State Law & State Taxation Corner

Courts Continue to Grapple with the Apportionability of Gains from Sales of Ownership Interests in Business Entities

By John A. Biek[*]

Introduction

One of the "big ticket" issues in state income taxation continues to be whether a taxpayer's capital gain or loss from the sale of its ownership interest in a corporation, partnership or limited liability company is subject to formulary apportionment by states where the taxpayer does not maintain a residence or commercial domicile. State tax administrators generally prefer to treat capital gains as apportionable business income because it allows the state to tax a portion of that gain rather than having the entire amount of the gain be allocated as nonbusiness income to the state of the taxpayer's residence or commercial domicile. Subjecting capital gains or losses to formulary apportionment raises both statutory and constitutional issues.

Two recent cases serve as a reminder that the apportionability of capital gains or losses from sales of ownership interests in business entities is determined, first, by the specific provisions of the nondomiciliary state's income tax laws. In *E.I. DuPont de Nemours & Co. v. Indiana Department of Revenue,*[1] the Indiana Tax Court held this past July that the capital gain that DuPont recognized from the sale of its partnership interest in a pharmaceutical joint venture constituted nonbusiness income under the Indiana income tax statutes, which resulted in the gain being allocated to DuPont's state of commercial domicile (Delaware). In *T. Ryan Legg Irrevocable Trust v. Testa,*[2] the Ohio Supreme Court determined at the end of last year that the capital gain that a nonresident irrevocable trust realized from the sale of its stock in an Ohio S corporation constituted a "qualifying trust amount" that was apportionable to Ohio based on the proportion of the S corporation's physical assets that were in Ohio, as provided in the Ohio income tax statutes. The Ohio Supreme Court further held that apportioning the nonresident trust's capital gain within and without Ohio did not violate the Due Process Clause because of the extensive contacts of the grantor who created the trust with Ohio and the S corporation.

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The Indiana *E.I. DuPont de Nemours* Case

In 1991, E.I. DuPont de Nemours and Company ("DuPont") and Merck & Co., Inc. ("Merck") formed a Delaware general partnership named DuPont Merck Pharmaceutical Company ("DMPC") to research, develop, manufacture and sell human pharmaceutical products, imaging agent products and other related product lines.[3] DuPont and Merck each owned 50 percent of the DMPC joint venture.[4] DuPont had begun doing business in 1802 as a gunpowder manufacturer and subsequently expanded into a variety of industrial, agricultural and chemical manufacturing businesses worldwide, but apparently not into the pharmaceutical industry.[5]

One of the "big ticket" issues in state income taxation continues to be whether a taxpayer's capital gain or loss from the sale of its ownership interest in a corporation, partnership or limited liability company is subject to formulary apportionment by states where the taxpayer does not maintain a residence or commercial domicile.

As often occurs in joint venture situations, DMPC operated autonomously of DuPont and Merck, maintaining its own management team and employees, its own separate research agenda and development facilities, and its own profit objectives, operating policies and procedures.[6] DuPont did lease certain facilities to DMPC in the initial years of its operations, and DuPont provided DMPC with certain "start up" personnel and administrative services, but all of this was done on an arm's-length basis.[7]

In May 1998, seven years into the joint venture, Merck sold its 50-percent partnership interest in DPMC to DuPont Pharma, Inc., a subsidiary of DuPont, for $2.6 billion in cash. With Merck out of the picture, DMPC was renamed DuPont Pharmaceuticals Company ("DPC"). DPC continued to operate independently of DuPont, paying arm's-length fees for the administrative services that DuPont provided to DPC.[8]

Three years later, in 2001, DuPont and DuPont Pharma sold their partnership interests in DPC to Bristol-Myers Squibb Company, recognizing a $4 billion capital gain from this sale transaction.[9]

When the Indiana Department of Revenue (the "Department") audited the 2005, 2006 and 2007 consolidated Indiana gross income tax returns of DuPont and its subsidiaries, the Department's auditors reclassified the $4 billion capital gain from the 2001 sale of the partnership interests in DPC as apportionable business income. This had the effect of substantially reducing the amount of 2001 Indiana net operating loss that DuPont could carry forward to subsequent tax years, including the 2005–2007 audit period.[10] The Department also disallowed interest expense deductions that DuPont had reported on its 2005 and 2007 Indiana tax returns for interest accrued (but not paid) on intercompany loans it had received in 1995, 1999 and 2005 from DuPont subsidiaries. This audit adjustment increased DuPont's adjusted gross income in 2006 and 2007 by $3 billion. Finally, the Department disallowed DuPont's 2007 research and development expense deduction, adding another $43 million to DuPont's adjusted gross income in 2007.[11] These three audit adjustments resulted in the Department proposing an assessment of more than $770,000 of Indiana adjusted gross income tax liability, plus interest and penalties, against DuPont for the 2006 and 2007 tax years.[12]

