State Law & State Taxation Corner

Ohio "Investee Apportionment" Statute Is Ruled Unconstitutional as Applied to Typical Nonresident Investors

By John A. Biek

Introduction

Ten years ago, one of these columns[1] questioned the validity of a recently enacted Ohio statute requiring a nonresident investor owning a 20-percent-or-more interest in a passthrough entity to apportion capital gain or loss from the nonresident investor's sale, exchange or disposition of a debt or equity interest in the passthrough entity *with the passthrough entity's apportionment factors* rather than to allocate that capital gain or loss to the nonresident investor's state of residence, as is generally provided for in the Ohio paid income tax laws. The purpose of Ohio Revised Code Section 5747.212 appeared to be to discourage owners of Ohio businesses from moving to a state like Florida that has no personal income tax shortly before selling the stock of the business in order to take advantage of the general rule that a capital gain from a sale of an equity interest is allocated to the taxpayer's state of residence or commercial domicile. However, this Ohio "investee apportionment" statute stood the principles of state taxation on their head by using the apportionment factors of the business being sold (the "investee") rather than the apportionment factors (or domicile) of the taxpayer realizing the capital gain (the "investor") to determine how much of the capital gain was taxable in Ohio.

On May 4, 2016, the Ohio Supreme Court ruled unanimously in *Corrigan v. Testa* that the application of Section 5747.212 to the capital gain that a nonresident individual recognized from selling an 80-percent ownership interest in an Ohio-based limited liability company, Mansfield Plumbing LLC, violated the Due Process Clause of the U.S. Constitution because Ohio was taxing income arising outside its borders.[2] The *Corrigan* opinion distinguishes between a distributive share of passthrough entity income, which results from the passthrough entity's

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business operations and, therefore, *is apportionable with the passthrough entity's apportionment factors,* and capital gain (or loss) from the sale of an ownership interest in the passthrough entity, which generally arises apart from the passthrough entity's business operations and, therefore, should be taxable by reference to the selling investor's state of residence or domicile. The Ohio Supreme Court correctly held that Ohio did not have the right to tax a portion of the capital gain from the sale of the nonresident investor's LLC ownership interest merely because the LLC was conducting some of its business operations in Ohio.

The recent decision of the Pennsylvania Commonwealth Court in *RB Alden Corp. v. Commonwealth,* [3] discussed herein, illustrates how a capital gain from the sale of a passthrough entity interest might be apportionable if the selling investor used that passthrough entity interest in a unitary business conducted in the taxing state. However, those facts were not present in the *Corrigan* case.

Ohio did not have the right to tax a portion of the capital gain from the sale of the nonresident investor's LLC ownership interest merely because the LLC was conducting some of its business operations in Ohio.

Ohio's Approach to Taxing Passthrough Entities and Their Nonresident Investors

The Ohio personal income tax is imposed at graduated rates of up to 4.997 percent on the Ohio taxable income of both resident individuals and nonresident individuals.[4] Because the U.S. Constitution does not permit Ohio to tax income of the nonresident individual that is earned or derived from sources outside Ohio's borders, Section 5747.05(A)(1) of the Ohio Revised Code provides a nonresident tax credit equal to the "amount of tax otherwise due under Section 5747.02 of the Revised Code on such portion of the combined adjusted gross income and business income of any nonresident taxpayer that is not allocable or apportionable to this state pursuant to sections 5747.20 to 5747.23 of the Revised Code."[5] As a result of the application of this nonresident tax credit, the nonresident individual does not end up paying Ohio personal income tax on his non-Ohio-source income, although the nonresident individual's Ohio-source income may be taxed at a higher Ohio marginal tax rate than would have been the case if tax had been computed only on the amount of the Ohio-source income of the nonresident individual.

The Ohio personal income tax statutes utilized the general allocation and apportionment rules of the Uniform Division of Income for Tax Purposes Act ("UDITPA") to determine how much of a nonresident individual's taxable income was derived from sources in states *other than Ohio*, and will, therefore, be includible in the numerator of the fraction utilized to compute the nonresident tax credit of Section 5747.05(A)(1). Ohio also takes the typical state approach of allocating and apportioning passthrough entity income at the passthrough entity level, with the Ohio-source income of the passthrough entity than flowing through to the nonresident investors in the passthrough entity to be reported on their Ohio personal income tax returns. Thus, Section 5747.22(B) provides that:

