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In this installment of Noonan's Notes, Noonan and Caito examine state trends regarding attempts to tax nonresidents on gains from the sale of intangible assets and on other types of intangible income and the litigation that those trends are generating.

Regular readers of this column (all seven of them) should be pretty comfortable with the basic framework that states use to tax residents and nonresidents. Residents, for example, pay tax on only one thing: *everything*. Nonresidents, on the other hand, pay tax only on income that is "sourced" to or earned in the state. Typical examples of sourced income include wage compensation, business income, gain from the sale of real property, and so forth. And typical examples of "unsourced" income include investment income from interest and dividends, capital gains from the disposition of stock or other securities, carried-interest income, and other so-called intangible income.

So, nonresident taxpayers could face different treatment, for example, when selling a business: If the transaction is an asset sale, generally that would result in sourced income in the states where the company does business; if the transaction is a "stock sale," states usually can't tax nonresidents on the gain from the sale.

But there are some troubling trends afoot. States are becoming more aggressive in their attempts to tax nonresidents on gains from the sale of intangible assets and on other types of intangible income. And those efforts are starting to generate litigation. In this article, we'll look at some recent cases and see how these trends are developing.

Massachusetts: The *Welch* Case

In *Welch*,[1] the issue centered on how to tax a nonresident on the sale of stock in a company he founded. The taxpayer started a Massachusetts-headquartered company in 2003, and after multiple rounds of funding, he was ultimately left with an ownership interest of 11.86 percent.[2] He considered himself the "chief evangelist" of the company, was an employee, and held numerous responsibilities and positions at times, including CEO, president, vice president, and treasurer.[3] In June 2015, after he had moved out of the state, he sold his $4 million worth of shares and exited the company.[4]

The gain from this sale would normally be off-limits to Massachusetts, as Welch was a nonresident, he sold stock (an intangible), and Massachusetts generally does not tax nonresidents

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[1] *Welch v. Commissioner*, Dkt. No. C339531 (Mass. App. Ct. 2023).

[2] *Id.*

[3] *Id.*

[4] *Id.*

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on gains from the sale of intangibles.[5] Yet the Massachusetts Appellate Tax Board found Welch's gain to be Massachusetts taxable income, as even though a nonresident's gain from the sale of stock in the normal course is generally not taxable, Massachusetts nonetheless has an expansive definition of source income, including "income derived from or effectively connected with . . . any trade or business, including any employment carried on by the taxpayer in" Massachusetts.[6] And the definition of gross income derived from or effectively connected with any trade or business includes "'gain from the sale of a business *or of an interest in a business*.'"[7] The board went on to say:

> While [a] regulation states that this rule "generally does not apply . . . to the sale of shares of stock in a C or S corporation, to the extent that the income from such gain is characterized for federal income tax purposes as capital gains," it makes clear that "[s]uch gain may . . . give rise to Massachusetts source income if, for example, the gain is otherwise connected with the taxpayer's conduct of a trade or business, including employment (*as in a case where the stock is related to the taxpayer's compensation for services*)."[8]

So, as the board identified, while a nonresident's gain from the sale of stock is normally off limits, Massachusetts can tax it if the gain resulted from his engagement in a trade or business or his employment in Massachusetts.[9] In reaching this conclusion, the board mentioned the range of responsibilities Welch performed as an employee at the Massachusetts company, including that he worked mostly in Massachusetts and was a resident of Massachusetts from the company's founding until a couple of months before the gain occurred, and that he engaged in his employment with continuity and regularity:

> [Welch] was a founder of [the company] and dedicated himself to its success, and he expected all his hard work would culminate with a payout at some point in the future. This was not a passive venture . . . but one to which he exclusively devoted his life . . . and to which he made crucial contributions that added to, and were critical to, the company's value. His payout — the stock gain — *was of a compensatory nature* that "result[ed] from, [was] earned by, [was] credited to . . . or otherwise attributable to" his employment and thus the gain here derived from and was effectively connected with the trade or business of employment carried on by Mr. Welch in [Massachusetts].[10]

But does this conclusion check out? The board stated that the gain was "of a compensatory nature,"[11] and to overcome the general rule that nonresidents aren't taxed on gain from the sale of stock in the normal course, the board needed this fact. It had to be able to basically treat the gain as if it were compensation for services. Perhaps on the surface, this conclusion might make sense: Welch worked hard at the company over the years, that work made his stock more valuable, and he did all that work in Massachusetts. But was the stock itself actually given to him as compensation for services? Definitely not; he founded the company and would have received the stock upon its formation as part of his investment of capital, not for his services.