DuPont and the Department filed cross motions for summary judgment with the Indiana Tax Court in connection with DuPont's appeal of the proposed assessments. On July 11, 2017, Judge Martha Blood Wentworth of the Indiana Tax Court ruled on the parties' cross motions for summary judgment, deciding the significant issues in favor of DuPont. Interestingly, nearly all of the facts stated in Judge Wentworth's opinion, including the crucial point that the DMPC/DPL joint venture always operated independently of DuPont, were based on affidavits of DuPont executives.

As a threshold issue, DuPont challenged the right of the Department to make an adjustment to its reporting of the $4 billion gain from the sale of the partnership interests in DPC as nonbusiness income in the closed 2001 tax year, arguing that the Department was retroactively assessing tax liability beyond what Indiana's three-year limitations period would allow.[13] Judge Wentworth correctly held that, when reviewing the accuracy of the tax returns that DuPont had filed in the open 2005–2007 tax years, the Department was allowed to review the accuracy of the NOL that DuPont had reported in the now closed 2001 tax year and carried forward to the 2005–2007 tax years under audit. This NOL had largely resulted from DuPont's allocation outside Indiana of the $4 billion gain from the sale of the partnership interests in DPC. Judge Wentworth

concluded that the Department had not assessed DuPont any additional tax liability with respect to the closed 2001 tax year. Rather, the Department had reduced the amount of Indiana NOLs that DuPont could carry forward and deduct on its returns filed in the open 2005–2007 tax years. Although not mentioned in Judge Wentworth's opinion, the IRS would be allowed to make such an adjustment to NOLs in closed tax years for the purpose of correcting the amount of NOLs being carried forward to open tax years.[14] Judge Wentworth observed that "DuPont has not directed the Court to any authority that precludes the Department from making adjustments to 'closed' years.[15] In fact, DuPont admits that it is not aware of any statutory provision or case law that prohibits the type of adjustments the Department made in this case."[16]

But Judge Wentworth went on to hold that DuPont had correctly reported the $4 billion capital gain from its sale of the partnership interests in DPC as nonbusiness income allocable to DuPont's state of commercial domicile, Delaware, rather than business income that would have been apportionable among Indiana and the other states where DuPont was doing business in 2001. The Indiana adjusted gross income tax statutes utilized the definition of "business income" provided in the 1957 Uniform Division of Income for Tax Purposes Act ("UDITPA"):

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.[17]

"Nonbusiness income," in turn, was defined in the Indiana adjusted gross income tax statutes as "all income other than business income."[18]

Judge Wentworth concluded that the capital gain from DuPont's sale of the partnership interests in DPC did not constitute apportionable business income under the first part of Indiana's statutory definition of "business income"—referred to as the "transactional test"—because the sale transaction had not occurred in the regular course of DuPont's business of industrial, agricultural and chemical manufacturing.[19] Judge Wentworth rejected the Department's claim, premised on certain variations in the subsidiaries listed in DuPont's federal Form 851 affiliation schedules that DuPont was engaged in the regular trade or business of buying and selling companies.[20]

Turning to the second portion of the Indiana statutory definition of "business income"—the so-called functional test—Judge Wentworth concluded that test would require that "DuPont's acquisition, management and disposition of DPC [be] integral (*i.e.,* necessary or essential) to its manufacturing operations."[21] The Department argued that the functional test was satisfied because evidence in the case supposedly showed that DuPont had bought out Merck's ownership interest in DMPC in order to enhance DuPont's competitiveness in the pharmaceutical industry, DuPont's public filings had stated that DPC and pharmaceutical products were integral to DuPont's business, and DuPont had sold DPC to Bristol-Meyers Squibb in response to changed market conditions, and used the cash sales proceeds to buy back DuPont stock and pay down debt.[22] Judge Wentworth concluded, however, that "[e]ven if it was reasonable to infer that DuPont both acquired and disposed of DPC as an integral part of its manufacturing business, DuPont must also have managed DPC as an integral part of its manufacturing business in order to characterize the gain as business income" under the functional test.[23] Judge Wentworth accepted statements in the affidavits of the DuPont executives that DuPont had played no role in the management of DPC while it owned that company and that DPC (and its predecessor, DMPC) "had maintained its own management team, its own research agenda, its own development facilities, its own employees, its own profit objectives, and its own operating policies and procedures."[24] Relying on this evidence, Judge Wentworth concluded that the $4 billion gain from DuPont's sale of the DPC partnership interests was not apportionable business income under the functional test.[25]