> With respect to a pass-through entity, one or more of the pass-through entity investors of which are liable for the tax imposed by section 5747.02 of the Revised Code, the *business income and deductions* included in the adjusted gross income of the pass-through entity shall be apportioned to this state *in the hands of the pass-through entity investors* pursuant to section 5747.21 of the Revised Code. The business income and deductions as thus apportioned to this state then shall be allocated to the pass-through entity investors in proportion to their right to share in that business income.[6]

Under Section 5747.21, the passthrough entity apportions its business income within and without Ohio utilizing a three-factor apportionment formula comprised of a 20-percent property factor, a 20-percent payroll factor and a 60-percent sales factor.[7]

In order to source the nonbusiness income of the passthrough entity, Section 5747.22(C) provides that:

> With respect to a pass-through entity described in division (B) of this section, the *nonbusiness income and deductions* included in the adjusted gross income of the pass-through entity shall be allocated to the pass-through entity investors in proportion to their right to share in the nonbusiness income, and then *the pass-through entity shares shall be allocated to this state in the hands of each pass-through entity investor* pursuant to section 5747.20 of the Revised Code.[8]

The Ohio personal income tax statutes define the term "nonbusiness income" to include compensation, rents

and royalties from real or tangible personal property, capital gains, interest, dividends and distributions, patent or copyright royalties or lottery winnings, prizes and awards.[9] Section 5747.20 specifically allocates these items of nonbusiness income in the same manner that they would be under UDITPA.[10] This means that Section 5747.20(B)(2)(c) allocates capital gains or losses from the sale or other transfer of intangible personal property to the taxpayer's *state of domicile* at the time of the sale or transfer. Section 5747.20(B)(6) specifically allocates interest, dividends and distributions of a nonresident individual *outside Ohio*.

In 2002, the Ohio legislature enacted a special rule for taxing a nonresident investor's capital gain or loss from a sale of a debt or equity interest in a passthrough entity if the nonresident investor owned a 20-percent-or-more interest in the passthrough entity during the past three tax years. In the 2004 tax year at issue in the *Corrigan* case, Ohio Revised Code Section 5747.212 provided as follows:

> **Section 5747.212. Apportionment by pass-through entity investor owning twenty per cent of entity.**
>
> This section applies solely for the purpose of computing the credit allowed under division (A) of section 5747.05 of the Revised Code and computing taxable income in this state under division (D) of section 5747.08 of the Revised Code.
>
> *A pass-through entity investor that owns,* directly or indirectly, *at least twenty per cent of the pass-through entity at any time during the current taxable year or either of the two preceding taxable years* shall apportion any income, including gains or losses, realized from the sale, exchange, or other disposition of a debt or equity interest in the entity as prescribed in this section. For such purposes, in lieu of using the method prescribed by sections 5747.20 and 5747.21 of the Revised Code, *the investor shall apportion the income using the average of the pass-through entity's apportionment fractions otherwise applicable under section 5747.21 of the Revised Code for the current and two preceding taxable years.* If the pass-through entity was not in business for one or more of those years, each year that the entity was not in business shall be excluded in determining the average.[11]

This "investee apportionment" rule took effect for tax years ending on or after June 5, 2002. The wording of Section 5747.212 has changed a couple of times—and the quoted paragraphs are now formatted as Section 5747.212(A) and (B)—but the substance of the statute has remained the same.

The *Corrigan v. Testa* Case

In 2000, Patton R. Corrigan, a resident of Connecticut, and several other business associates acquired the assets of Mansfield Plumbing, a multistate sanitary ware producer based in Perrysville, Ohio.[12] They organized the business as Mansfield Plumbing, LLC, with Corrigan owning a 79.29-percent membership interest in the LLC.[13] Corrigan served as a member of the board of managers of Mansfield Plumbing, occasionally traveling from Connecticut to the company's headquarters in Perrysville, Ohio, to attend board meetings and management presentations.[14] Corrigan testified in the proceedings before the Ohio Board of Appeals (the "BTA") that, while his involvement with Mansfield Plumbing was "easily a hundred hours" per year, his involvement was limited to stewardship of his investment in the company rather than active management of its business operations.[15] It does not appear that the Ohio Department of Taxation offered any evidence that Corrigan had a more in-depth relationship to the operations of the Mansfield Plumbing business.

Section 5747.20(B)(6) specifically allocates interest, dividends and distributions of a nonresident individual outside Ohio.

