Ohio: Supreme Court holds state may not tax a nonresident on sale of an in-state business

David M. Kall | Monday, May 9, 2016

In a May 4, 2016, opinion vacating the decision of the Ohio Board of Tax Appeals (BTA), the Ohio Supreme Court unanimously concluded that the Ohio Tax Commissioner's application of an income tax apportionment provision of the Ohio Revised Code, specifically R.C. 5747.212, violates the Due Process Clause of the United States Constitution.

The Ohio Supreme Court's decision in *Corrigan v. Testa* carries special significance because it is the first state court decision holding that a state may not constitutionally tax a nonresident's capital gain income from the sale of an in-state business.

Background

In 2000, taxpayer Patton R. Corrigan, who was a Connecticut resident, and others, acquired the assets of Perrysville, Ohio-based Mansfield Plumbing, LLC, a manufacturer of sanitary ware with plants in Texas and California. The company did business in all 50 states and in other countries. Corrigan's share of the entity was 79.29 percent.

As the main co-owner and a member of the "board of managers," Corrigan traveled to Perrysville, Ohio for meetings and "other matters important to the goal of growing Mansfield's market share." He testified that his involvement in Perrysville was "stewardship" rather than active management of the business, acting as an investor "who bought companies with the intention of providing financing and strategic expertise to

grow the company for an eventual exit via a sale to a third party." In this role, he visited Ohio for at least 100 hours per year.

In 2004, Corrigan and his fellow investors sold their shares, resulting in a capital gain of $27,563,977 to Corrigan for that tax year. Presumably because he was domiciled in Connecticut, Corrigan treated the entire amount of the gain as allocable outside Ohio. Due to Corrigan's gain, the Ohio Tax Commissioner in 2009 assessed Corrigan for tax, interest, and penalty totaling $847,085.19. Corrigan paid only $100,000 of the assessment, then filed a refund claim for $100,000 in March 2010 after the assessment had become final.

The Court's analysis

The Court first recognized that the U.S. Constitution sets limits on Ohio's taxing authority, as follows: "[i]t is a venerable if trite observation that seizure of property by the State under pretext of taxation when there is no jurisdiction or power to tax is simple confiscation and a denial of due process of law." Thus, the Court recognized the "bedrock principle" that the Constitution forbids a state from taxing value earned outside its borders.

But the Court also recognized that there was no dispute that Corrigan, as a non-Ohio resident, "earned or received" his capital gain income under Ohio statutory law. When he sold his interest in 2004, Corrigan's capital gain was lawfully apportioned, in part, to Ohio pursuant to a law that the Ohio General Assembly enacted in 2002. Namely, under R.C. 5747.212, a non-Ohio resident's capital gain from the sale of equity in a pass-through entity of which he or she owns at least a 20 percent ownership stake is apportionable to Ohio. Corrigan's 79 percent interest in Mansfield Plumbing, LLC, easily exceeded that threshold. As a consequence, Corrigan "earned or received" the capital gain income in Ohio under Ohio statutory law.

Turning to the constitutional Due Process issue, the Court looked to a 1992 U.S. Supreme Court use tax case, *Quill Corp. v. North Dakota*, that stressed that "[d]ue process centrally concerns the fundamental fairness of government activity…" and requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." Citing another familiar case, *Hillenmeyer v. Cleveland Bd. of Rev.*, (the "jock tax" case), the Court recognized the "need for a link between the state and the person being taxed as well as between the state and the activity being taxed."

The Ohio Supreme Court rejected the Tax Commissioner's reliance on U.S. Supreme Court precedent including *Int'l Harvester v. Wisconsin* (1944) and *Wisconsin v. J.C. Penny* (1940) for the proposition that "the simple but controlling [Due Process] question is whether the state has given anything for which it can ask a return." Though distinguishing *Int'l Harvester in Corrigan*, the Court had cited *Int'l Harvester* with approval as recently as 1996 in *Couchot v. State Lottery Comm.*, and also rejected a similar Due Process challenge in the 1999 case *Agley v. Tracy*.

As the Tax Commissioner argued, Ohio afforded Corrigan "benefits, protections, and opportunities" providing jurisdiction to tax a portion of his gain because value giving rise to the gain was created within Ohio's borders through the operation of Mansfield Plumbing. But the Ohio Supreme Court rejected that argument. The Court instead held that the tax generating activity was the non-resident's transfer of intangible property, which it held is not the same, tax-wise, as an Ohio business activity. Consequently, since the transfer of the intangible property occurred outside of Ohio, Corrigan had only an indirect connection to Ohio.

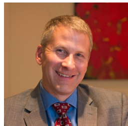
The Court rested its conclusion upon the U.S. Supreme Court's 1992 decision in *Allied-Signal v. Dept. of*

Revenue, which addressed an apportionment issue in the context of the unitary business principle. The Court rejected the Ohio Tax Commissioner's argument that the unitary business principle did not apply and that the "apportionment" decision in *Allied-Signal* was inapposite because the Tax Commissioner apportioned Corrigan's capital gain income through a three factor formula based solely upon Mansfield Plumbing's property, payroll, and sales, rather than combine Mansfield's factors with another entity.

Conclusion

The Court remanded the case to the Tax Commissioner with an order to grant the $100,000 refund to Corrigan. In so doing, it rejected a facial challenge to the constitutionality of R.C. 5747.212 and stated that its holding is limited to Corrigan's situation. Accordingly, the imposition of taxes on a different individual taxpayer who conducts business with or through a corporate entity could be upheld.

The Ohio Tax Commissioner is not likely to petition for a writ of certiorari to the U.S. Supreme Court. *Bloomberg BNA* reports that, in response to the ruling, the Ohio Department of Taxation said it "is always helpful when the court can provide this sort of clarity and guidance on how to enforce the law." "We are duty-bound to presume those laws are constitutional," said Matthew Chafin, chief counsel of the department. "Obviously, in this case, the court determined otherwise and we will act accordingly going forward."



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