Judge Wentworth further held that Indiana's apportionment of the capital gain would be unconstitutional under the U.S. Supreme Court's decisions in *Allied-Signal, Inc. v. Director, Division of Taxation*[26] and *MeadWestvaco Corp. v. Illinois Department of Revenue*[27] because DuPont and DPC were not engaged in a unitary business (referred to as "enterprise unity"). Judge Wentworth concluded that:

> Here, the designated evidence does not show that DuPont and DPC were unitary. First, but for some initial (*i.e.*, "start-up") flow of value between DuPont and DPC, DPC operated independently of DuPont, and it paid DuPont arm's-length rates for all services it was provided. (Pet'r Des'g Evid., Vol. I., Aff. of Carmen Giannantonio ("Giannantonio Aff.") ¶¶ 8-9, 39, 44-45,47, Landgraf Aff. ¶ 29; Resp't Des'g Evid., Ex. 5 at 56.) Second, there is uncontradicted evidence that DuPont exercised no more than the "occasional oversight" over DPC that would be typically afforded to an investor over his investment. (*Compare* Giannantonio Aff. ¶¶ 37, 54 *and* Pfeiffer

Aff. ¶ 23 *with* Resp't Br. at 17 (claiming that there was centralized management merely because DuPont owned DPC).) Finally, there were no economies of scale. (*See* Pfeiffer Aff. ¶ 26: Giannantonio Aff. ¶ 48 (explaining that DuPont and DPC did not share any centralized purchasing whatsoever).) Because DuPont and DPC are not unitary, the unitary business principle directs that DuPont's gain on its sale of DPC is not apportionable business income.[28]

DuPont also prevailed on its deduction of the intercompany interest expenses on its 2005 and 2007 Indiana adjusted gross income tax returns. The Department had disallowed these deductions because it determined that the intercompany loans, which did not require DuPont to make interest or principal payments until the end of the 10-year loan period, lacked economic substance and were sham transactions.[29] Judge Wentworth determined, however, that (1) the DuPont subsidiaries making the intercompany loans to DuPont had economic substance, (2) interest expense accrued on the loans and was added to the principal balance of the new loans that DuPont received at the end of the 10-year loan period, and (3) the interest rates on the intercompany loans were arm's length.[30]

However, the Department did prevail on its disallowance of DuPont's research and development expense deduction in the 2007 tax year because DuPont had claimed a *federal* R & D credit rather than a deduction for that tax year. Judge Wentworth agreed with the Department that there was no separate Indiana R & D expense deduction provision in the Indiana adjusted gross income tax statutes that could have reduced DuPont's 2017 Indiana adjusted gross income by the amount of its R & D expenses.[31]

The Ohio *T. Ryan Legg Irrevocable Trust* Case

Decided by the Ohio Supreme Court at the end of 2016, *T. Ryan Legg Irrevocable Trust v. Testa*[32] involved an apparent attempt by an Ohio resident individual to utilize a trust to avoid having to pay Ohio personal income tax liability on the capital gain from the sale of his shares of stock in an Ohio business. The trust claimed that Ohio taxation of the capital gain was unconstitutional.[33] However, the Ohio Supreme Court agreed with the Ohio Tax Commissioner that the capital gain was subject to Ohio income tax on an apportioned basis, albeit with a smaller Ohio apportionment factor than the Tax Commissioner had applied in his tax assessment against the trust, and that taxation of the nonresident trust's gain was constitutional.[34]

T. Ryan Legg was an Ohio resident individual who co-founded Total Quality Logistics, Inc. ("Logistics"), a trucking logistics business, in 1997.[35] Logistics was an S corporation for federal and Ohio income tax purposes. Legg and Ken Oaks each owned 50 percent of the shares of stock of Logistics.[36]

In 2005, Legg retired from the management of Logistics, and in November of that year, Legg transferred his 50 percent of the shares of Logistics stock to two Delaware irrevocable trusts that he had created. The T. Ryan Legg Irrevocable Trust (the "Trust") received 32.5 percent of the Logistics shares, while the other 17.5 percent of the Logistics shares were transferred to the other irrevocable trust.[37] One month later, on December 2, 2005, the two irrevocable trusts entered into a purchase agreement to sell all their shares of Logistics stock to Oaks, giving him total ownership of the company.[38] The sale transaction closed in February 2006, giving rise to an $18.6 million capital gain for the Trust.[39]

