Could Ohio's Latest Due Process Case Spell Trouble for New York?

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In this edition of Noonan's Notes, the authors discuss a recent decision from the Ohio Supreme Court addressing the taxation of nonresidents on their share of income from the sale of a passthrough entity. The authors conclude that the reasoning of the Ohio decision could form the basis of a challenge to a similar New York law.

There has been a lot of buzz recently about the application of federal constitutional provisions in the state tax world. A lot of that buzz was generated by the U.S. Supreme Court's decision last year in *Comptroller of Treasury of Maryland v. Wynne*,[1] in which the Court invalidated an aspect of Maryland's resident credit scheme on commerce clause grounds. We know from some of our own client work that you can expect more action on that issue fairly soon, so stay tuned.

But the Ohio Supreme Court has also not been shy recently about enforcing constitutional principles in state tax cases. First came its decision finding that the city of Cleveland's method of apportioning professional athletes' income for income tax purposes was invalid under the due process clause.[2] And in *Corrigan v. Testa*[3] in May, the court struck down — also on due process grounds — an Ohio income tax statute that required a nonresident to apportion capital gain from the sale of an interest in a passthrough entity. In its own right, *Corrigan v. Testa* is an interesting decision that obviously has important ramifications for Ohio. It has also generated debate among commentators, some of whom have questioned the court's constitutional analysis.[4]

But why stop there? Several years ago, the state of New York passed a provision requiring payment of state income tax by nonresident taxpayers on some sales of interests in passthrough entities that looks a bit like the Ohio provision invalidated in *Corrigan*. Back then, we questioned whether that kind of provision would pass muster on federal constitutional grounds.[5] Now, we may have our answer. Specifically, we think that the analysis in *Corrigan* could set the stage for a similar challenge in New York. We'll outline that issue in this article.

Background: The Ohio and New York Provisions

The New York provision was enacted as part of a package of statutory "loophole" closers in 2009. The measure was designed to halt the creative use of corporate entities by nonresidents to shield them from New York tax on the gain from the sale of real property located in the state. Before the amendment, the play was simple: Since taxable income for a nonresident includes income attributable to owning "real property or tangible property located in this state" but does not generally include income from intangible personal property, a nonresident could place New York real property into an entity like a limited liability company and thereby avoid tax when selling the property. That was because the property sold was an intangible interest in a company, not a sale of the underlying real estate. The statute amended in 2009, Tax Law section 631(b)(1)(A)(1), closed that perceived loophole by simply defining the phrase "real property located in this state" to include interests in an entity whose assets consisted predominantly of New York real property, with some limitations.

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[1] 135 S. Ct. 1787 (2015).

[2] *See Hillenmeyer v. Cleveland Bd. of Review,* 144 Ohio St.3d 165 (2015).

[3] Slip op. No. 2016-Ohio-2805 (May 4, 2016).

[4] Walter Hellerstein, "Substance and Form in Jurisdictional Analysis: *Corrigan v. Testa,*" *State Tax Notes*, June 13, 2016, p. 849.

[5] *See* Timothy P. Noonan and Mark S. Klein, "Tough Measures for Tough Times — New York's Budget Bill," *State Tax Notes,* Aug. 10, 2009, p. 401.

The Ohio provision struck down in the decision is similar to New York's statute. Ohio Rev. Code Ann. section 5747.212(B) requires nonresidents who own at least 20 percent of a passthrough entity to apportion not only the entity's business income but also any gain on the sale of interests in the entity. Specifically, the statute as it read in 2004 — the tax year at issue in *Corrigan* — stated that:

> A pass-through entity investor that owns, directly or indirectly, at least twenty percent 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 gain or loss, realized from the sale, exchange, or other disposition of a debt or equity interest in the entity*.[6]

In other words, like New York's statute, the Ohio statute declared that income from otherwise intangible property — for example capital gain from the sale of a partnership interest — has a source in the state and may therefore be taxed. But the Ohio Supreme Court found that such a designation failed under a due process clause analysis as a form of extraterritorial taxation. Could New York's statute be susceptible to a similar fate under the *Corrigan* analysis?

