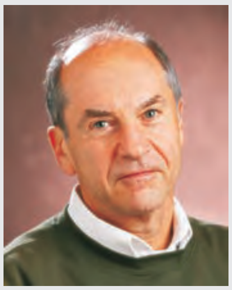
Substance and Form in Jurisdictional Analysis: *Corrigan v. Testa*

by Walter Hellerstein



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In this article, Hellerstein discusses the Ohio Supreme Court's holding in *Corrigan v. Testa*. He says that while there appears to be nothing startling about the court's decision at first blush, beneath the surface is a poorly reasoned and indefensible analysis that flies in the face of constitutional doctrine.

I. Introduction

In *Corrigan v. Testa*,[1] the Ohio Supreme Court held that the due process clause of the 14th Amendment barred Ohio from imposing a personal income tax on the Ohio portion of a capital gain that a nonresident realized on the sale of his interest in a limited liability company.[2] At first blush, there is nothing particularly startling about this conclusion. After all, the due process clause confines the states' power to tax nonresidents' income to income derived from sources within the state.[3] Moreover, when a nonresident realizes gain from the disposition of an interest in a flow-through entity (whether a partnership, an S corporation, or an LLC), the states typically attribute the source of the gain under the rules governing income from the sale of intangibles.[4] These rules generally attribute the source of the gain to the intangibles' deemed "location,"[5] which is usually the owner's domicile,[6] unless the intangibles have a business situs in another state.[7] Thus, in accord with this understanding, tribunals in California, Delaware, and Massachusetts have held that nonresidents are not taxable on gains from the sale of interests in flow-through entities owning property or carrying on activities in the state, because the transactions were sales by nonresidents of intangible interests that had not acquired a business situs in the state.[8]

So why clutter up the pages of *State Tax Notes* with an article about an unexceptional case, especially when one no longer needs another line on one's vita demonstrating to his colleagues that he is tenure-worthy? The answer is that the Ohio General Assembly had explicitly repudiated the conventional understanding of the source of income from disposition of interests in flow-through entities for taxpayers like Patton Corrigan. For the years at issue in *Corrigan*, Ohio law provided:

> 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 gain or loss, realized from the sale, exchange, or other disposition of a debt or equity interest in the entity as prescribed in this section. For

[1] No. 2014-1836, slip op. 2016-Ohio-2805 (May 4, 2016).

[2] A multi-member LLC (like the LLC at issue in *Corrigan*) can elect to be treated either as a C corporation or a partnership for federal income tax purposes. *See* Jamie S. Fenwick, Michael W. McLoughlin, Scott A. Salmon, Patrick H. Smith, Arthur E. Tilley, and Brian W. Wood, *State Taxation of Pass-Through Entities and Their Owners*, para. 1.05 (2016). The LLC in *Corrigan* elected to be treated as a partnership.

[3] *See generally* Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para 20.05[1] (3rd ed. 2016 rev.) [hereinafter cited as Hellerstein, *State Taxation*].

[4] *Id.* para. 20.08[3].

[5] Intangibles have no physical location, a point considered in more detail below; hence the quotation marks around the word "location."

[6] They do so under the traditional doctrine of *mobilia sequuntur personam* ("movables follow the person"). *See generally* Hellerstein, *State Taxation*, *supra* note 3, para 9.03[1] (describing doctrine).

[7] *See id.* paras. 9.03[1], 9.03[2].

[8] *Appeals of Amyas & Ames*, 87-SBE-042, 1987 WL 50165 (Cal. State Bd. of Equaliz. June 17, 1987); *Disabatino v. Director of Revenue*, Nos. 832, 833, Del. Tax Appeals Bd. (Feb. 13, 1987) *available at* www.checkpoint.thomsonreuters.com; *Dupee v. Commissioner of Revenue*, 670 N.E.2d 173 (Mass. 1996); *Cohen v. Commissioner of Revenue*, Nos. 205165, 205166, 206601, 1995 WL 575131 (Mass. App. Tax Bd. Aug. 30, 1995). *See also* Hellerstein, *State Taxation*, *supra* note 3, para. 9.12 (discussing corporate income from sale of a partnership interest).

> such purposes, . . . the investor shall apportion the income using the average of the pass-through entity's apportionment fractions otherwise applicable . . . 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.[9]

Patton Corrigan, a nonresident of Ohio, owned a 79.29 percent interest in Mansfield Plumbing LLC, a producer of sanitary supplies that did business in all 50 states and had its headquarters in Ohio. In 2004, Corrigan sold his interest in Mansfield and realized a capital gain of $27.5 million, which generated an Ohio tax of roughly $675,000 under the above-quoted statute, according to the tax commissioner's assessment. The fundamental — and controversial — question raised by *Corrigan* is *not* whether states generally possess the constitutional power to tax nonresidents on the sale of intangibles with no business situs in the state, which conventional wisdom suggests that they do not. Rather, the fundamental and controversial question raised by *Corrigan* is whether constitutional restraints on state taxation prohibit a state, under specified circumstances, from looking through the form of a transaction and treating it in a manner that corresponds to the state's view of the transaction's economic substance or from providing a particularized sourcing rule for such a transaction. Even assuming that the Ohio Supreme Court's refusal in *Corrigan* to honor the legislature's intent in analyzing the transaction was defensible, which is questionable at best, the court's analysis of the constitutional issues raised by its questionable approach to the statute was fundamentally flawed.