In 2004, Corrigan and the other investors in Mansfield Plumbing sold their membership interests to Ceramicorp, Inc.[16] Corrigan realized a $27.5 million capital gain from the sale of his nearly 80-percent membership interest in Mansfield Plumbing.[17] Corrigan specifically allocated this capital gain outside Ohio on his 2004 Ohio personal income tax return on the theory that the gain was nonbusiness income to him that was allocable to his state of residence (*i.e.*, Connecticut).[18]

On audit, the Ohio Department of Taxation applied Section 5747.212 to apportion Corrigan's capital gain from the sale of his membership interest in Mansfield Plumbing within and without Ohio using the apportionment factors of the LLC. This resulted in the Department issuing Corrigan an assessment for $847,085.19 of Ohio personal income tax and interest.[19] Corrigan paid $100,000 of the assessment and filed a refund claim for

that payment in March 2010. The Department denied this refund claim in August 2012.[20]

Corrigan appealed the denial of the refund claim to the BTA, which upheld the Tax Commissioner's final determination on September 24, 2014.[21] The BTA determined that the capital gain from Corrigan's sale of his 80-percent membership interest in Mansfield Plumbing was subject to formulary apportionment with the LLC's apportionment factors, pursuant to Section 5747.212. However, the BTA lacked jurisdiction to consider Corrigan's constitutional objections to this statute.[22]

On appeal to the Ohio Supreme Court, Corrigan argued that the application of Section 5747.212 to his capital gain from the sale of the sale of his membership interest in Mansfield Plumbing violated the Due Process Clause and Commerce Clause of the U.S. Constitution because Corrigan did not have nexus in Ohio and he had sold his intangible membership interest outside Ohio. The Department contended, on the other hand, that "Ohio enjoyed the constitutional prerogative of taxing the proceeds of a nonresident's out-of-state sale of intangible property, based on nothing more than the fact that the entity being sold conducted some of its business in Ohio."[23] The Ohio Supreme Court rejected this expansive view of the state's taxing jurisdiction.

Taking up Corrigan's due process claim, the Ohio Supreme Court explained that:

> "It 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 … 'Jurisdiction is as necessary to valid legislation as to valid judicial action.'" *Miller Bros. Co. v. Maryland,* 347 U.S. 340, 342, 74 S.Ct. 535, 98 L.Ed. 744 (1954), quoting *St. Louis v. Wiggins Ferry Co.,* 78 U.S. 423, 430, 20 L.Ed. 192 (1870). And "[g]overnmental jurisdiction in matters of taxation … depends upon the power to enforce the mandate of the state by action taken within its borders, either *in personam* or *in rem.*" *Shaffer v. Carter,* 252 U.S. 37, 49, 40 S.Ct. 221, 64 L.Ed. 445 (1920). These precepts point to the importance of the Due Process Clause of the Fourteenth Amendment as a means of "guarding against extraterritorial taxation" by defining the limits of state taxing authority. *Hillenmeyer v. Cleveland Bd. of Review,* 144 Ohio St. 3d 165, 2015-Ohio-1623, 41 N.E.3d 1164, p. 40.[24]

The Ohio Supreme Court observed that "under both the Due Process Clause and the Commerce Clause, the bedrock principle is 'that a State may not tax value earned outside its borders.'"[25] The Ohio Supreme Court overturned the Department's denial of Corrigan's refund claim on due process grounds without separately considering his Commerce Clause claim, although Corrigan clearly would have prevailed on that claim, too.[26]

In order for Ohio to be able to tax the income of a nonresident like Corrigan, the Ohio Supreme Court explained, the Due Process Clause requires that Ohio have *in rem* jurisdiction over the income-producing activities giving rise to that income:

> [J]ust as a State may impose general income taxes upon its own citizens and residents whose persons are subject to its control it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon incomes accruing to nonresidents from their property or business within the State, or their occupations carried on therein.[27]

This meant that Ohio had to be able to demonstrate that it had a connection with both the person being taxed (Corrigan) and the activity being taxed (the sale of Corrigan's membership interest in Mansfield Plumbing) in order for Ohio to be allowed to tax Corrigan's capital gain.[28]

The Ohio Supreme Court noted that under these due process principles, Ohio clearly has the authority to tax a nonresident investor on a distributive share of the income that a passthrough entity realizes from its business operations in Ohio.[29] Indeed, the Ohio Supreme Court had reached this very conclusion in *Agley v. Tracy*, a case in which nonresident shareholders of three S corporations were subjected to Ohio personal income tax on their distributive shares of Ohio apportioned business income of the S corporations.[30] In its *Agley* opinion, the Ohio Supreme Court had explained that:

> Appellants have admitted that their S corporations conducted business in Ohio. Thus, it is evident that the S corporations have utilized the protections and benefits of Ohio by carrying on business here. This income was then passed through to the appellants as personal income. Thus, the appellants, through their S corporations, have also availed themselves of Ohio's benefits, protections, and opportunities by earning income in Ohio through their respective S corporations. We find that this provides Ohio the 'minimum contacts' with the appellants to justify taxing appellants on their distributive share of income.[31]

The Ohio Supreme Court observed: "Simply stated, even though the taxpayers in *Agley* were nonresidents

who did not themselves conduct business in Ohio, we determined that their decision to invest using corporate structures in Ohio and making federal pass-through elections satisfied the purposeful-availment criterion for imposing the tax obligation on them personally."[32]

The Ohio Supreme Court concluded, however, that its holding in *Agley* did not support Ohio's taxation of Corrigan's capital gain from the sale of his intangible membership interest in Mansfield Plumbing (as opposed to his distributive share of the losses from the LLC's business operations in Ohio):

> The tax at issue here differs, however, with respect to Ohio's connection both to the activity and to the taxpayer. In this case, the activity at issue is a transfer of intangible property by a nonresident. Thus, Ohio's connection is an indirect one, whereas in *Agley* the activity being taxed was the very income derived from business activity in Ohio. Moreover, although Corrigan's availment of Ohio's protections and benefits is clear with respect to the pass-through of Mansfield Plumbing's income to him, Corrigan's sale of his interest in Mansfield Plumbing did not avail him of Ohio's protections and benefits in any direct way.[33]

The Ohio Supreme Court criticized the Ohio Department of Taxation for attempting to tax Corrigan's capital gain from the sale of his membership interest pursuant to Section 5747.212 as if it were income from Mansfield Plumbing's business itself, which was factually incorrect and clearly beyond Ohio's due process taxing jurisdiction.[34]

The Department of Taxation relied on the U.S. Supreme Court's hoary decisions in *Int'l Harvester Co. v. Wisconsin Dep't of Taxation*[35] and *Wisconsin v. J.C. Penney Co.*[36] to assert broad state authority under the Due Process Clause to tax income of nonresidents of the state. In *J.C. Penney*, the question was whether Wisconsin was acting unconstitutionally by imposing a dividend privilege tax on an apportioned share of dividend payments to resident and nonresident shareholders, with that tax being withheld from the dividend payments by the corporation that was conducting business operations in Wisconsin. The U.S. Supreme Court upheld the imposition of this dividend privilege tax withholding obligation because the Supreme Court viewed the dividend privilege tax as an additional tax on corporate earnings within Wisconsin, with the liability for that tax being postponed until such earnings were paid out as dividends.[37] Because Wisconsin clearly had authority under the Due Process Clause to tax J.C. Penney Co. on its Wisconsin earnings, the Supreme Court was not troubled by the state requiring the corporation to collect the dividend privilege tax from its distribution of those Wisconsin earnings as dividend payments to nonresident shareholders.

In *Int'l Harvester*, four years later, the U.S. Supreme Court considered this question again in light of the Wisconsin Supreme Court's clarification that the dividend privilege tax was imposed on the shareholders rather than on the corporation paying the dividends. The U.S. Supreme Court affirmed its due process analysis in *J.C. Penney* because "[p]ersonal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them."[38]

The Department of Taxation argued in the *Corrigan* case that, given the Supreme Court's holdings in *J.C. Penney* and *Int'l Harvester*, Section 5747.212 passed muster under the Due Process Clause because the nonresident Corrigan's liability for payment of Ohio personal income tax on his capital gain from the sale of his membership interest in Mansfield Plumbing was "determined by the business done by *the entity in which the taxpayer has invested* and that the investment income realized—whether that income is a dividend, a capital gain from the sale of the investment, or the payment of a debt—may be taxed *to the nonresident investor.*"[39]

The Ohio Supreme Court rejected this argument, finding that while the U.S. Supreme Court had upheld the imposition of the Wisconsin dividend privilege tax in *J.C. Penney* and *Int'l Harvester* even though the economic burden of that tax fell upon nonresident shareholders of those corporations, "the propriety of imposing the economic burden of a tax on a nonresident does not necessarily require the conclusion that *the tax liability itself* can be imposed on those nonresident investors."[40] Moreover, the Ohio Supreme Court explained:

> It is self-evident that the dividend has a more direct relationship to corporate earnings, out of which the dividend is paid, than does the capital gain from the sale of corporate ownership. Indeed, it is possible in a given situation that the purchaser of a business may be more interested in acquiring specific business assets than in the profits generated by the ongoing business. That could, in fact, be true here inasmuch as Mansfield Plumbing realized losses in the years immediately preceding the sale.[41]