Corrigan's Due Process Analysis

As with New York, nonresidents of Ohio are taxed only on income earned or received in the state.[7] A nonresident with an interest in a passthrough entity doing business in the state has Ohio-source income to the extent of the entity's business income and is required to apportion that income. Ohio distinguishes between business income (income from "the regular course of a trade or business") and nonbusiness income (including royalties, capital gains, and rents).[8] Nonbusiness income is allocated, rather than apportioned, and — outside the statute at issue in *Corrigan* — capital gains from the sale of intangible property are allocated to the state where the taxpayer is domiciled.[9]

The taxpayer in *Corrigan*, a nonresident of Ohio, owned 80 percent of an LLC doing business in Ohio (Mansfield Plumbing) and sat on its board of managers. In 2004 he and other LLC members sold their interests to a competitor. The sale netted the taxpayer a capital gain of more than $27.5 million. The taxpayer did not report the gain on his return, but Ohio assessed tax on the sale, based on Ohio Rev. Code Ann. section 5747.212(B) and using the same apportionment ratio as the LLC used to report its business income. The taxpayer challenged the assessment to the Ohio Board of Tax Appeals (BTA), arguing that the statute was unconstitutional on due process and commerce clause grounds. The BTA held that it lacked jurisdiction to declare a statute unconstitutional and affirmed the assessment, after which the taxpayer appealed to the Ohio Supreme Court.

The state supreme court's unanimous decision began with the acknowledgment that the "bedrock principle" overlapping the due process clause and the commerce clause, when state taxation is involved, "is that a State may not tax value earned outside its borders."[10] The court found it did not need to engage in a separate commerce clause analysis, however, as it held that "the tax on Corrigan's capital gain cannot be sustained under the basic due-process test for the exercise of proper tax jurisdiction."[11]

In reaching its due process conclusion, the court emphasized that due process "requires some definite link, some minimum connection, between a state and person, property or transaction it seeks to tax." A state's power to tax nonresidents is reflective of the state's "in rem jurisdiction over the income-producing activities conducted within the state," the court noted.[12] Both a link between the state and person being taxed and between the state and the activity being taxed are necessary, the court held. The minimum contacts test for basic jurisdiction to tax may be satisfied as long as a person has purposely availed himself of the benefits and protections within the state.[13] However, the court also stressed that "in the case of a tax on activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax."[14] Under those tests, the court stated that taxing a nonresident on a portion of his distributive share of business income from a passthrough entity doing business in Ohio does not run afoul of due process. First, the generation of income from in-state business activity gives the state in rem jurisdiction. Second, the nonresident has purposefully availed himself "of the protections and benefits of the state's laws by conducting a portion of the business within that state."[15]

However, turning to the capital gain the taxpayer in *Corrigan* realized by selling his intangible interests in his Ohio business, the court found no such jurisdiction:

> 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.[16]

[6]Ohio Rev. Code Ann. section 5747.212(B) (emphasis added).
[7]Ohio Rev. Code. Ann. section 5747.02(A).
[8]*See* Ohio Rev. Code Ann. section 5747.01(B) and (C).
[9]Ohio Rev. Code Ann. section 5747.20(B)(2)(c).

[10]*Corrigan*, slip op. at 6 (quoting *Allied-Signal Inc. v. Director, Division of Taxation,* 504 U.S. 768, 777 (1992)).
[11]*Id.*
[12]*Id.* at 10 (citing *Hillenmeyer v. Cleveland Bd. of Review*, 144 Ohio St.3d 165 (2015)).
[13]*Id.* at 11.
[14]*Id.* (quoting *Allied Signal*, 504 U.S. at 778).
[15]*Id.* at 12.
[16]*Id.* at 13.

The court contrasted *Corrigan*'s facts with those in *Agley v. Tracy*,[17] in which the court rejected a due process challenge from nonresident taxpayers claiming that taxation of their distributive share of S corporation income was unconstitutional. Even though the nonresidents in *Agley* were merely passive investors with no other link to Ohio besides their investments, the court held that the taxpayers "have availed themselves of Ohio's benefits, protections, and opportunities by earning income in Ohio through their respective S corporations."[18] The *Corrigan* court distinguished *Agley* on the basis that the gain being taxed was not derived from Mansfield's business activities in Ohio (or the taxpayer's through his investment in the business). Rather, it was derived from the transfer of an intangible by a nonresident.