Legg and his family members were the beneficiaries of the Trust. The trust agreement provided for an "initial period" during which the trustee was required to retain the Trust's income and add it to the Trust's assets. This initial period extended to January 3, 2007, well beyond the date of the Trust's sale of the Logistics shares to Oaks.[40]

A brief summary of the Ohio income tax rules for trusts will help explain the tax issues in the *T. Ryan Legg Irrevocable Trust* case. Since 2002, irrevocable trusts have been subject to Ohio personal income tax rates on their "modified Ohio taxable income."[41] In order to be taxable in Ohio, the irrevocable trust must be an Ohio resident, have income or gain earned or received in Ohio, or otherwise have nexus with Ohio under the U.S. Constitution.[42] An irrevocable trust is considered to be an Ohio resident if the trust consists of assets (net of any related liabilities) that were transferred to the trust, directly or indirectly, by a person domiciled in Ohio at the time the assets were transferred to the trust, or on the date that the trust became irrevocable, but only to the extent the trust has at least one qualifying beneficiary who is domiciled in Ohio during the tax year.[43] A "qualifying beneficiary" has the same meaning as a "potential current beneficiary" as defined in Code Sec. 1361(e)(2), *i.e.,* a person who is entitled during the tax year to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.[44]

An irrevocable trust's "Ohio modified taxable income" is defined as the sum of (1) the trust's "modified business income" apportioned to Ohio with the factor set forth in Ohio Revised Code Section 5747.01(BB)(4)(a)(i), (2) the trust's "qualifying investment income" apportioned

to Ohio with the factor set forth in Ohio Revised Code Section 5747.01(BB)(4)(a)(ii), (3) the trust's "qualifying trust amount" multiplied by the Ohio apportionment ratio described in Ohio Revised Code Section 5747.01(BB)(4)(b), and (4) the trust's "modified nonbusiness income" allocated to Ohio with the allocation rules set forth in Ohio Revised Code Section 5747.01(BB)(4)(c).

The "qualifying trust amount" of the irrevocable trust means its capital gains or losses from the sale, exchange or other disposition of equity or ownership interests in, or debt obligations of, a qualifying investee to the extent included in the trust's income, but only if (1) the book value and location of the physical assets of the qualifying investee are available to the trust *and* (2) the trust had a closely held investment in the qualifying investee, as provided in Ohio Revised Code Section 5747.011.[45] Notably, Section 5747.011 requires that the trust must have owned *at least five percent* of the total outstanding ownership interests in the qualifying investee at any time during the 10-year period ending on the last day of the trust's taxable year during which the trust's sale, exchange or other disposition of the equity or debt interest in the qualifying investee occurred.[46]

If all these tests are met, the capital gain or loss from the trust's sale, exchange or other disposition of the equity or debt interest in the qualifying investee is allocated to Ohio with the ratio of the net book value of the qualifying investee's physical assets located in Ohio on the last day of the fiscal or calendar year immediately preceding the year of the sale, exchange or disposition transaction, divided by the net book value of the qualifying investee's physical assets everywhere.[47] This is the same allocation method that the now-repealed Ohio corporation franchise tax applied to dividends and capital gains or losses from the sale or other disposition of intangible personal property that might produce dividend income.[48]

A trust's "modified business income" is its business income that is not treated as a qualifying trust amount.[49] The modified business income (and qualifying investment income) of the trust is apportioned to Ohio with a fraction comprised of the average of its property, payroll and sales factors, weighted 20 percent, 20 percent, and 60 percent, respectively.[50]

Finally, the "modified nonbusiness income" of the trust is allocated entirely to Ohio if the trust is an Ohio resident, or with the specific allocation rules set forth in Ohio Revised Code Section 5747.20 if the trust is a nonresident of Ohio. However, a nonresident trust's nonbusiness gain or loss from the sale, exchange or other disposition of an equity or debt interest in a "Section 5747.212 entity" is apportioned to Ohio with the Ohio apportionment factors of the Section 5747.212 entity for the current and two preceding taxable years.[51] A "Section 5747.212 entity" is defined as any person other than a trust that on at least one day during the current and two preceding tax years was a passthrough entity, a closely held entity in which five or fewer persons own, directly or indirectly, all of the voting equity interests with voting rights in the entity, or a closely held entity in which one person owns, directly or indirectly, at least 50 percent of the voting equity interests in the entity.

Two recent cases serve as a reminder that the apportionability of capital gains or losses from sales of ownership interests in business entities is determined, first, by the specific provisions of the nondomiciliary state's income tax laws.