II. Form, Substance, and Source

There is no dispute that Ohio law, in accord with conventional wisdom, generally treats a nonresident's income from the disposition of an interest in a flow-through entity with no business situs in the state as income from the disposition of an intangible attributable to the taxpayer's domicile and, accordingly, income from sources outside the state that lies beyond the state's taxing power.[10] At the same time, there is (or can be) no dispute that Ohio law treats a 20-percent-or-more nonresident flow-through entity owner's income from disposition of an interest in the entity as income from sources within the state based on the flow-through entity's apportionment percentage. There are two ways of describing what the Ohio legislature has done. The first is to say that the legislature looked through the form of the transaction (disposition of an intangible interest in a flow-through entity) and recharacterized it as a disposition of the underlying assets of the entity as determined by the entity's apportionment percentage. The second is to say that the legislature has adopted a specific sourcing rule for particular types of dispositions by substantial owners of interests in flow-through entities. Either way, if one accepts the description of what Ohio has done, its power to tax the gain at issue falls comfortably within a state's authority under a fair reading of existing constitutional norms limiting the exercise of state tax power. The court's holding to the contrary should raise eyebrows throughout a tax community that is familiar with such legislative recharacterizations and with a wide variety of sourcing rules whose constitutional propriety should not be subjected to unwarranted doubt.

A. Form and Substance

The heart of the Ohio Supreme Court's determination lies in the court's unshakable belief that "the activity at issue" in the case "is a transfer of intangible property by a nonresident" and that merely "selling the shares does not involve purposeful availment" of "Ohio's protections and benefits" that is essential to satisfy due process requirements.[11] Wholly apart from the merits of the court's due process analysis, which are addressed below,[12] the initial question is why the court felt bound by the form of the transaction in the face of a legislative directive to treat the transaction as effectively a disposition of the entity's underlying assets.

A short answer could be that the Ohio legislature did not say *explicitly* that the transaction should be treated as an asset sale, but said only that "the investor shall apportion the income using . . . the pass-through entity's apportionment fractions."[13] Such a crabbed view of the force of the statute, however, would ignore the obvious legislative intent and would conflate a wordsmithing issue into a constitutional problem that could be cured by the stroke of a legislative pen. Indeed, if the result of the Ohio decision could be overturned by a statutory amendment stating that the disposition should be "treated as" as an asset sale, there would be much less to the case than meets the eye.

It would appear, however, that the Ohio court's concern goes beyond the failure of the legislature specifically to characterize a more-than-20-percent passthrough owner's disposition of his ownership interest in the entity as a sale of a pro rata share of the entity's assets. The commissioner had argued that the tax on Corrigan should be sustained because (1) the gain from a sale by the LLC of its assets would have been realized at the LLC level; (2) the Ohio-apportioned share of the gain would then have been taxed to Corrigan on

[9] *Corrigan v. Testa*, slip op. at 9 (quoting the statute). The current statute is in substance substantially the same as the statute at issue in the case. *See* Ohio Rev. Code section 5742.212 (2016).

[10] As the court explained, "if [the quoted statute] were not the law, Corrigan would be subject to the ordinary treatment of capital gains derived from intangible property: he would allocate the entire amount of the gain outside Ohio because he was not domiciled in Ohio." *Corrigan v. Testa*, slip op. at 2 (citations omitted).

[11] *Id.* at 13.

[12] *See infra* Part III.

[13] *Corrigan v. Testa*, slip. op. at 9 (quoting the statute).

a pass-through basis; and, accordingly, (3) "because the gain could be taxed to Corrigan in an asset sale, it may also be taxed in the form of Corrigan's individual capital gain."[14] In rejecting this argument, the court declared: "Although this argument may appear plausible, the jurisdictional question before us presents *more than merely a matter of form*."[15] While recognizing that "an asset sale and a sale of ownership interest may be different forms involving the same *economic* substance to the parties,"[16] the court reiterated that this "does not mean that the jurisdictional limits on Ohio's taxing powers lack their own substantive importance."[17] In short, despite its protestation that the jurisdictional question presented "more than a matter of form," the Ohio court determined that it was required to tether its constitutional analysis to the form of the disposition — "a transfer of intangible property by a nonresident"[18] — even though the legislature provided that, in the case of a 20-percent-or-more interest owner, the disposition should be treated effectively as an asset sale.

The Ohio Supreme Court's approach is inconsistent with a series of New York rulings sustaining taxes on dispositions by nonresident taxpayers of intangible interests in entities owning New York real estate under the real property transfer taxes of New York state and New York City. Thus, in *Bredero Vast Goed N.V. v. Tax Commission*,[19] the New York Appellate Division sustained the taxability of the transfer by three Dutch corporations of the stock in a domestic corporation that had an interest in a partnership that owned New York real estate under a statute imposing a tax of 10 percent on gains from "the transfer . . . of any interest in real property . . . including but not limited to . . . a controlling interest in any entity with an interest in real property."[20] As the court declared in sustaining the provision over the foreign corporations' objections that the domestic corporation they sold did not enjoy direct ownership of the property:

> Here, respondent looked beyond the two-tiered nature of the conveyance and determined that petitioners "effectively" transferred an interest in the 342 Madison Avenue building. This construction keys into the economic reality that the partnership's sole asset consisted of the Madison Avenue property, and that the new 85% general partner . . . acquired a controlling interest in the real estate. In our view, respondent's interpretation is entirely rational and we defer to that construction.[21]

The New York Tax Appeals Tribunal likewise sustained the application of the statute to a nonresident trust that transferred its stock in a nonresident corporation with a controlling interest in New York property.[22] The tribunal noted that the taxpayer "rested its whole case on its claim that the Division has asserted the subject taxes on the transfer of . . . stock."[23] Relying on *Bredero*, the tribunal concluded that there was a transfer of real property within the meaning the statute. Moreover, the tribunal went on to observe that it was therefore "proper to analyze the legal issues raised by petitioner" — including, most importantly for present purposes, constitutional issues[24] — "on the premise that there was a transfer of real property in New York because this was the gravamen of the transaction"[25] and "any other approach would ignore the economic reality of the transaction."[26]

Rulings under New York City's real property transfer tax reflect similar respect by judicial and administrative tribunals for statutes providing that disposition of intangible interests in entities owning real property should be treated as the disposition of the underlying real property.[27] The New York City tax applies to the transfers of an "economic interest in real property," which includes the "ownership of shares of stock in a corporation which owns real property; the ownership of an interest or interests in a partnership, association or other unincorporated entity which owns real property; and the ownership of a beneficial interest or interests in a trust which owns real property."[28] Construing the application of the statute to a tiered structure of entities, which included a partnership that owned New York real estate, the court concluded that the "sales of plaintiff's partnership interests were, in essence, the sales of interests in real property situated in New York City, and the economic value of such interests was derived solely from that parcel of realty."[29] Similarly, relying on the foregoing precedents, the New York City Tax Appeals Tribunal sustained the application of the city's real property tax to the transfer of stock in foreign corporations that collectively owned indirect interests in real property located in New York City, observing that "clearly the statute would apply to a transfer of a

[14] *Id.* at 21.