The *Corrigan* court also distinguished the case from prior U.S. Supreme Court cases relied on by the commissioner, in which the Court upheld the imposition of Wisconsin's privilege dividend tax on out-of-state corporations: *International Harvester Co. v. Department of Taxation*[19] and *Wisconsin v. J.C. Penney Co.*[20] In these cases, the Court found that although the economic burden of the tax (a withholding tax) may have been borne by nonresidents, it was imposed on the corporation paying out the dividends. The Ohio court concluded that even if the tax could have been deemed a tax imposed on a nonresident's intangible income, "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."[21]

Notably, *Corrigan* did not hold Ohio Revised Code section 5747.212 to be unconstitutional on its face. Rather, it held that its decision was limited to the statute as applied to the taxpayer himself. The court suggested that the tax conceivably could have been sustained, for example, if "Corrigan's own activities amounted to a unitary business with that of Mansfield Plumbing."[22] The court held that "because there is at least a possibility that the statute could be applied when the unitary-business situation is present, we reject the facial challenge."[23]

Applying *Corrigan* to New York's Statute

Although never enacting it by statute, as Ohio did, the New York State Department of Taxation and Finance up until 1992 had treated a nonresident's sale of an interest in a partnership or LLC doing business in New York as subject to personal income tax. Nonresidents are, by statute, taxed on intangible property only to the extent it is "employed in a business, trade, profession or occupation carried on in [New York.]"[24] Nonetheless, the department's previous view was that a nonresident was employing his or her partnership in a trade or business (that is, the business of the partnership) and therefore gains from the sale of the partnership interest constituted income from New York sources. The practice was challenged in *Matter of Loehr*,[25] in which an administrative law judge rejected the department's position that a partner was "employing" his intangible partnership interest in a trade or business in New York merely by owning the interest. The department never appealed the ruling and issued a policy memorandum that same year confirming the department's position that the gain (or loss) from a nonresident's sale of a partnership interest was no longer considered New York source income.[26]

Notwithstanding that general preclusion of taxing nonresidents on the sale of intangible entity interests, the New York State Legislature in 2009 felt differently regarding entities used in structuring real estate deals. It enacted Tax Law section 631(b)(1)(A)(1) for the stated purpose of closing a loophole caused, in part, by that policy regarding passthrough entities. The memorandum in support of the measure cut right to the chase:

> Under current law, nonresidents are taxed on income attributable to an ownership interest in real or tangible property located in New York. A nonresident can escape taxation by placing the New York real property in an entity and then selling his or her interest in the entity. New York has traditionally treated the sale of an interest in these entities as a sale of an intangible asset that is not taxable to a nonresident. . . . This bill ensures that the gain or loss on the direct or indirect sale of New York real property by a nonresident accomplished through the sale of an interest in an entity is subject to New York personal income tax.[27]

The fix? Simply amend the definition of the phrase "real property located in this state" to include an entity whose total asset value consists more than 50 percent of real estate located in New York. The statute also contains an "antistuffing" provision to prevent boosting the value of nonreal-estate assets to more than 50 percent in contemplation of a sale. Under the statute, no assets owned by the entity for fewer than two years are factored when computing the 50 percent threshold.[28] Clearly, the purpose of Tax Law section 631(b)(1)(A)(1) was to prevent tax avoidance on real estate gains that would otherwise be taxable to a nonresident if sold directly.

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[17] 87 Ohio St.3d 265 (1999).
[18] *Agley v. Tracy*, 87 Ohio St.3 at 267.
[19] 322 U.S. 435 (1944).
[20] 311 U.S. 435 (1940).
[21] *Corrigan*, slip op. at 16.
[22] *Id.*, at 22 (citing *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16 (2009), and *Allied-Signal,* 504 U.S. at 768).
[23] *Id.*

[24] N.Y. Tax Law section 631(b)(2).
[25] Administrative law judge opinion (Feb. 27, 1992).
[26] *See* TSB-M-92(2)I (Aug. 28, 1992).
[27] *See* 2009-10 New York State Exec. Budget Rev. Article VII Leg. Mem. in Support, p. 14.
[28] *See* Tax Law section 631(b)(1)(A)(1).

Thus far, the statute has not been challenged on constitutional or other grounds. And for the most part, it has been begrudgingly accepted by practitioners. But *Corrigan* suggests a challenge could be valid.

Certainly, New York's ability to impose real property taxes on New York-based property would pass due process muster, even when paid by a nonresident owner. New York can assert in rem jurisdiction over the in-state property, and a nonresident owner clearly avails himself of the benefits and protections of the state by owning the property. The *Corrigan* analysis also acknowledges that any income generated by the property could be taxable to its owner. Thus, if a nonresident individual, for example, was doing business in New York vis-à-vis a partnership holding various rental properties, it should not offend due process for the state to impose tax on his distributive share of the entity's business income. However, as *Corrigan* suggests, things change when the tax is imposed on the sale of an intangible interest in an entity — whether the entity owns in-state real property or not.