The Ohio Tax Commissioner seemed to have some difficulty deciding how these complicated Ohio trust income tax rules should apply to the $18.6 million capital gain that the Trust recognized from its sale of the shares of its Logistics stock. The notice of assessment for $1,868,382 of Ohio income tax, penalties and interest referred to the capital gain as "business income," but the Department of Taxation had apportioned the gain with a three-year average of *Logistics' Ohio property, payroll and sales factors* for 2006 (the year in which the shares were sold) and the two preceding tax years, 2004 and 2005.[52] This was the apportionment method of Ohio Revised Code Section 5747.212, which is applied to "*modified nonbusiness income*" of a trust. As discussed earlier, "modified business income" should have been apportioned with the Trust's own Ohio property, payroll and sales factors for the 2006 taxable year in which the Trust sold its share of Logistics stock.

After the T. Ryan Legg Irrevocable Trust filed a petition for reassessment, the Tax Commissioner issued his final determination in March 2013, which concluded that (a) the Trust was a nonresident of Ohio during the 2006 taxable year when the Trust sold the Logistics shares, (b) the Trust's capital gain was a "qualifying trust amount" under Ohio Revised Code Section 5747.01(BB)(2), or (c) alternatively, the capital gain constituted "modified nonbusiness income." Under both of these two scenarios,

the Tax Commissioner's final determination apportioned the Trust's capital gain to Ohio using the Section 5747.212 method (*i.e.,* a three-year average of Logistics' Ohio property, payroll and sales factors), which was contrary to the Ohio personal income tax statutes with regard to the "qualifying trust amount" determination. The Tax Commissioner did waive the penalty.[53]

On further appeal, the Ohio Board of Tax Appeals (the "BTA") held that the T. Ryan Legg Irrevocable Trust was an Ohio resident trust (reversing the Tax Commissioner on that point) and that the capital gain constituted a "qualifying trust amount" or, alternatively, apportionable "business income."[54] The BTA also affirmed the Tax Commissioner's application of the Section 5747.212 apportionment method to the capital gain, which, as already noted, was not the correct apportionment method for either a "qualifying trust amount" or "modified business income" of a trust.[55]

The constitutional analysis in the T. Ryan Legg Irrevocable Trust *case is disappointing.*

The T. Ryan Legg Irrevocable Trust then filed a direct appeal to the Ohio Supreme Court, which attempted to resolve all this confusion over how the Ohio income tax rules applied to the Trust's capital gain from its sale of the shares of Logistics stock. The Ohio Supreme Court held that the capital gain did constitute a "qualifying trust amount" defined in Section 5747.01(BB)(2) as capital gains that a trust realizes from "the sale, exchange, or other disposition of equity or ownership interests in, or debt obligations of, a qualifying investee," subject to two conditions. First, the Ohio Supreme Court noted, the "book value of the qualifying investee's physical assets in this state and everywhere, as of the last day of the qualifying investee's fiscal or calendar year ending immediately prior to the date on which the trust recognizes the gain or loss" must be "available to the trust." Second, the requirements of Ohio Revised Code Section 5757.011 must be satisfied, notably, the trust's ownership interest in the qualifying investee must have been at least five percent "at any time during the ten-year period ending on the last day of the trust's taxable year in which the sale, exchange, or other disposition occurs."[56]

The T. Ryan Legg Irrevocable Trust conceded that the capital gain from its sale of Logistics stock had satisfied all these requirements for a "qualifying trust amount" except, the Trust argued, the requirement that the book value and location of the physical assets of Logistics, the "qualifying investee," have been "available" to the Trust.[57] This information had clearly been available to, and utilized by, the trust's accountant, who also had served as the accountant for Logistics, but the Trust nevertheless claimed that the information regarding the physical assets of Logistics had not been available to the Trust itself, so the capital gain from the Trust's sale of the Logistics shares could not be considered a "qualifying trust amount."[58] The Ohio Supreme Court rejected this argument because the Trust had been a shareholder of Logistics, which had provided it the right under Ohio corporation law to access Logistics' corporate financial information.[59] The Ohio Supreme Court explained that:

> We are persuaded that in enacting the qualifying-trust-amount provision, the legislature thought that the provision would ordinarily apply to a trust that is a pass-through shareholder of a closely-held corporation, precisely because such a trust, as that type of shareholder, would usually have access to the relevant corporate information in the course of complying with its own tax obligations.[60]

That had certainly been the case for the Trust. Accordingly, the Ohio Supreme Court "conclude[d] that the allocation information was available to the trust and that the gain at issue therefore constituted a 'qualifying trust amount.'"[61]