Finally, the Ohio Supreme Court reasoned, in the more recent case of *MeadWestvaco Corp. v. Illinois Dep't of Revenue*,[42] the U.S. Supreme Court held that Illinois could *not* constitutionally apportion and tax a $1 billion

intangible "good will" gain that MeadWestvaco Corporation realized from the sale of its Lexis-Nexis division without demonstrating either that MeadWestvaco Corporation and its Lexis-Nexis division were engaged in a unitary business in Illinois (the Illinois circuit court had found that was not the case while the appellate court had not addressed this issue in its opinion the case) or that MeadWestvaco, the taxpayer, utilized the assets of the Lexis-Nexis division in MeadWestvaco's unitary business operations in Illinois. The Ohio Supreme Court declared in its *Corrigan* opinion that:

> Of special relevance here is the question that the high court declined to address. As a fallback position, the state in *MeadWestvaco* had argued that Lexis-Nexis's own business in Illinois justified the imposition of the additional tax on its former parent's gain. The Supreme Court characterized this argument as a 'new ground for the constitutional apportionment of intangibles based on the taxing State's contacts with the capital asset rather than the taxpayer.' *Id.* at 30. (Using the terminology we have employed in this opinion, Illinois was arguing *for investee apportionment* as an alternative to investor apportionment.) The court then declined to address the "new ground" for apportionment for two reasons. First, it noted that the argument had not previously been raised and passed upon. Second, it recognized that the states that relied on investee apportionment, including Ohio, had not been notified that the constitutionality of their statutes would be determined. *Id.* at 31. In other words, the United States Supreme Court regards the imposition of an investee-apportioned tax on the gain realized by an investor as an unsettled question. Because the high court has not answered that question, we cannot properly regard it as settled by *J.C. Penney* and *International Harvester*.[43]

In practice, it should be difficult for the Ohio Department of Taxation to constitutionally apply the investee apportionment rule of Section 5747.212 to most nonresident individual investors in passthrough entities doing business in Ohio.

The salient facts of the *Corrigan* case, then, were that Corrigan, a resident of Connecticut, was not doing business in Ohio solely as a result of his occasional visits to Ohio to attend board meetings or management presentations of Mansfield Plumbing; that Corrigan was not engaged in a unitary business with Mansfield Plumbing in his capacity as a nonresident investor in the company; and that the Department of Taxation had not shown that Corrigan made use of his membership interest in Mansfield Plumbing in a unitary business that Corrigan conducted in Ohio. The capital gain that the Department was attempting to tax was income of Corrigan, not Mansfield Plumbing, so the Department could not rely on the Ohio business operations of Mansfield Plumbing, as expressed in its apportionment factors, to tax the nonresident Corrigan on an apportioned share of his capital gain from the sale of his membership interest in Mansfield Plumbing at a location outside Ohio.

For all these reasons, the Ohio Supreme Court held that the Department's application of the Section 5747.212 investee apportionment statute to Corrigan's capital gain was unconstitutional. Because the Supreme Court thought it conceivable that some other individual nonresident taxpayer might utilize his ownership interest in a passthrough entity in a unitary business that taxpayer conducts in Ohio, giving Ohio the constitutional authority to tax the nonresident individual's capital gain from the sale of his ownership interest in the passthrough entity under the U.S. Supreme Court's holdings in the *Meadwestvaco* and *Allied-Signal* line of cases, the Ohio Supreme Court declined to find Section 5747.212 facially unconstitutional.[44] That question would have to wait for another day.

The *RB Alden Corp. v. Commonwealth* Case

The recent decision of the Pennsylvania Commonwealth Court in *RB Alden Corp. v. Commonwealth* illustrates when it might be permissible for a state to apportion a capital gain from the sale of an ownership interest in a passthrough entity.[45] This case involved Eastview Associates LP, a New Jersey limited partnership (the "Partnership"), that owned the Alden Park Apartments complex in Philadelphia, Pennsylvania.[46] Prior to 1995, the Partnership borrowed $40 million from National Westminster Bank (USA), granting the bank a mortgage on the Alden Park Apartments complex to secure the loan. In January 1995, National Westminster's successor, Nat West Bank National Association ("NatWest"), sold the secured loan to Hampton Ponds, a subsidiary of

River Bank America. In May 1998, River Bank America was reorganized into RB Assets, Inc.[47]

