principles to the situation at issue by noting that the court's 1999 decision in *Agley v. Tracy* approved the taxation of an investor's income from an Ohio pass-through entity, even if the investor is a nonresident.<sup>11</sup> The court in *Agley* reasoned that the decision to invest in an Ohio entity and make pass-through elections for federal tax purposes satisfied the purposeful-availment requirement of the Due Process Clause. Thus, the court noted, any income Corrigan gained from Mansfield's regular business activities in Ohio would be properly taxable in Ohio.

However, the court distinguished that situation from the sale of Corrigan's Mansfield stock at issue. The court reasoned that whereas Corrigan's activity that Ohio sought to tax was “a transfer of intangible property by a nonresident,” the activity subject to tax in *Agley* “was the very income derived from business activity in Ohio.” Further, the court reasoned, while Corrigan's availment of Ohio's protection was “clear” for his pass-through income on Mansfield's Ohio business activities,



<sup>1</sup> See, e.g., *J. McIntyre Mach., Ltd. v. Nicastro*, 564 U.S. 873, 131 S. Ct. 2780 (2011); *Walden v. Fiore*, 134 S. Ct. 1115 (2014).

<sup>2</sup> 2016 WL 2341977 (May 4, 2016).

<sup>3</sup> Ohio Rev. Code Ann. § 5747.02(C); Ohio Rev. Code Ann. § 5747.20.

<sup>4</sup> Ohio Rev. Code Ann. § 5747.20(B)(2)(c).

<sup>5</sup> Ohio Rev. Code Ann. § 5747.212.

<sup>6</sup> Quoting *Quill Corp. v. North Dakota*, 504 U.S. 298, 312, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992).

<sup>7</sup> Quoting *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 777, 784, 112 S. Ct. 2251, 119 L. Ed. 2d 533 (1992).

<sup>8</sup> Quoting *Quill*, 504 U.S. at 306.

<sup>9</sup> Quoting *Allied-Signal*, 504 U.S. at 778.

<sup>10</sup> Quoting *Allied-Signal*, 504 U.S. at 773.

<sup>11</sup> *Agley v. Tracy*, 719 N.E.2d 951, 954 (Ohio 1999).

<sup>12</sup> Ohio Rev. Code Ann. § 5747.01(B).

<sup>13</sup> See, e.g., Wash. Admin. Code § 458-20-280 (adopting department regulations to “address unfair tax avoidance”).

“Corrigan’s sale of his interest in Mansfield Plumbing did not avail him of Ohio’s protections and benefits in any direct way.”

In other words, the court adopted a fairly narrow view of the transaction involved, addressing it solely as a nonresident’s sale of his stock from outside Ohio. The court then concluded that Ohio had no jurisdiction to impose tax on income from that out-of-state sale of stock by a nonresident.

This narrow view of the transaction and corresponding result might be subject to question or criticism in other cases, where the facts suggest that there might be some in-state legal protections to an investor selling his or her ownership interest in an in-state company. However, the commissioner’s approach in this case downplayed Corrigan’s connections with Mansfield’s Ohio operations, focusing instead on Mansfield’s business activities in Ohio. As a result, the court’s conclusion does not appear far-fetched in light of the facts and arguments presented.

**Court rejects commissioner’s “form-over-substance” argument.** The commissioner also asserted that Corrigan’s proposed result would improperly lead to different results depending on the taxpayer’s structure of the sale at issue. Specifically, Ohio law provides that apportionable business income includes the gain or loss from a liquidation of a business via an asset sale.<sup>12</sup> The commissioner pointed out that if the transaction involving Mansfield had

been structured as an asset sale (instead of a sale of ownership interest), then this transaction would provide the “same economic substance” for the basic underlying transactions and yet would subject Corrigan to tax on his pass-through income from the sale.

The court stated that it “recognized” that an asset sale and a sale of ownership interest “may be different forms involving the same economic substance of the parties,” but such a similar result “does not mean that the jurisdictional limits on Ohio’s taxing powers lack their own substantive importance.”

The court then went on to implicitly affirm the validity of structuring corporate transactions to minimize tax: “Nor is it unusual that two different methods of achieving the same economic result could have drastically different tax implications.” While this statement may not be surprising to a corporate transaction practitioner, it is somewhat surprising to see a court endorse this practice so strongly in the context of a state tax dispute. Especially in recent years, courts and legislatures have tended to focus on substance over form and on seeking ways to prevent taxpayers from structuring transactions in a way that is perceived as “avoiding tax.”<sup>13</sup>

To further illustrate its point, the court also noted that the commissioner’s “form over substance” position “can cut both ways.” After all, the court reasoned, a taxpayer could assert “with equal logical force”

that an asset sale is “in substance” a sale of corporate ownership, and thus argue that “Ohio cannot constitutionally treat the gain from the asset sale as apportionable business income.” In other words, the commissioner’s own argument could be used against Ohio in a future case.

The court’s point is well-taken and helps illustrate why the “form-over-substance” argument can be so fraught with problems. This doctrine is inherently subjective and often requires the court to examine the reasoning behind selecting a certain structure for corporate transactions. It also grants taxing agencies broad authority to assess tax and create long, drawn-out disputes as they attempt to uncover various facts related to a taxpayer’s subjective intentions in entering into the transactions at issue. In order to be effective, any form-over-substance position must be narrowly tailored and clearly defined.

**Court rejects facial invalidity challenge.** Although the court held in favor of Corrigan in his as-applied challenge under the Due Process Clause, the court rejected Corrigan’s argument that the statute was facially unconstitutional. The court reasoned that a taxpayer “might engage in the conduct of a business with or through a corporate entity,” such as where a unitary business is created. As a result, the court could not conclude that “there exists no set of circumstances under which the statute would be invalid,” which would be required in order to reach facial invalidity. ■

