AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

OHIO SUPREME COURT HOLDS THAT NONRESIDENT TAXPAYER'S GAIN FROM THE SALE OF AN LLC INTEREST IS NOT SUBJECT TO OHIO INCOME TAX

SUMMARY

On May 4, 2016, the Ohio Supreme Court held in *Corrigan v. Testa*, No. 2014-1836, slip opinion 2016-Ohio-2805 (Ohio May 4, 2016) that a nonresident individual taxpayer's gain arising from the sale of an interest in a limited liability company that did business in the state was not subject to income tax.

DETAILS

Background

The taxpayer in *Corrigan* is a Connecticut resident that owned a 79.29 percent interest in Mansfield Plumbing, L.L.C. ("Mansfield Plumbing") – a limited liability company that produced sanitary ware and operated in all 50 states, including Ohio. The taxpayer was a managing member of Mansfield Plumbing that visited the company's Ohio headquarters for board meetings and management presentations regarding operations, labor, finance, strategic positioning, and other matters, which required at least 100 hours of involvement from the taxpayer per year. The day-to-day operations of the company were overseen by officers and managers employed by Mansfield Plumbing.

In 2004, the taxpayer sold his 79.29 percent interest in Mansfield Plumbing to a third-party. The taxpayer realized a $27,563,977 gain on the sale of his interest, all of which he allocated outside Ohio for income tax purposes. Ohio subsequently issued the taxpayer a $674,924.58 tax assessment, plus interest. The taxpayer paid $100,000 of the assessment, and then filed a refund claim with the Tax Commissioner. The Commissioner denied the taxpayer's refund claim on the basis of a strict reading of Ohio Rev. Code § 5747.212, which requires a taxpayer owning at least 20 percent of a pass-through entity to

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apportion gain realized from a sale of an interest in that entity using the average of the pass-through entity's apportionment fractions for the current and two preceding taxable years.

The taxpayer appealed the Commissioner's refund claim denial to the Board of Tax Appeals. The Board of Tax Appeals affirmed the Commissioner's final determination, and the taxpayer appealed to the Ohio Supreme Court.

The Ohio Supreme Court's Decision

The Ohio Supreme Court held that Ohio Rev. Code § 5747.212 as applied to the taxpayer violates the Due Process Clause in the 14th Amendment to the U.S. Constitution, reversed the decision of the Board of Tax Appeals, and remanded to the Commissioner to grant the taxpayer a refund. The court rejected the taxpayer's facial challenge because the taxpayer could not demonstrate that there exists no set of circumstances under which the statute would be valid, and the court thought the statute could possibly be applied when a unitary business relationship exists.

In holding that Ohio Rev. Code § 5747.212 as applied to the taxpayer violates the Due Process Clause, the court reasoned that the Due Process Clause requires a connection between the state and the person and activity it seeks to tax. The former may be satisfied via purposeful availment of benefits within the taxing state, and the latter a direct connection with the state. In finding that neither criteria was present in this case, the court distinguished the present case from *Agely v. Tracy*, 719 N.E.2d 951 (Ohio 1999) – a case in which the court had held that due process protections allow the state to tax an S corporation shareholder's share of distributive income arising from business conducted in the state because the decision to invest using corporate structures and making an S corporation election satisfies the purposeful availment criterion. Here, the taxpayer did not avail himself of Ohio's protections and benefits in any direct way when he sold his interest in Mansfield Plumbing, and Ohio's connection to the taxpayer's sale of the interest in Mansfield Plumbing was indirect, as the gain was not generated from business activity conducted in Ohio.

The Ohio Supreme Court rejected the Commissioner's argument that *International Harvester Company v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944) and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940) control in this case for three reasons. First, both of the cases addressed a privilege tax on dividends distributed by the taxpayer (i.e., the investee), not the investor. Second, dividends have a more direct relationship to corporate earnings than a capital gain arising from the sale of corporate ownership. Third, in *MeadWestvaco Corp. v. Ill. Dep't. of Revenue*, 553 U.S. 16 (2008), the U.S. Supreme Court characterized the apportionment of intangibles based on the capital asset's unitary business relationship (i.e., operational function) connection with the state as a ground for constitutional apportionment. Thus, the Ohio Supreme Court found the issue in this case (i.e., the imposition of an investee-apportioned tax on the gain realized from the sale by an investor) an unsettled question that the court could not properly regard as settled by *International Harvester* and *J.C. Penney*.

The court also was not persuaded by the Commissioner's reliance on state court cases as support for applying Ohio Rev. Code § 5747.212 to the taxpayer. For example, the court distinguished *Johnson v. Collector of Revenue*, 165 So.2d 466 (La. 1964) from the present case. In *Johnson*, the Louisiana Supreme Court upheld the imposition of income tax under a statutory scheme that allowed for taxation of a nonresident taxpayer's pro rata share of capital arising from an exchange of shares for direct ownership interests in Louisiana lands pursuant to a liquidation. The Ohio Supreme Court found the Louisiana statutory scheme, which limited the tax to gain related to Louisiana property, did nothing more than prevent avoidance of Louisiana tax on a capital gain from the sale of a Louisiana asset through a manipulation of corporate forms. On the other hand, the application of Ohio Rev. Code § 5747.212 to the taxpayer would broadly subject the taxpayer's gain to tax.

The court also found *Allied-Signal, Inc. v. Commissioner of Finance*, 588 N.E.2d 731 (N.Y. 1991) and *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225 (Ohio 1996) to be inapposite. In *Allied-Signal*, the New York Court of Appeals upheld a New York City income tax on a nonresident parent corporation's capital gain arising from the sale of its interest in a subsidiary based *International Harvester* and *J.C. Penney Co.* However, the Ohio Supreme Court had already declined to read those cases to allow for the imposition of a tax on a nonresident dividend recipient. And, in *Couchot*, the Ohio Supreme Court had upheld a tax on a nonresident's winnings from an Ohio lottery. The court found the situation in *Couchot* to be quite different from the present taxpayer's situation because the taxpayer in *Couchot* clearly enjoyed Ohio-created benefits and protections, thus, the tax was justified.

Lastly, the court rejected the Commissioner's substance-over-form argument that the gain would have been taxable had the corporation sold the assets instead. The court noted that it is not unusual for two different methods of achieving the same economic result to have drastically different results, and the Commissioner's argument could cut against the state since a sale of assets (taxable) is in substance the same as sale of corporate ownership (not taxable).

BDO INSIGHTS

- A nonresident taxpayer that realized a gain from the sale of an interest in a pass-through entity should consider whether a refund opportunity or return position may be available based on the decision in *Corrigan*.
- Consideration should also be given as to whether or not an S corporation should make the federal election under Internal Revenue Code section 338 to treat a stock sale as an asset sale given that Ohio generally adopts federal taxable income for purposes of computing income at the state-level, and the application of *Corrigan* may result in a non-resident shareholder's gain being allocated outside the state if the sale is treated as a stock sale.

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