

Ohio Supreme Court holds taxation of capital gain from LLC sale is invalid

Overview

On May 4, 2016, the Ohio Supreme Court held in *Corrigan v. Testa*¹ that Ohio Rev. Code § 5747.212 violated the Due Process Clause of the US Constitution as applied to the nonresident taxpayer at issue on capital gains realized from the sale of his equity interest in a limited liability company that was doing business in Ohio and not unitary with the nonresident taxpayer. Pursuant to this decision, Ohio potentially may not tax certain capital gains realized by nonresidents on sales of their equity interests in various non-unitary pass-through entities that are doing business in Ohio.

This Tax Alert provides a brief overview of Ohio's personal income tax, reviews the underlying facts and the procedural history of *Corrigan*, summarizes the Ohio Supreme Court's recent decision, and provides related taxpayer considerations.

Ohio personal income tax

Ohio imposes personal income tax on "every individual...residing in or earning or receiving income in this state."² An individual's Ohio income tax base is founded on federal adjusted gross income subject to various state modifications, which is referred to as "Ohio adjusted gross income."³ Ohio then computes personal income tax based on the entire amount of Ohio adjusted gross income; however, nonresidents are entitled to a nonresident credit to the extent that their Ohio taxable income is not sourced to Ohio through either apportionment or allocation.⁴

Nonresident individuals must calculate the proportion of any capital gains to situs to Ohio when computing their nonresident credit.⁵ In lieu of utilizing Ohio's general apportionment and allocation provisions for this nonresident credit calculation,⁶ Ohio Rev. Code § 5747.212 specifically provides that the capital gains realized by a nonresident investor on the sale of certain closely held pass-through entities must be sited to Ohio based upon the disposed pass-through entity's average apportionment factors over the last three tax years.⁷

Background of *Corrigan*

The taxpayer in *Corrigan* was a nonresident of Ohio. In 2000, the taxpayer acquired an interest in Mansfield Plumbing LLC (Mansfield), a pass-through entity doing business in Ohio. The taxpayer owned over 79 percent of Mansfield and held the title of manager. As manager, the taxpayer often visited Mansfield's headquarters in Ohio for board meetings and management presentations regarding operations, labor, finance, strategic positions, and other Mansfield business matters. The taxpayer's stated role in such activities was to serve as an investor intending to provide financing and strategic expertise; the taxpayer evidently was not involved in overseeing Mansfield's day-to-day operations. In this respect, the taxpayer apparently assumed a stewardship role, rather than actively managed the business. In 2004, the taxpayer (along with other investors) sold his interest in Mansfield to an unrelated third party. As a result of this sale, the taxpayer realized a capital gain of approximately \$27 million. For Ohio personal income tax purposes, the taxpayer treated the entire amount of this capital gain as nonbusiness income that was allocable outside Ohio in accordance with the rules applicable to situsing nonbusiness income found in Ohio Rev. Code § 5747.20.

Procedural history of *Corrigan*

In 2009, the Ohio Department of Taxation (Department) issued an assessment to the taxpayer based on Ohio Rev. Code § 5747.212 for unpaid 2004 personal income tax liability arising from the \$27 million capital gain realized on

¹ *Corrigan v. Testa*, Slip Opinion No. 2016-Ohio-2805 located [here](#).

² Ohio Rev. Code § 5747.02(A).

³ Ohio Rev. Code § 5747.01(A).

⁴ Ohio Rev. Code § 5747.05(A)(1).

⁵ Ohio Rev. Code § 5747.20(B)(2)(c).

⁶ See, Ohio Rev. Code § 5720 and Ohio Rev. Code § 5721 for general apportionment and allocation provisions.

⁷ Ohio Rev. Code § 5747.212(B). To be subject to this provision, twenty percent or more of the equity or voting rights of the "closely-held pass-through entity" must have been owned by the nonresident individual, directly or indirectly, at any time during the three-year period ending on the last day of the taxpayer's taxable year.

the sale of the taxpayer's interest in Mansfield.⁸ The taxpayer then paid a portion of this assessment and subsequently filed a refund claim. In the refund claim, the taxpayer challenged the assessment by claiming that Ohio Rev. Code § 5747.212 was unconstitutional under the Due Process Clause and the Commerce Clause of the US Constitution, as well as the Equal Protection Clauses of both the US and Ohio Constitutions.⁹ The Department denied this refund claim and the Ohio Board of Tax Appeals (Board) subsequently affirmed;¹⁰ the taxpayer then appealed the Board's decision to the Ohio Supreme Court.

On May 4, 2016, the Ohio Supreme Court reversed the Board's decision.¹¹ The issue before the Ohio Supreme Court was whether Ohio Rev. Code § 5747.212 satisfied the dormant Commerce Clause and Due Process Clause of the US Constitution, both facially and as applied to the taxpayer. Specifically, the issue before the Ohio Supreme Court was whether Ohio may constitutionally levy an income tax on the capital gain realized as a result of the sale of an interest in a pass-through entity (i.e., the sale of an intangible) of a nonresident of Ohio with a greater than 20 percent interest in the pass-through entity doing business in Ohio. Given that the taxpayer was deemed not unitary with his investment in Mansfield, the Ohio Supreme Court held that the assessment issued on the taxpayer's capital gain violated the Due Process Clause of the US Constitution.¹² As Ohio Rev. Code § 5747.212 did not satisfy the Due Process Clause, the taxpayer's dormant Commerce Clause and Equal Protection Clause arguments were not addressed by the Ohio Supreme Court.¹³

The Ohio Supreme Court observed that this was not a successful facial challenge to Ohio Rev. Code § 5747.212, and that had the taxpayer been involved in a unitary business with the business of Mansfield (i.e., had the taxpayer been actively engaged in Mansfield's business operations), it may have been constitutional under the Due Process Clause for Ohio to tax the capital gain realized by the nonresident on the sale of his equity interest in Mansfield.¹⁴ It should be noted that the Department potentially may petition the US Supreme Court to review the Ohio Supreme Court's decision in *Corrigan*.

Considerations

An Ohio nonresident individual who has paid tax under Ohio Rev. Code § 5747.212 on the sale of an interest in a pass-through entity (including partnerships, S corporations, and limited liability corporations) may want to consider whether a refund opportunity may be available based on the *Corrigan* decision.

Contacts

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⁸ See, *Corrigan v. Testa*, Slip Opinion No. 2016-Ohio-2805, paragraph 10.

⁹ See, *Corrigan v. Testa*, Ohio Board of Tax Appeals, No. 2013-3244, September 24, 2014.

¹⁰ *Id.*

¹¹ See, *Corrigan v. Testa*, Slip Opinion No. 2016-Ohio-2805, paragraph 71.

¹² See, *Corrigan v. Testa*, Slip Opinion No. 2016-Ohio-2805, paragraph 70.

¹³ *Id.*

¹⁴ See, *Corrigan v. Testa*, Slip Opinion No. 2016-Ohio-2805, paragraph 69.