Having held that the Trust's capital gain constituted a "qualifying trust amount," the Ohio Supreme Court concluded that this gain could not also be considered "modified business income," as the Tax Commissioner contended, or "modified nonbusiness income," as the Trust argued. The Ohio Supreme Court explained that "once the BTA affirmed the Tax Commissioner's determination that the gain was a 'qualifying trust amount,' that fact alone precluded the gain from being treated as 'modified business income' or 'modified nonbusiness income,' under R.C. 5747.01(BB)."[62]

The Ohio Supreme Court also determined, however, that the Tax Commissioner had applied the wrong apportionment method to the Trust's capital gain. As discussed earlier, the Tax Commissioner had averaged Logistics' Ohio property, payroll and sales factors for the 2004, 2005 and 2006 taxable years and apportioned 91.8307 percent of the capital gain to Ohio.[63] This was the apportionment method described in Section 5747.212. But as a "qualifying trust amount," the capital gain should have been apportioned to Ohio, pursuant to Section 5747.01(BB), with the ratio of Logistics' physical assets in Ohio versus

everywhere, as of the last day of its fiscal or calendar year ending immediately prior to the date on which the Trust sold its shares of Logistics stock. The Ohio Supreme Court remanded the *T. Ryan Legg Irrevocable Trust* case to the BTA for a determination of whether the physical assets allocation ratio of Logistics for the 2005 taxable year was less than the 91.8307-percent apportionment factor that the Tax Commissioner used in his assessment. The Ohio Supreme Court noted that Logistics' Ohio property factor in the 2005 taxable year had been only 80.5094 percent, making it likely that the Trust had been overassessed Ohio income tax on its capital gain from the sale of its shares of Logistics stock.[64]

Finally, the Ohio Supreme Court considered the claim by the Trust that the tax assessment violated its right to due process and equal protection of the laws because the Trust and its capital gain allegedly lacked sufficient connection to Ohio to permit the state to tax the capital gain.[65] As a threshold matter, the Ohio Supreme Court determined that, contrary to the BTA's opinion, the Trust was a *nonresident* trust. While T. Ryan Legg himself had been an Ohio resident in 2005, when he created the Trust and transferred his Logistics shares to the Trust, the "initial period" provision in the trust agreement precluded Legg from receiving any trust distributions in 2006, the year in which the Trust recognized the capital gain from selling its Logistics shares. This meant that the Trust did not have a "potential current beneficiary" in the 2006 taxable year and, for that reason alone, the Trust did not fit within the statutory definition of an Ohio resident trust in that taxable year.[66]

However, the Ohio Supreme Court rejected the Trust's constitutional claim based on the court's recent decision in*Corrigan v. Testa* that the Tax Commissioner was taxing income of a nonresident taxpayer arising outside the state's borders.[67] The *Corrigan* case was discussed in detail in one of these articles last year.[68] The *Corrigan* case held that the Tax Commissioner's application of the Ohio Revised Code Section 5747.212 apportionment method *to Corrigan* was unconstitutional because Corrigan had not participated in the management of the business operations of the investee LLC and Corrigan's capital gain had resulted from the sale of his intangible ownership interest in the investee LLC, as opposed to being a passthrough to Corrigan of the business profits of the investee LLC, which clearly would have had a taxable connection to Ohio.

The Ohio Supreme Court acknowledged in its *T. Ryan Legg Irrevocable Trust* opinion that:

> To be sure, there are two strong parallels between this case and *Corrigan*. The tax commissioner found that the trust was a nonresident here, just as Corrigan was a nonresident individual. And the tax commissioner here apportioned to Ohio the capital gain from the sale of the pass-through entity as if it were business income and did so in the very manner prescribed by R.C. 5747.212, the statute that the tax commissioner applied to Corrigan's capital gains from the sale of his ownership interest in Mansfield Plumbing, L.L.C., a pass-through entity.[69]

But the Ohio Supreme Court also saw critical differences between the *T. Ryan Legg Irrevocable Trust* case and the *Corrigan* case:

> A more comprehensive look at the situation, however, persuades us that the differences are more important than the similarities. Although the trust was a nonresident under the statute, it is undisputed that the grantor of the trust and contributor of the Logistics shares, T. Ryan Legg, was an Ohio resident in 2005 and for at least part of 2006. Moreover, unlike Corrigan, Legg was a founder and manager of the business of the pass-through entity—a material distinction, see *Corrigan at ¶ 68* (finding the tax unconstitutional as applied to Corrigan "in light of the absence of any assertion or finding that Corrigan's own activities amounted to a unitary business with that of Mansfield Plumbing").
>
> Properly analyzed, this case involves an Ohio resident who conducted business in significant part in Ohio through the corporate form and who disposed of his business and corporate interest not by a personal sale but by means of a trust that he created to accomplish his objectives for himself and his family. Although Legg deliberately set up a Delaware trust, his Ohio contacts are still material for constitutional purposes.[70]

Those facts were sufficient, the Ohio Supreme Court concluded, to allow Ohio to apportion and tax the Trust's capital gain consistently with the Due Process Clause. In October 2017, the U.S. Supreme Court denied the Trust's petition for review of this Due Process Clause holding in the *T. Ryan Legg Irrevocable Trust* case.