After the Partnership defaulted on the secured loan held by RB Assets, that company caused its indirect subsidy, RB Alden Corporation ("RB Alden"), to acquire a one-percent general partner interest and an 87.36-percent limited partner interest in the Partnership in order to give RB Asset control over the business operations of the Partnership and the Alden Park Apartments complex that was the collateral for the defaulted on loan.[48] As the sole general partner of the Partnership, RB Alden's only business activity was operating and controlling the Partnership's operations and its apartment complex in Philadelphia.[49]

In the ensuing years, the Partnership incurred a series of operating losses that passed through *pro rata* to RB Alden's federal and Pennsylvania corporate income tax returns.[50] RB Alden reported all of its taxable income or losses to Pennsylvania.[51]

During the 2006 tax year, RB Alden sold a 45-percent limited partner interest in the Partnership to PCK Capital, Inc., in exchange for $5,000 of cash and PCK Capital's assumption of $29.9 million of the Partnership's nonrecourse liabilities attributable to the transferred limited partner interest.[52] RB Alden retained its one-percent general partner interest and a 42.36-percent limited partner interest in the Partnership, continuing to operate and control the Partnership and the Philadelphia apartment complex as it had done prior to selling the partnership interest to PCK Capital.[53]

RB Alden reported a $29.9 million capital gain from the sale of the partnership interest on its 2006 federal tax return. However, RB Alden's 2006 Pennsylvania corporate tax return classified this capital gain as nonbusiness income allocable to RB Alden's corporate domicile in New York (where RB Alden did not file income tax returns).[54] The Pennsylvania Department of Revenue reclassified the $29.9 million gain as apportionable business income and assessed $2,243,291 of Pennsylvania corporate net income tax liability, plus interest, against RB Alden.[55]

The Pennsylvania net income tax statutes defined the term "business income" to mean:

> [I]ncome 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 *either* the acquisition, the management *or* the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. The term includes all income which is apportionable under the Constitution of the United States.[56]

The Department of Revenue agreed that the capital gain from RB Alden's sale of the limited partner interest to PCK Capital did not constitute business income under the first clause of this statutory definition, the so-called transactional test, because the sale of the partnership interest was a one-time event occurring outside the course of RB Alden's regular course of business.[57] However, the Department contended that the capital gain qualified as business income under the second part of the statutory definition, the so-called functional test, because the acquisition, management *or* disposition of the partnership interest had constituted an integral part of RB Alden's regular trade or business of being the sole general partner of the Partnership.[58]

The Pennsylvania Commonwealth Court upheld the Department's reclassification of the capital gain as apportionable business income, finding that:

> Based on the stipulated facts, Taxpayer acquired its interests in the Partnership for the purpose of gaining control over the Partnership. As the Partnership's sole general partner, Taxpayer's sole business activity was directing and controlling the Partnership's operations, including the Apartment Complex operations through its officers and directors. Moreover, RB Assets, Taxpayer's indirect parent, strategically acquired the lender's rights to the Secured Loan in order for Taxpayer to operate and control on its behalf the Partnership and Apartment Complex. Taxpayer's subsequent sale of a portion of its Partnership interest was, therefore, in line with 'the management *or* the disposition of the property constitut[ing] an integral part of the taxpayer's regular trade or business operations management,' and, thus, the income gained from the sale is business income. *Glatfelter Pulpwood Company v. Commonwealth of Pennsylvania*, 19 A.3d 572, 578 (Pa. Cmwlth. 2011) (*Glatfelter I*) (citation omitted).[59]

A few pages later in its *RB Alden* opinion, the Commonwealth Court returned to this theme:

> Taxpayer acknowledged in the Stipulation that it acquired its interests in the Partnership for the purpose of gaining control over the Partnership and thereafter directed and controlled both the Partnership and the Apartment Complex, located in Pennsylvania, to operate them as an integrated whole. Taxpayer then made a strategic business decision to sell a portion of its interest in the Partnership, but retained a 42.36% limited partnership interest, continued to be the sole general partner and maintained its operations over the Partnership as

> before. For these reasons, we conclude that Taxpayer's interest in the Partnership was integrally related to its business activities in Pennsylvania and, thus, the income from the sale of the Partnership interest is subject to tax in Pennsylvania as business income.[60]

Thus, the Commonwealth Court grounded its holding in the *RB Alden* case on statutory interpretation of the term "business income" rather than on the line of constitutional apportionment cases that the Ohio Supreme Court analyzed in the *Corrigan* case. It is not difficult to imagine, however, that the Commonwealth Court could have easily found that the partnership interest that RB Alden sold to PCK Capital was a capital asset utilized as an operational investment in the unitary business operations of RB Alden and its parent corporation, RB Asset, in Pennsylvania, thereby allowing Pennsylvania to apportion the capital gain under the U.S. Supreme Court's holdings in the *Allied-Signal* and *MeadWestvaco* cases.