[15] *Id.* at 21 (emphasis added).

[16] *Id.* (emphasis in original).

[17] *Id.*

[18] *Id.* at 13.

[19] 539 N.Y.S.2d 823, 825 (App. Div., 3d Dep't 1989), *appeal dismissed*, 543 N.E.2d 748 (N.Y. 1989).

[20] *Id.* at 825 (quoting the statute). A "controlling interest" meant a 50 percent or more beneficial interest in an entity. Although the tax was repealed in 1996, its provisions on taxable transfers closely resemble those in New York's current real estate transfer tax. N.Y. Tax Law section 1401 et seq. (2016).

[21] *Bredero*, 539 N.Y.S.2d at 825.

[22] *Petition of Cafcor Trust Reg. Vaduz*, Nos. 812682, 812683, 1997 WL 202424 (N.Y. Tax App. Trib. Apr. 17, 1997).

[23] *Id.*, 1997 WL 202424, at *10.

[24] As noted earlier, I consider the court's analysis of the constitutional issues below. *See* Part III.

[25] *Id.*, 1997 WL 202424, at *10.

[26] *Id.*

[27] *See 595 Investors Ltd. Partnership v. Biderman*, 531 N.Y.S.2d 714 (Sup. Ct., N.Y. Cty. 1988); *In re Corwood Enters. Inc.*, TAT(E) 00-39(RP), 2006 WL 1621955 (N.Y.C. Tax App. Trib. June 2, 2006).

[28] *Corwood*, 2006 WL 1621955, at *10 (quoting the statute).

[29] *595 Investors Ltd. Partnership*, 531 N.Y.S.2d at 717.

controlling interest in a partnership that owned real property"[30] and that "'tax legislation should be implemented in a manner that gives effect to the economic substance of a transaction.'"[31]

The Ohio court in *Corrigan* easily could have avoided the constitutional question it confronted by respecting the apparent legislative intent of treating a 20-percent-or-more flow-through entity owner's disposition of an intangible interest in the entity as a disposition of the underlying assets of the entity generating income from sources within the state based on the flow-through entity's apportionment percentage. Indeed, such treatment would have been particularly unproblematic when one considers that Corrigan was no run-of-the-mill 20-percent-or-more interest owner but one who was its "main co-owner"[32] (owning nearly 80 percent of the entity) and its "manager."[33] By confining its constitutional analysis to "the transfer of intangible property by a nonresident," not only does the court fail to focus on the economic substance of the transaction as contemplated by the Ohio legislation, and ignore the interpretation of analogous legislation in the New York decisions, but it also reflects a judicial insensitivity to tax provisions that routinely ignore the form of transactions because of a legislative judgment that their economic substance should govern their treatment for tax purposes.[34]

B. Source

Even if one regards as reasonable the Ohio court's unwillingness to recharacterize a 20-percent-or-more nonresident flow-through entity owner's disposition of an intangible interest in the entity as a disposition of its assets and as generating income from sources within the state based on the entity's apportionment percentage, there was a smoother path to the same result that avoids the inquiry into form versus substance. Moreover, it was one that more accurately reflects the precise language of the Ohio statute. After all, what the Ohio statute said was that a 20-percent-or-more passthrough entity investor that disposes of his interest in the entity "shall apportion the income using the average of the pass-through entity's apportionment fractions."[35] This is a sourcing provision, not a taxing provision, and the fundamental question raised by *Corrigan*, apart from the power to enforce the tax,[36] was whether there was substantive jurisdiction to tax — that is, whether Ohio had power to impose a tax on Corrigan's income.[37] As the Ohio court put it, "the issue in this case is whether Ohio may . . . levy an income tax on Corrigan's capital gain."[38] The answer to that question turns on whether Ohio may reasonably regard the source of the income as being in Ohio, and, as I hope the ensuing discussion demonstrates, the answer is yes.

As indicated at the outset of this article, the states typically attribute the source of gain from the sale of intangibles to the intangibles' deemed "location."[39] Intangible property, however, has no obvious or generally accepted location for tax purposes. This is hardly surprising considering that "intangibles themselves have no real situs."[40] They are "but relationships between persons, natural or corporate, which the law recognizes by attaching to them certain sanctions enforceable in courts."[41] Thus, the location of intangible property for tax purposes has variously been attributed to the owner's legal or commercial domicile,[42] to the intangible's business situs,[43] to the place where the evidence of the intangible rights are physically located,[44] and to the location of those who possess rights or obligations under the intangibles (for example, the issuer of corporate stock[45] or the debtor under a loan[46]). By the same token, income from the disposition of intangibles is potentially subject to a similar array of sourcing rules.

Given the geographically indeterminate "location" of intangible property and the existence of various competing

[30] *Corwood*, 2006 WL 1621955, at *17.

[31] *Id.* (citation omitted).

[32] *Corrigan v. Testa*, slip. op. at 3.