Analysis of the *DuPont* and *T. Ryan Legg Irrevocable Trust* Cases

The Indiana Tax Court's holding that DuPont's sale of the intangible partnership interests in its DPC pharmaceutical

joint venture produced *nonbusiness income* allocable to DuPont's state of commercial domicile, Delaware, turned principally on how the Indiana adjusted gross income tax statutes defined "business income." DuPont's statutory argument was aided by the fact that Indiana still utilizes the original UDITPA definition of "business income." It was pretty clear that DuPont's sale of the partnership interests in the DPC joint venture was not a transaction in the regular course of DuPont's industrial, agricultural and chemical manufacturing business, so the sale of the partnership interests did not satisfy the transactional test in the UDITPA definition of "business income." Perhaps the Indiana Department of Revenue hoped to prevail on the functional test, but from the Indiana Tax Court's opinion the Department appears to have made little or no effort to refute the affidavits from several DuPont executives stating that the DPC joint venture operated totally autonomously of DuPont. With this uncontroverted evidence in the record, the Indiana Tax Court determined that DuPont share of the DPC partnership interests did not satisfy the functional test, either.

DuPont's victory on the business income statutory issue illustrates that state statutory definitions of "business income" matter greatly in litigation over the apportionability of taxpayer gains from sales of intangible ownership interests in business entities. DuPont would not have been able to make this argument in a state like Illinois that has revised its statutory definition of "business income" to mean any and all income or gain that the state is permitted to subject to formulary apportionment under the U.S. Constitution.[71] The statutory definition of "business income" cannot be any more expansive than that.

Based on the evidence before the Indiana Tax Court, it correctly held that the Indiana Department of Revenue was constitutionally prohibited from apportioning DuPont's capital gain from its sale of the DPC partnership interests. Again, the Department more or less conceded, factually, that DuPont and the DPC joint venture were not engaged in a unitary business, which squarely supported the legal conclusion that Indiana was not allowed to apportion DuPont's gain from the sale of the DPC partnership interests under the holdings of the U.S. Supreme Court's *Allied-Signal* and *MeadWestvaco* decisions. The Indiana Tax Court's holding on this apportionability issue in the *DuPont* case is also squarely supported by the *Hercules, Inc.* line of cases involving a similar sale of ownership interests in a joint venture.[72]

The *T. Ryan Legg Irrevocable Trust* case presented much more technical Ohio income tax statutes that are designed to subject income and gains of an irrevocable trust to formulary apportionment. Again, the definitions of terms like "qualifying trust amount," "modified business income" and "modified nonbusiness income" were the crux of the case. Once the Ohio Supreme Court determined that the capital gain from the irrevocable trust's sale of its closely held stock investment in the S corporation fit within the statutory definition of a "qualifying trust amount," that gain was apportionable within and without Ohio pursuant to the provisions of the Ohio personal income tax statutes, albeit with a different apportionment rule than the one that the Ohio Tax Commissioner had utilized in his tax assessment against the irrevocable trust.

The constitutional analysis in the *T. Ryan Legg Irrevocable Trust* case is disappointing. Once the Ohio Supreme Court determined that the irrevocable trust was a *nonresident* taxpayer because the trust did not have any Ohio-domiciled beneficiary who was entitled to receive trust distributions during the taxable year, the Ohio Supreme Court's *Corrigan v. Testa* decision suggested that the Tax Commissioner should not have been able to resort to the Ohio investee apportionment statutes, Ohio Revised Code Sections 5747.212 and 5747.01(BB), to apportion the trust's gain from its sale of the S corporation stock. Instead, that gain should have been allocated outside Ohio because the trust was a nonresident taxpayer. The Ohio Supreme Court's willingness to distinguish the *Corrigan* case confirms that the *Corrigan* case did not determine that the Ohio investee apportionment statue was constitutionally invalid on its face. Rather, it appears that the Ohio Supreme Court is going to examine the nature and degree of the contacts between the nonresident taxpayer and Ohio and the investee business in determining whether Ohio may subject the nonresident taxpayer's gain from the sale of an intangible ownership interest in the investee business to formulary apportionment.