Administrative and judicial rulings dealing with New York state and City's real property transfer taxes have found the imposition of transfer tax on transfers of an "economic interest in real property" (including a "controlling interest" in an entity owning real property) rather than a direct transfer of the underlying property to be permissible, including on due process grounds.[29] However, the transfer taxes are distinguishable in some respects. Most notably, the intangible interest being taxed must be a "controlling interest" in the entity (that is, a more than 50 percent stake), suggesting a unitary relationship between ownership and activity of the underlying business. In contrast, the income tax statute at issue here looks only to the makeup of the entity's assets, without regard to the stakeholder's interest or level of participation. In any case, no rulings have directly addressed due process in the context of the income tax statute, and *Corrigan* suggests a potentially different outcome.

The challenge under a *Corrigan* analysis is not that New York is simply barred from *any* intangible income realized by a nonresident. The general exclusion nonresidents enjoy from tax on income from intangibles not used in any trade or business in the state is largely a matter of legislative grace.[30] The New York Court of Appeals recently rejected a constitutional challenge by a taxpayer who claimed that the taxation of a nonresident's sale of corporate stock as the sale of "assets" under an IRC section 338(h)(10) election violated New York's constitution. In *Burton v. New York State Department of Taxation and Finance*,[31] the taxpayer argued that taxing income from a nonresident's disposition of intangible property — regardless of any federal elections — violated article 16, section 3, of the New York State Constitution. That provision states that "moneys, credits, securities and other intangible personal property within the state not employed in carrying on any business therein by the owner shall be deemed to be located at the domicile of the owner for the purposes of taxation." The taxpayer argued that language barred taxing income from the disposition of an ownership interest in a business.

The *Burton* court found that such language contained no "express prohibition on the *income taxation* of a nonresident's intangible personal property."[32] Rather, the court found that the language of the provision and the history of its adoption made it clear that the provision was intended specifically to prevent ad valorem taxation of intangibles solely based on their "physical ownership, possession or presence in New York State."[33] According to the court, Tax Law section 631(a)(2), which requires that the deemed asset sale under a section 338(h)(10) election be respected when a nonresident sells S corporation stock, is not a form of ad valorem taxation of intangibles but rather results in a tax "based on income generated by those intangibles which are derived from New York sources."[34]

Burton, however, does not foreclose a due process argument under the U.S. Constitution similar to that raised in *Corrigan.* As in *Corrigan*, Tax Law section 631(b)(1)(A)(1) changes what would normally constitute gain derived from intangible nonbusiness investment property (ownership interests in an entity) and converts it by statute into income derived from state sources. Although declaring that an interest in an entity owning real property constitutes "real property in New York" for sourcing purposes may create a statutory basis for taxation, *Corrigan* suggests that the measure may not create a constitutional basis for taxation.

For example, suppose Mark, a New York nonresident, holds a 15 percent stake in Rentals LLC, a passthrough entity that owns two New York City apartment buildings and earns rental income from those buildings. Under Tax Law 632(a)(1), Mark can be taxed on his distributive share of the entity's rental income, because the LLC income is derived from New York state sources (the ownership of and rental receipts from real property located in New York). As the *Corrigan* court reasoned, this taxation does not run afoul

[29] *See Bredero Vast Goed N.V. v. Tax Commission*, 539 N.Y.S.2d 823 (App. Div., 3d Dep't 1989), *appeal dismissed*, 543 N.E.2d 748 (N.Y. 1989); *Matter of Cafcor Trust Reg. Vaduz*, Nos. 812682, 812683, 1997 WL 202424 (N.Y. Tax. App. Trib. Apr. 17, 1997); and *Matter of Corwood Enters. Inc.*, TAT(E) 00-39(RP), 2006 WL 1621955 (N.Y.C. Tax App. Trib. June 2, 2006).

[30] *See* N.Y. Tax Law section 631(a)(2), which provides that "income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property" constitute New York-source income for a nonresident only to the extent they are "employed" in a trade or business carried on in New York.

[31] 25 N.Y.3d 732 (2015) (emphasis added).

[32] *Burton*, 25 N.Y.3d at 739.

[33] *Id.* at 740.