[33] *Id.*

[34] Consider, for example, subpart F of the Internal Revenue Code, IRC section 951 et seq. (treating as a deemed dividend certain undistributed income earned by controlled foreign corporations); the Foreign Investment in Real Property Tax Act, P.L. 96-499, Title XI, section 1122(a), 94 Stat. 2682, Dec. 5, 1980, as amended (codified at IRC section 897) (treating the disposition of a U.S. Real Property Interest, which includes the interest in a U.S. Real Property Holding Corp., thus looking through its form to its underlying assets, "*as if* the taxpayer were engaged in a trade or business within the United States during the taxable year and *as if* such gain or loss were effectively connected with such trade or business" (emphases added)); and IRC section 1258 (recharacterizing gain "which would (but for this section) be treated as the sale or exchange of a capital asset" as "ordinary income").

[35] *Corrigan v. Testa*, slip op. at 9 (quoting the statute).

[36] To be sure, jurisdiction to enforce a tax obligation may be no trivial concern, *see, e.g.*, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (involving power to require vendor to collect use taxes that were legally due), but it is analytically distinct from the question of the power to impose the tax on the subject matter of the exaction — here, income.

[37] I have elaborated on the distinction between substantive jurisdiction and enforcement jurisdiction in Walter Hellerstein, "Jurisdiction to Tax in the New Economy: A Theoretical and Comparative Perspective," 38 *Ga. L. Rev.* 1 (2003). The question whether Ohio had jurisdiction to enforce Corrigan's obligation to pay a tax on income from sources within Ohio is considered below.

[38] *Corrigan v. Testa*, slip op. at 2.

[39] *See supra* note 5 and accompanying text.

[40] *Greenough v. Tax Assessors*, 331 U.S. 486, 493 (1947).

[41] *Curry v. McCanless*, 307 U.S. 357, 366 (1939).

[42] *See, e.g.*, *Cream of Wheat Co. v. County of Grand Forks*, 253 U.S. 325 (1920) (legal domicile); *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936) (commercial domicile).

[43] *See, e.g.*, *Farmer's Loan & Trust Co. v. Minnesota*, 280 U.S. 204 (1903).

[44] *See, e.g.*, *Wheeler v. New York*, 233 U.S. 434 (1914).

[45] *See, e.g.*, *State Tax Comm'n v. Aldrich*, 316 U.S. 174 (1942).

[46] *See, e.g.*, *Blackstone v. Miller*, 188 U.S. 189 (1903).

rules for determining the deemed location of such property and the income it generates, it would be difficult as a matter of principle to maintain that the due process clause prescribes a single location (or theory of location) to which intangibles and the income they generate must be assigned. Indeed, it is bedrock constitutional doctrine that the due process clause *does not* prescribe such a rule. As the U.S. Supreme Court famously declared in *Curry v. McCanless*[47]:

> In cases where the owner of intangibles confines his activity to the place of his domicile it has been found convenient to substitute a rule for a reason by saying that his intangibles are taxed at their situs and not elsewhere, or, perhaps less artificially, by invoking the maxim *mobilia sequuntur personam*, which means only that it is the identity or association of intangibles with the person of their owner at his domicile which gives jurisdiction to tax. But when the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state, in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains, and the rule is not even a workable substitute for the reasons which may exist in any particular case to support the constitutional power of each state concerned to tax. Whether we regard the right of a state to tax as founded on power over the object taxed, . . . through dominion over tangibles or over persons whose relationships are the source of intangible rights; or on the benefit and protection conferred by the taxing sovereignty, or both, it is undeniable that the state of domicile is not deprived, by the taxpayer's activities elsewhere, of its constitutional jurisdiction to tax, and consequently that there are many circumstances in which more than one state may have jurisdiction to impose a tax and measure it by some or all of the taxpayer's intangibles. Shares of corporate stock may be taxed at the domicile of the shareholder and also at that of the corporation which the taxing state has created and controls; and income may be taxed both by the state where it is earned and by the state of the recipient's domicile. Protection, benefit, and power over the subject matter are not confined to either state. The taxpayer who is domiciled in one state but carries on business in another is subject to a tax there measured by the value of the intangibles used in his business.[48]

Moreover, although the traditional jurisdictional bases for attributing income to a state, including income from intangibles, are residence and source,[49] it is important to recognize that the U.S. Supreme Court, in interpreting due process (and commerce) clause[50] restraints on state jurisdiction to tax income, has taken a broad view of the states' source-based taxing jurisdiction. In particular, by tying the states' taxing power to "benefits" and "protection" afforded, the Court has eschewed a narrow conception of source as a limitation on the states' power to tax nonresidents' income. Thus, in *Wisconsin v. J.C. Penney Co.*,[51] which sustained a state's power to impose a tax on a foreign corporation for the privilege of declaring dividends on income earned within the state, the Court declared:

> A State is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the State has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.[52]

In an even more sweeping oversimplification of the matter, the Court continued that "the simple but controlling question is whether the State has given anything for which it can ask return."[53] Such generalizations do not, of course, resolve concrete cases, but they indicate the Court's relaxed view of a state's power to assert its power to tax on the basis of source.

This brings us to what should have been the dispositive question in *Corrigan*, namely, whether the Ohio legislature exceeded constitutional bounds on its power to define the source of income by providing that the source of a 20-percent-or-more flow-through entity owner's income from the disposition of an interest in the entity should be determined by the entity's apportionment percentage. Based on constitutional principles described above and on the adoption of sourcing rules in other contexts that look to the assets or activities underlying intangible interests in determining the source of the gain from their disposition,[54] Ohio's sourcing provision lay well within its constitutional prerogative. Indeed, whatever one may say in general about the state's power to determine the source of the gain from a passthrough entity-owner's disposition of his intangible ownership interest in the entity based on the entity's activities, there can be no serious question as to the constitutionality of that approach with regard to a 79.29 percent owner

[47]307 U.S. 357 (1939).
[48]*Id.* at 367-368 (citations omitted).
[49]*See* Hellerstein, *State Taxation*, *supra* note 3, para. 6.04.