ENDNOTES

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1 *E.I. DuPont de Nemours & Co. v. Indiana Department of Revenue*, 79 NE3d 1016 (Ind. Tax Ct. 2017).

2 *T. Ryan Legg Irrevocable Trust v. Testa*, 149 Ohio St. 3d 376, 75 NE3d 184 (2016).

3 *E.I. DuPont de Nemours & Co. v. Indiana Department of Revenue*, 79 NE3d 1016, 1018 (Ind. Tax Ct. 2017).

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*, at 1019.

11 *Id.*

12 *Id.*

13 *Id.*, at 1020. *See* Ind. Code §6-8.1-5-2(a).

14 *See* Rev. Rul. 56-285, 1956-1 CB 134.

15 *See* Pet'r Br. at 14–20.

[16] *DuPont*, 79 NE3d at 1021.
[17] Ind. Code §6-3-1-20, based on UDITPA §1(a).
[18] Ind. Code §6-3-1-21, based on UDITPA §1(e).
[19] *DuPont*, 79 NE3d at 1022–1023.
[20] *Id.*, at 1022.
[21] *Id.*, at 1023.
[22] *Id*.
[23] *Id.*, citing *May Department Stores Co. v. Indiana Department of State Revenue*, 749 NE2d 651, 664 (Ind. Tax Ct. 2001).
[24] *Id*.
[25] *Id.*, at 1023–1024.
[26] *Allied-Signal, Inc. v. Director, Division of Taxation*, SCt, 504 US 768, 112 SCt 2251, 119 Led2d 533.
[27] *MeadWestvaco Corp. v. Illinois Department of Revenue*, SCt, 553 US 16, 128 SCt 1498, 170 Led2d 404.
[28] *DuPont*, 79 NE3d at 1024.
[29] *Id.*, at 1024.
[30] *Id.*, at 1025–1027.
[31] *Id.*, at 1027–1028.
[32] *T. Ryan Legg Irrevocable Trust v. Testa*, 149 Ohio St. 3d 376, 75 NE3d 184 (Ohio 2016).
[33] *Id.*, at 376.
[34] *Id.*, at 376–377.
[35] *Id.*, at 377.
[36] *Id*.
[37] *Id*.
[38] *Id*.
[39] *Id*.
[40] *Id*.
[41] Ohio Rev. Code §5747.02(D) and (E).
[42] Ohio Rev. Code §5747.02(A).
[43] Ohio Rev. Code §5747.01(I)(e)(a)(ii) and (III).
[44] Ohio Rev. Code §5747.01(I)(3)(c).
[45] Ohio Rev. Code §5747.01(BB)(2).
[46] Ohio Rev. Code §5747.011(B).
[47] Ohio Rev. Code §5747.01(BB)(4)(b).
[48] Ohio Rev. Code §5733.051(F).
[49] Ohio Rev. Code §5747.01(BB)(1).
[50] Ohio Rev. Code §§5747.01(BB)(4)(a) and 5747.013(B).
[51] Ohio Rev. Code §§5747.01(BB)(4)(c), 5747.20(b)(2)–(5) and 5747.212.
[52] *T. Ryan Legg Irrevocable Trust*, 149 Ohio St. 3d at 377–378.
[53] *Id.*, at 378.
[54] *Id.*, at 378–379.
[55] *Id.*, at 379.
[56] *Id.*, at 382–383.
[57] *Id.*, at 383.
[58] *Id*.
[59] *Id.*, citing Ohio Rev. Code §1701.37.
[60] *Id.*, at 384.
[61] *Id.*, at 385.
[62] *Id.*, at 386.
[63] *Id*.
[64] *Id.*, at 387.
[65] *Id.*, at 388.
[66] *Id.*, at 389–390.
[67] *Corrigan v. Testa*, 149 Ohio St. 3d. 18 (2016).
[68] John A. Biek, *Ohio "Investee Apportionment" Statute Is Ruled Unconstitutional as Applied to Typical Nonresident Investors*, J. Passthrough Entities, Sept.–Oct. 2016, at 43.
[69] *Id.*, at 390.
[70] *Id.*, at 390–391.
[71] 35 ILCS 5/1501(a)(i).
[72] *See Hercules, Inc. v. Illinois Department of Revenue*, 324 Ill. App. 3d 329, 753 NE2d 418 (1st Dist. 2001); *Hercules, Inc. v. Commissioner of Revenue*, 575 NW2d 111 (Minn. 1998); *Hercules, Inc. v. Comptroller of Treasury*, 716 A2d 276 (Md. 1997).