[34] *Id.* at 743.

of due process. New York has a link between the taxpayer (who has purposefully availed himself of the state's protections by engaging in an in-state business) and the income-producing activity: the rents on in-state real property. But if Mark later sells his stake in the entity, do either of those links or minimum contacts exist for due process purposes?

Corrigan would say no. Regardless of the statutory provision calling Mark's intangible LLC interest "real property located in this state," Mark has not availed himself of the protections of New York in any direct way in transferring his 15 percent stake in the LLC. We think *Corrigan*'s reasoning is persuasive in that respect. The gain Mark receives from transferring his LLC shares is not akin to a dividend paying out deferred profits from the company's in-state activity; nor does the gain derive from any change in ownership of title to in-state property. Rather, the source of the gain is from an intangible interest in an entity, which continues to own the real property and whose members will continue to be taxed on the entity's in-state business activities.

It may be that a due process analysis in New York would take into account the clearly stated purpose of New York's statute — to dissuade the more aggressive use of entities specifically to avoid tax that would otherwise be assessed if the property were owned directly. After all, the statute still permits long-term tax planning by allowing non-real-estate assets owned for more than two years to be factored in determining the 50 percent threshold.[35] But what's interesting is that Ohio's tax commissioner offered a similar argument in *Corrigan* to justify Ohio's statute — arguing that the same gain would have been taxable if the sale were structured as a bulk sale of the Ohio partnership's assets and that precluding tax from being assessed on the economically equivalent situation of selling the business's ownership interests would elevate form over substance. Clearly, the goal of New York's statute was based on the similar premise of not putting form (the use of entities) over substance (the sale of New York real property). Still *Corrigan*'s response to that idea is worth noting:

> We recognize that an asset sale and a sale of ownership interest may be different forms involving the same *economic* substance to the parties, but that does not mean that the jurisdictional limits on Ohio's taxing power lack their own substantive importance. Nor is it unusual that two different methods of achieving the same economic result could have drastically different tax implications.[36]

[35]*See* Tax Law section 631(b)(1)(A)(1).

[36]*Corrigan*, slip op. at 21.

Other Implications?

Above, we discussed the results of the recent *Burton* case in New York, in which a law change also involving the taxation of a nonresident's sale of an intangible was subject to a constitutional attack. But as we noted, it appeared that the taxpayer in *Burton* challenged New York's statute on state constitutional grounds only. *Corrigan* suggests that perhaps a valid attack on federal constitutional grounds could be levied.

And while we're at it, the same kind of constitutional challenge perhaps could be directed at a companion case issued the same day as *Burton* — *Caprio v. New York State Department of Taxation and Finance.*[37] *Caprio* involved a due process challenge to the same law but in a totally different context. Specifically, the taxpayer in *Caprio* argued that the state's attempts to retroactively change the law and tax a nonresident on the sale of S corporation stock itself was invalid on due process grounds. The *Caprio* court, however, held that the state's retroactive taxation did not violate due process. But as we outlined in our critique of that decision in a prior column, the court's conclusion could be susceptible to challenge.[38] Indeed, in a decision after *Caprio*, the state's tax appeals tribunal expressed "serious concerns as to the ramifications" of the decision in reluctantly allowing retroactive application of the same law against another taxpayer who undisputedly was able to show that he detrimentally relied on the prior law and that such reliance was reasonable.[39] The Ohio decision in *Corrigan* signals that maybe a due process argument from another angle might be met with more success.

Conclusion

The *Corrigan* case certainly suggests that New York's practice of taxing nonresidents on the sale of intangible interests in entities owning real property is susceptible to a due process challenge. While Tax Law section 631(b)(1)(A)(1)'s stated justification as a narrowly tailored "loophole" closer to address a particular tax avoidance technique could have a bearing in that kind of analysis, we think the *Corrigan* rationale is compelling. And in any event, the case should revive the question whether New York's efforts to tax nonresidents on that kind of intangible income in this and other contexts is viable. ■

[37]26 N.Y.3d 955 (2015).

[38]*See* Noonan, Daniel P. Kelly, and Joshua K. Lawrence, "The Empire Strikes Back in *Caprio*," *State Tax Notes*, Aug. 10, 2015, p. 533.

[39]*Matter of Jeffrey M. and Melissa Luizza*, N.Y. Tax Appeals Tribunal, Mar. 29, 2016 ("While we are not without serious concerns as to the ramifications of this decision, we find that the holding in Caprio does control our decision in this matter"). The authors represented the taxpayer in this case.