[50]It may be worth noting that the *Corrigan* court's analysis was based entirely on the due process clause, and the court explicitly observed that this "obviates the need for any separate analysis under the Commerce Clause." *Corrigan v. Testa*, slip op. at 6.
[51]311 U.S. 435 (1940).
[52]*Id.* at 444.
[53]*Id.*
[54]*See, e.g.*, IRC section 865(f) (sale of foreign affiliate by U.S. resident, which normally is U.S.-source income based on the residence of the seller, is foreign-source income if the sale occurs in a foreign country where the affiliate is engaged in the active conduct of a trade or business and more than 50 percent of its income over the past three years was incurred in such foreign country).

like Corrigan.[55] To suggest, as the Ohio court effectively held, that only the state of Corrigan's domicile provided him with the "protection and benefit" that contributed to the $27.5 million in capital appreciation of Mansfield Plumbing — a company that did business in all 50 states — is "to substitute a rule for a reason."[56] In short, the Ohio court could easily have disposed of the controversy in *Corrigan* by sourcing Corrigan's gain on the basis of the LLC's Ohio apportionment percentage, in which case Ohio's tax would properly be imposed on a nonresident's income from sources within the state.

C. Enforcement Jurisdiction

The foregoing discussion strongly suggests that Ohio had substantive jurisdiction[57] to tax a share of Corrigan's gain from the sale of his interest in his LLC. The conclusion follows from the undisputed principle that Ohio has the right to tax the income of a nonresident from sources within the state and the view that Ohio may reasonably attribute a portion of Corrigan's gain to Ohio either by looking through the form of the transaction and recharacterizing it as a disposition of the underlying assets or by adopting a specific sourcing rule for particular types of dispositions by substantial owners of interests in flow-through entities. The question then becomes whether Ohio has power to effectively compel collection of the tax over which it has substantive jurisdiction.[58]

Although there can be challenging issues of jurisdiction to enforce income tax obligations incurred by nonresidents who earn income from sources within the state,[59] Corrigan's case does not appear to be one of them. States almost invariably treat nonresident partners (both general and limited) as well as owners of interests in other flow-through entities (including S corporation shareholders and members of LLCs that elect partnership status[60]) as having nexus in the states in which their flow-through entities have nexus on the basis of the aggregate theory of partnership.[61] Further, courts and administrative tribunals have almost invariably rebuffed constitutional objections to the assertion of nexus over the nonresident passthrough interest owner on this basis.[62]

As the Ohio Supreme Court declared in *Agley v. Tracy*,[63] rebuffing due process objections to the assertion of jurisdiction to tax nonresident S corporation shareholders on their S corporation income:

> 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.[64]

The Ohio court's holding in *Agley* establishes the state's jurisdiction to tax Corrigan. Because the LLC conducted business in Ohio during the year that Corrigan sold his interest in the LLC, Corrigan availed himself "of Ohio's benefits, protections, and opportunities by earning income in Ohio" through his LLC, and this provides Ohio with the minimum contacts needed to justify taxing Corrigan on his distributive share of the LLC's income as well as (presumably) on the income he earned from disposition of the interest.[65]

III. The *Corrigan* Court's Flawed Constitutional Analysis

The Ohio Supreme Court in *Corrigan* never seriously considered either the recharacterization or the sourcing issues considered in Part II because its wooden approach to

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[55]In this connection, it is worth observing that the court's "holding of unconstitutionality is limited . . . *as applied to Corrigan.*" *Corrigan v. Testa*, slip op. at 6 (emphasis added).

[56]*Curry v. McCanless*, 307 U.S. 357, 366 (1939).

[57]*See supra* notes 36-38 and accompanying text.

[58]*See generally* Hellerstein, *supra* note 37 (exploring in detail the relationship between substantive jurisdiction and enforcement jurisdiction).

[59]*Id.*

[60]As noted at the outset, the LLC in *Corrigan* elected to be treated as a partnership.

[61]*See* Hellerstein, *State Taxation*, *supra* note 3, para. 20.08. The theory underlying the states' power to tax nonresident partners is that a partnership is an aggregation of individual partners rather than an entity separate and distinct from their owners, as in the case of corporations. Hence, nonresident partners are viewed as directly participating through the partnership in the business carried on in the state and owning a share of the partnership's assets located there. States also (or alternatively) have relied on the theory that partners who actually conduct the business of the partnership within the taxing state act as agents for the nonresident partners. *Id.* para. 20.08[a][i].

[62]*Id.*

[63]719 N.E.2d 951 (Ohio 1999).

[64]*Id.* at 953. Indeed, the Ohio court in *Corrigan* quotes this passage. *Corrigan v. Testa*, slip op. at 12.

[65]Any suggestion that Corrigan's nexus with Ohio for personal income tax purposes during the year at issue should somehow be confined to his distributive share of the LLC's income and not to any income earned on disposition of the LLC seems weak at best. Even if one accepts the principle that, in some instances, nexus with a state can be compartmentalized because the in-state presence is unrelated to the tax obligation in question, *see* Hellerstein, *State Taxation*, *supra* note 3, para. 19.02[3][b], the position that Corrigan's nexus in Ohio for purposes of his distributive share in the LLC is "dissociated" from his gain from disposition of the LLC (*see Norton Co. v. Department of Revenue*, 340 U.S. 534, 537 (1951)), thereby depriving Ohio of nexus over Corrigan with respect to such gain, is not a case I would take on contingency.

the case drew a line in the sand between Corrigan's "personal capital gain"[66] from the "sale of the corporate ownership,"[67] on the one hand, and the underlying assets or activities of the business, on the other. The court therefore was of the mind that the latter could not properly inform an inquiry into the former, "in the absence of any assertion or finding that Corrigan's own activities amounted to a unitary business with that of Mansfield Plumbing."[68] Accordingly, the court's approach to the constitutional issues in the case proceeded on the assumption that Corrigan and the LLC existed essentially in separate "silos." Even on that assumption, however, the court's constitutional analysis is open to serious question, as the ensuing discussion reveals.