Analysis of the *Corrigan* and *RB Alden* Cases

The Ohio Supreme Court correctly held in the *Corrigan* case that, pursuant to Ohio Revised Code Section 5747.212, Ohio may not constitutionally tax a capital gain that a nonresident investor realizes from selling an ownership interest in a passthrough entity doing business in Ohio merely because the nonresident investor owns a significant stake (20 percent or more under Section 5747.212) in the passthrough entity. The facts of the *Corrigan* case established that Corrigan was a nonresident of Ohio who sold his membership interest in Mansfield Plumbing at a location outside Ohio, that he was not engaged in business in Ohio through the stewardship of his investment in Mansfield Plumbing and that he was not utilizing his membership interest in Mansfield Plumbing in a unitary business in Ohio. Under the general allocation and apportionment rules that Ohio and most other states have adopted, Corrigan's capital gain from the sale of his intangible membership interest would be allocable to his state of residence (*i.e.*, Connecticut) and courts in other states have so held.[61]

The special investee apportionment rule provided by Section 5747.212 ran afoul of the Due Process Clause, at least as applied to Corrigan, because it resulted in Ohio taxing gain that Corrigan had realized from a capital asset sale transaction conducted outside Ohio without Ohio having any connection to that sale transaction or Corrigan having utilized his membership interest in Mansfield Plumbing in a unitary business conducted in Ohio, as required by the U.S. Supreme Court's holdings in *Allied-Signal* and *MeadWestvaco*. The Ohio Supreme Court correctly held that the mere fact that Mansfield Plumbing was doing business in Ohio did not provide due process justification for Ohio to tax Corrigan on his gain from the sale of his membership interest in Mansfield Plumbing. The intangible membership interest was not to be confused with Corrigan's distributive share of Mansfield Plumbing's income (or loss), which was clearly apportionable by Ohio and the other states where that passthrough entity income or loss was earned.

One might quibble with the Ohio Supreme Court's not finding Section 5747.212 facially unconstitutional because the Court could conceive of some fact pattern that would allow Ohio to apportion a nonresident investor's capital gain from selling an ownership interest in a passthrough entity. The Ohio Supreme Court appears to have been thinking of a situation where the nonresident investor either is engaged in a unitary business with the passthrough entity or utilized the ownership interest in a unitary business that the nonresident investor engaged in Ohio. Under that scenario, however, Ohio would be authorized to apportion the capital gain by the holdings of the *Allied-Signal* and *MeadWestvaco* cases, not because the nonresident investor owed the requisite percentage of the equity in the passthrough entity, as prescribed by Section 5747.212. In practice, it should be difficult for the Ohio Department of Taxation to constitutionally apply the investee apportionment rule of Section 5747.212 to most nonresident individual investors in passthrough entities doing business in Ohio.

The *RB Alden* case presented facts necessary to support the treatment of a partnership interest as an intangible capital asset utilized in an operational function in a unitary business conducted in the taxing state. As a result, the Pennsylvania Commonwealth Court held that RB Alden's capital gain from the sale of part of its partnership interest was business income apportionable within and without Pennsylvania. While the Commonwealth Court based its holding on its statutory interpretation of the term "business income," it appears that the court reached the constitutionally correct result under the *Allied-Signal* and *MeadWestvaco* cases.

ENDNOTES

[1] John A. Biek, *Ohio Takes an Unusual Approach to Taxing Nonresident Individuals on Sales of Interests in Passthrough Entities and Closely Held Businesses*, J. Passthrough Entities, May–June 2006, at 15.

[2] *Corrigan v. Testa*, 2016 Ohio LEXIS 1163 (May 4, 2016).

[3] *RB Alden Corp. v. Commonwealth*, 2016 Pa. Commw. LEXIS 278 (June 15, 2016).

[4] Ohio Rev. Code §5747.02(A). To compute Ohio taxable income, the taxpayer takes his federal adjusted gross income, makes the addition and subtraction modifications listed on Schedule A to the Ohio Form IT-1040 and subtracts a $1,700 exemption for the taxpayer and each of his dependents. *See* Ohio Rev. Code §§5747.01(A), 5747.02(A) and 5747.025 and Ohio Form IT 1040, *Ohio Income tax Return*.

[5] Ohio Rev. Code §5747.05(A)(1).

[6] Ohio Rev. Code §5747.22(B) (emphasis added).

[7] Ohio Rev. Code §§5747.21(B) and 5733.05(B)(2).

[8] Ohio Rev. Code §5747.22(C) (emphasis added).

[9] Ohio Rev. Code §5747.01(C).

[10] Ohio Rev. Code §5747.20.

[11] Ohio Rev. Code §5747.212 (2002) (emphasis added).

[12] *Corrigan v. Testa*, 2016 Ohio LEXIS 1163 at 3–4 (May 4, 2016).

[13] *Corrigan*, slip op., at 4.

[14] *Id.*

[15] *Id.*

[16] *Id.*, slip op., at 4–5.

[17] *Id.*, slip op., at 5.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*, slip op., at 6.

[22] *Id.*

[23] *Id.*, slip op., at 3.

[24] *Id.*, slip op., at 6–7.

[25] *Id.*, slip op., at 8 (quoting from *Allied-Signal, Inc., v. Dir., Div. of Taxation*, SCt, 504 US 768, 777, 784, 112 SCt 2251 (1992)).

[26] *Corrigan*, 2016 Ohio LEXIS 1163, slip op., at 8.

[27] *Id.*, slip op., at 14 (quoting *Shaffer v. Carter*, SCt, 252 US 37, 52, 40 SCt 221 (1920)).

[28] *Corrigan*, 2016 Ohio LEXIS 1163, slip op., at 14–15 (citing *Allied-Signal, Inc., v. Dir., Div. of Taxation*, SCt, 504 US 768, 778, 112 SCt 2251 (1992)).

[29] *Corrigan*, 2016 Ohio LEXIS 1163, slip op., at 16.

[30] *Agley v. Tracy*, 87 Ohio St3d 265, 719 NE2d 951 (1999).

[31] *Corrigan*, 2016 Ohio LEXIS 1163, slip op., at 16–17 (*quoting Agley*, 87 Ohio St3d at 267).

[32] *Corrigan*, 2016 Ohio LEXIS 1163, slip op., at 17.

[33] *Id.*, slip op., at 17–18.

[34] *Id.*, slip op., at 2 and 3.

[35] *Int'l Harvester Co. v. Wisconsin Dep't of Taxation*, SCt, 322 US 435, 64 SCt 1060 (1944).

[36] *Wisconsin v. J.C. Penney Co.*, SCt, 311 US 435, 61 SCt 246 (1940).

[37] *J.C. Penney*, SCt, 311 US at 442–444.

[38] *Int'l Harvester*, SCt, 322 US at 441.

[39] *Corrigan*, 2016 Ohio LEXIS 1163, slip op., at 21 (emphasis in original).

[40] *Id.*

[41] *Id.*, slip op., at 22.

[42] *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, SCt, 553 US 16, 128 SCt 1498 (2008).

[43] *Corrigan*, 2016 Ohio LEXIS 1163, slip op., at 23–24.

[44] *Id.*, slip op., at 31–32.

[45] *RB Alden Corp. v. Commonwealth*, 2016 Pa. Commw. LEXIS 278 (June 15, 2016).

[46] *Id.*, slip op., at 3.

[47] *Id.*

[48] *Id.*

[49] *Id.*, slip op., at 3–4.

[50] *Id.*, slip op., at 4.

[51] *Id.*

[52] *Id.*, slip op., at 5.

[53] *Id.*

[54] *Id.*, slip op., at 5–6.

[55] *Id.*, slip op., at 6.

[56] 72 P.S. §7401(3)(2.)(a)(1)(A) (emphasis added).

[57] *RB Alden*, 2016 Pa. Commw. LEXIS 278, slip op., at 12.

[58] *Id.*

[59] *Id.*, slip op., at 15.

[60] *Id.*, slip op., at 19–20.

[61] *See, e.g.*, *Dupee v. Commissioner of Revenue*, 423 Mass. 617, 670 NE2d 173 (1996); *Appeals of Amyas Ames*, 87-SBE-042 (Cal. SBE June 17, 1987), 1987 WL 50165; *Disabatino v. Director of Revenue*, Nos. 832 and 833 (Del. Tax App. Bd., Feb. 13, 1987); *Cohen v. Commissioner of Revenue*, Nos. 205165, 205166, 206601 (Mass. App. Tax Bd., Aug. 30, 1995), 1995 WL 575131.