A. *International Harvester* and *J.C. Penney*

The Ohio Supreme Court's constitutional analysis focused on the question whether, in the absence of a unitary relationship between Corrigan and his LLC, one could properly consider the LLC's underlying activity in determining Corrigan's income that was properly subject to tax by Ohio. In addressing this question, the court first considered the U.S. Supreme Court's decisions in *International Harvester v. Wisconsin Department of Revenue*[69] and *Wisconsin v. J.C. Penney Co.*[70] In *International Harvester*, the U.S. Supreme Court sustained the constitutionality of a withholding regime as applied to Wisconsin-source dividends paid to nonresident shareholders over whom the state had no personal jurisdiction. Wisconsin had imposed a tax "for the privilege of declaring and receiving dividends, out of income derived from property located and business transacted in this state."[71] The tax was measured by the proportion of the corporation's dividends attributable to Wisconsin, determined by applying the corporation's income tax apportionment percentage to the dividends. The dividend payers were required to deduct the tax from the dividends payable to both resident and nonresident shareholders. Because of this withholding provision, the Court had previously sustained the levy in *J.C. Penney* on the ground that "the practical operation of the tax is to impose an additional tax on corporate earnings within Wisconsin, but to postpone the liability for payment of the tax until such earnings are paid out in dividends."[72] The Wisconsin courts, however, subsequently construed the state taxing statute as imposing the levy on the shareholders. In *International Harvester*, the Court revisited the constitutional questions raised by the tax on the assumption

> that the statute, by directing deduction of the tax from declared dividends, distributes the tax burden among the stockholders differently than if the corporation had merely paid the tax from its treasury and *that the tax is thus in point of substance, laid upon and paid by the stockholders*.[73]

International Harvester challenged the statute on the ground that it violated the due process clause by taxing (1) the act of declaring dividends and (2) the act of receiving dividends, both of which activities occurred outside Wisconsin (International Harvester declared its dividends in Chicago, and 98 percent of its shareholders were nonresidents of Wisconsin). The Court rejected this claim and sustained the tax in broad terms:

> The power to tax the corporation's earnings includes the power to postpone the tax until the distribution of those earnings, and to measure it by the amounts distributed. In taxing such distributions, Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal presence within the state of the stockholders-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. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers. And the privilege of receiving dividends derived from corporate activities within the state can have no greater immunity than the privilege of receiving any other income from sources located there.[74]

Wisconsin had plainly afforded "protection and benefits to appellants' corporate activities and transactions within the state."[75] Accordingly, Wisconsin was entitled to tax the dividends because "these activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities."[76] Finally, as long as the earnings actually arose in the state, the fact that "some practically effective device [may] be necessary in order to enable the

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[66]*Corrigan v. Testa*, slip op. at 21.
[67]*Id.* at 22.
[68]*Id.*
[69]322 U.S. 345 (1944).
[70]311 U.S. 435 (1940). The ensuing description of these cases draws freely from their description in Hellerstein, *State Taxation*, *supra* note 3, para. 6.04[2][a].
[71]Wis. Stat. section 71.60 (1941), quoted in *International Harvester*, 322 U.S. at 446 (Jackson, J., dissenting).
[72]*J.C. Penney*, 311 U.S. at 442.
[73]*International Harvester*, 322 U.S. at 440 (emphasis added).
[74]*Id.* at 441-442 (citations omitted).
[75]*Id.* at 442.
[76]*Id.*

state to collect the tax — here by imposing on the corporation the duty to withhold"[77] — did not deprive the state of power to impose the levy on the nonresident shareholder.[78]

In *Corrigan*, the tax commissioner relied on *International Harvester* and *J.C. Penney* as authority for Ohio's power to tax Corrigan on the Ohio-sourced share of his capital gain from his sale of his LLC. The Ohio Supreme Court rejected the commissioner's reliance for several reasons, none of which withstands analysis. The court declared:

> First and foremost, *J.C. Penney* and *Internatl. Harvester* address a tax law that, unlike [the Ohio statute], *never imposes tax liability on the investor*. To be sure, in upholding the tax, the high court accepted the proposition that the economic burden of Wisconsin's privilege dividend tax fell upon nonresident investors, even though it was actually paid by the corporation that declared and paid the dividend. But 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. The Wisconsin statute at issue did not do so, and the decisions upholding that statute should not be construed to authorize other statutes that were not under review by the high court at that time.[79]

The Ohio court simply misreads and misunderstands *International Harvester*. As noted above, the Court in *International Harvester* analyzed the constitutional questions raised by the tax on the assumption

> that the statute, by directing deduction of the tax from declared dividends, distributes the tax burden among the stockholders differently than if the corporation had merely paid the tax from its treasury and *that the tax is thus in point of substance, laid upon and paid by the stockholders*.[80]

Thus, the Ohio court's statement that the Wisconsin tax "*never imposes tax liability on the investor*" is plain error. Indeed, one simply has to wonder whether the justices on the Ohio Supreme Court or their law clerks ever read the passage quoted above from *International Harvester* and, in particular, the observation that "*a state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.*"[81]

Indeed, the Ohio court seems to have profoundly confused the distinction between substantive jurisdiction and enforcement jurisdiction. Wisconsin's substantive jurisdiction *to tax* the nonresident's income did not, of course, provide it, *ipso facto*, with personal jurisdiction over the nonresident that would have enabled Wisconsin to enforce the levy directly against the nonresident. Instead, as the U.S. Supreme Court observed in *International Harvester*, "some practically effective device [may] be necessary in order to enable the state to collect the tax — here by imposing on the corporation the duty to withhold"[82] — over which it had unquestioned substantive jurisdiction, because the income arose from sources within the state. As we have observed above, however, there appears to be no issue of enforcement jurisdiction with respect to the taxation of Corrigan's gain.[83]

The Ohio Supreme Court offered another basis for distinguishing *International Harvester* and *J.C. Penney*:

> Second, even if *J.C. Penney* and *Internatl. Harvester* were construed to extend to the imposition of a state income tax on the nonresident *recipient of a dividend*, that would still not require the conclusion that the same reasoning extends to a capital gain from the sale of corporate ownership. 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.[84]

[77] *Id.* at 444.

[78] The Court's sweeping affirmation of Wisconsin's power to impose a tax on dividends earned from sources within the state by nonresident shareholders over whom the state lacks personal jurisdiction and to enforce the tax through a withholding mechanism imposed on the jurisdictionally present corporate payer thus puts to rest any constitutional doubts about the states' power to adopt tax regimes analogous to the federal regime applied to U.S.-source interest, dividends, rents, annuities, and "other fixed or determinable annual or periodical gains, profits, and income" earned by nonresident alien individuals or by foreign corporations, when such income is not effectively connected with a U.S. trade or business. *See* IRC sections 871, 881, 1441, and 1442. *See also Borden Chems. & Plastics LP v. Zehnder*, 726 N.E.2d 73, 78 (Ill. App., 1st Dist. 2000) (reaffirming *International Harvester*'s declaration that "personal 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"). The enforcement issues raised by *International Harvester* are considered further in Walter Hellerstein, "State Taxation of Corporate Income From Intangibles: *Allied-Signal* and Beyond," 48 *Tax. L. Rev.* 739, 824-826 n.446 (1993).

[79] *Corrigan v. Testa*, slip op. at 15-16 (emphases in original).

[80] *International Harvester*, 322 U.S. at 440 (emphasis added).

[81] *Id.* at 441-442 (emphasis added).

[82] *Id.* at 444.

[83] *See supra* Part II(C).

[84] *Corrigan v. Testa*, slip. op. at 16 (emphasis in original).

Even if a dividend has a "more direct relationship to corporate earnings" than a "capital gain from the sale of corporate ownership," this does not speak to the *constitutional* question in *Corrigan*, namely, whether a state may tax a nonresident's income (here in the form of capital gain) that is apportioned to the state on the basis of the underlying activities of the entity whose sale generated the gain. For all of the reasons advanced above, the answer to that question is yes.

B. *MeadWestvaco* and 'Investee' Apportionment

The Ohio Supreme Court offered a third and final reason for dismissing the commissioner's reliance on *International Harvester* and *J.C. Penney*, namely, that its "reluctance to accept the tax commissioner's . . . interpretation of *J.C. Penney* and *Internatl. Harvester* is consistent with *MeadWestvaco*."[85] In *MeadWestvaco Corp. v. Illinois Department of Revenue*,[86] the U.S. Supreme Court considered the question whether Mead Corp.'s disposition of its LexisNexis division gave rise to apportionable income under the unitary business principle.[87] The narrow holding in *MeadWestvaco* was that in determining whether two businesses are engaged in a unitary enterprise, one does not undertake an additional inquiry into the "enterprise unity" question under the "operational function" criterion of apportionability, or what I have called the "asset unity" test.[88]

The Ohio Supreme Court's "reluctance" to follow the commissioner's interpretation of *International Harvester* and *J.C. Penney* on the basis of *MeadWestvaco* was based, as the court recognized, on a "question that the high court declined to address"[89]:

> 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." (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. 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 *Internatl. Harvester*.[90]

The Ohio Supreme Court's reading of *MeadWestvaco* as a basis for refusing to consider the "investee apportionment" theory in support of Ohio's power to tax the portion of Corrigan's capital gain sourced to Ohio by the LLC's apportionment factors while perhaps more defensible than its misreading of *International Harvester* is nonetheless misguided. As I have explained at length elsewhere,[91] and, indeed, as the preceding discussion reveals, the basic "investee apportionment" theory rests on a solid constitutional foundation. Although constraints of time and space — not to mention readers' patience — prevent me from repeating that explanation here, a brief summary of its essential points is nevertheless in order.

First, as indicated in the preceding discussion, there can be no serious constitutional objection to attributing income from intangible assets (or their disposition) "based on the taxing State's contact with the capital asset rather than the taxpayer."[92] If a state has "contact" with an intangible "capital asset," there is no constitutional principle of which I am aware that, as a general matter, would preclude a state from taxing the income derived from the asset (or its disposition). Indeed, as explained at length above, the basic due process principle provides an indisputable basis for a state to exercise its taxing power over intangible property with which the state has some minimum connection or contact. The U.S. Supreme Court recognized these principles in *MeadWestvaco*.

The problem, of course (and it is one to which the preceding discussion has also alluded), is that determining the state or states that have contact with intangibles — and therefore have a constitutional basis for taxing the income they produce — is much more challenging than determining the state or states that have contact with tangible assets. This suggests that the inquiry into the *implementation* of a taxing regime that attributes income from intangibles by reference to the asset's connection to the state rather than the owner's connection must proceed with care. It does not suggest, however, that there can be any fundamental quarrel with the constitutional underpinnings of such a taxing regime.

The U.S. Supreme Court in *MeadWestvaco* seemed to appreciate this point. Despite its characterization of the constitutional grounding of the theory as "new" and its

[85] *Id.*

[86] 553 U.S. 16 (2008).

[87] *MeadWestvaco* is considered in detail in Hellerstein, *State Taxation*, *supra* note 3, para. 8.08[f] and in Walter Hellerstein, "*MeadWestvaco* and the Scope of the Unitary Business Principle," 108 *J. Tax'n* 261 (2008).

[88] I elaborate on these concepts in Hellerstein, *State Taxation*, *supra* note 3, para. 8.07[2].

[89] *Corrigan v. Testa*, slip. op. at 17.

[90] *Id.* (citations and footnote omitted).

[91] *See* Hellerstein, *supra* note 78; *see also* Hellerstein, *State Taxation*, *supra* note 3, para. 9.11[2][a]. The Court in *MeadWestvaco* cites both of these references. *See also* Hellerstein, *supra* note 87.

[92] *MeadWestvaco*, 553 U.S. at 30.

suggestion that the constitutionality of a regime based on such a ground might be in play because neither New York nor Ohio was on notice that the constitutionality of its tax scheme was at issue, the Court, in refusing to address this alternative theory in the case before it, nevertheless appeared to recognize that there were plausible means of implementing the theory. Thus, the Court observed that "if a constitutionally sufficient link between the State and the value it wishes to tax is founded upon the State's contacts with Lexis rather than Mead, then presumably the apportioned tax base should be determined by applying the State's . . . apportionment formula not to Mead, but to Lexis."[93]

Finally, litigation over the constitutionality of this approach to taxing income from intangibles suggests that it is a regime that can be defended on constitutional grounds without fear of embarrassment. As the Court itself noted, New York is one of the states that had long embraced a tax regime that looks to the activities of the investee, rather than the investor, as the basis for taxing intangible investment income such as dividends, interest, and capital gains.[94] The former New York franchise tax law was based on the concept that stock and the income it produces should be attributed to the state in which the corporation whose stock is held conducts its business. Dividends on stocks of nonsubsidiary corporations (New York did not tax dividends paid by subsidiaries), as well as other "investment income," were attributed to New York by reference to the payer corporation's apportionment percentage.

In *Allied-Signal Inc. v. Commissioner of Finance*[95] (*Allied-Signal I*), the New York Court of Appeals (the state's highest court) held that New York City (whose tax regime was similar to the state's) could tax an apportioned share of the capital gain that Bendix Corp. derived from the sale of its investment in ASARCO Inc. This was the very same capital gain that the U.S. Supreme Court subsequently held was beyond New Jersey's constitutional reach in the U.S. Supreme Court's decision in *Allied-Signal Inc. v. Director, Division of Taxation*[96] (*Allied-Signal II*). The New York Court of Appeals so held, despite a stipulation that Bendix was not engaged in a unitary business with ASARCO, as the U.S. Supreme Court ultimately concluded in *Allied-Signal II*. The appeals court declared:

> In determining whether a sufficient nexus exists between a taxing jurisdiction and the income it seeks to tax, the Supreme Court has emphasized that the inquiry should focus upon whether "the taxing power exerted . . . bears fiscal relation to protection, opportunities and benefits given by the state. The simple question is whether the state has given anything for which it can ask return." Here it is undisputed that New York City has afforded privileges and opportunities to ASARCO. That these privileges and opportunities have contributed to ASARCO's capital appreciation and thus also inured to the benefit of all of its shareholders, including Bendix, is also beyond question. Thus we agree with the City that it has given Bendix something "for which it can ask return," and that consequently a sufficient nexus existed to support the City's tax.[97]

After the U.S. Supreme Court handed down its decision in *Allied-Signal II*, Allied-Signal again challenged the application of the New York tax to its gain from the sale of its ASARCO stock — this time under the state rather than the city tax — on the ground that *Allied-Signal I* could not be reconciled with *Allied-Signal II*. The New York Appellate Division rejected the argument, essentially on the ground that the theory underlying the taxes in the two cases and ample authority supported the New York approach.[98] In short, contrary to the Ohio court's suggestion that "an investee-apportioned tax on the gain realized by an investor is an unsettled question,"[99] the investee-apportionment rests on solid constitutional grounds.[100]

IV. Conclusion

The Ohio Supreme Court's decision in *Corrigan v. Testa* reflects the conventional wisdom that nonresidents are not taxable on gains from the sale of interests in flow-through entities owning property or carrying on activities in the state, because the transactions constitute sales of intangibles without a business situs in the state. If one scratches beneath the surface of the decision, however, and examines the opinion that purportedly supports it, one finds a formalistic, poorly reasoned, and indefensible analysis that flies in the face of established constitutional doctrine. One can only hope that other courts will recognize *Corrigan* for the rogue opinion that it is. Indeed, the Ohio Supreme Court's decision in *Corrigan* has created a conflict with the decision of the New York Court of Appeals in *Allied-Signal I*,[101] rendering *Corrigan* an appropriate case for U.S. Supreme Court review.[102] ■

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[93] *Id.* at 32 n.4.

[94] Effective 2015, New York substantially overhauled its corporate income tax regime and eliminated the provisions that apportioned capital gains and other income from intangibles by reference to the state in which the "investee" corporation conducted its business.

[95] 588 N.E.2d 731 (N.Y. 1991).

[96] 504 U.S. 768 (1992).

[97] *Allied-Signal I*, 588 N.E.2d at 736-37.

[98] *In re Allied-Signal Inc.*, 645 N.Y.S.2d 895 (App. Div., 3d Dep't 1996), *appeal denied*, 675 N.E.2d 1234 (N.Y. 1996).

[99] *Corrigan v. Testa*, slip. op. at 17.

[100] Perhaps unsurprisingly, but also tellingly, the Ohio Supreme Court found one of the *dissenting* opinions in the New York Court of Appeals decision in *Allied-Signal I* "more persuasive." *Corrigan v. Testa*, slip. op. at 20.

[101] *See supra* notes 95-97 and accompanying text and, especially, *supra* note 100.

[102] *See* Rules of the Supreme Court of the United States, Rule 10(b) (Considerations Governing Review on Certiorari): "A state court of last resort has decided an important question of federal law in a way that conflicts with the decision of another state court of last resort."