Interestingly enough, a question like this popped up in a New York case about 20 years ago. In *Matter of Nielsen*, an administrative law judge held that income from a nonresident taxpayer's gain from the sale of his shares of stock *was* New York-source income and subject to New York tax.[12] Central to the conclusion was that the income was compensatory in nature, because while the gain derived from an intangible and resulted in capital

[5] 830 Mass. Code Regs. section 62.5A.1(1)(a) (In Massachusetts, gains of a nonresident "from the sale or exchange of intangibles that are not derived from or effectively connected with the carrying on of a trade or business" are excluded from taxation).

[6] *Welch*, Dkt. No. C339531 (quoting Mass. Gen. Laws ch. 62, section 5A).

[7] *Id.* (emphasis added).

[8] *Id.* (emphasis added) (quoting 830 Mass. Code Regs. section 62.5A.1(3)(c)(8)).

[9] *Id.*

[10] *Id.* (emphasis added) (quoting Mass. Gen. Laws ch. 62, section 5A).

[11] *Id.*

[12] *Matter of Nielsen*, DTA No. 818817 (N.Y. Div. Tax App. 2004).

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gains (as opposed to ordinary income), the taxpayer was only able to acquire the shares — for less than their market value — *in exchange for the performance of services*.[13] The ALJ explained that "an employee's payment of less than fair market value in exchange for property received from his employer gives rise to the receipt of compensation income by the employee required to be recognized and subjected to tax"[14] and that "[b]ut for petitioner's prior, ongoing and future active service (i.e., employment) . . . he could neither have acquired his stock in the first instance, nor continued to own such stock or receive the benefits resulting therefrom."[15]

So, while the stock was given to the taxpayer in *Nielsen* directly in exchange for services,[16] the board's reasoning in *Welch* falls short in this regard and does not clearly articulate how the taxpayer's stock gain was in exchange for services.[17] Yes, Welch worked diligently to grow his company's value over the years, but that's not enough under the Massachusetts regulation. Instead, under the regulation, the gain must actually be "related to the taxpayer's compensation for services."[18] That language seemingly refers to something like we saw in *Nielsen*, where stock was given to the taxpayer actually *in exchange for* services.[19]

But here, Welch's stock was never part of his compensation package; he founded the company and held the shares since the early years of its inception.[20] To say that the creation of value in the company that Welch worked toward is "related to the taxpayer's compensation for services" is too surface level of an analysis to hold water. This same rationale could apply to any employee who owned their employer's stock, regardless of whether it was received as part of a compensation package: If the employee did good work and the stock price went up, you could always conclude that the gain was "related to the taxpayer's services." But that's not the test; Massachusetts makes clear that a nonresident's gain from the sale of stock is not taxed and is not connected with a trade or business unless it is related to the taxpayer's *compensation for services*.[21] And in Welch's case, the stock itself was not related to his compensation for services; it was reflective of his founding and ownership of an interest in the company[22] — an interest of an intangible nature that states usually won't tax if the taxpayer is a nonresident.

We'll have to see how the case plays out. It is still under appeal, so the story isn't over yet.

Ohio: The *Rayant* Case

A similar result recently played out in Ohio. The Ohio tax commissioner issued a final determination in March 2024 denying Garry Rayant and Kathy Fields's $719,492 refund application filed with their amended 2018 Ohio tax return.[23] The taxpayers sold 25 percent of their interest in Rodan & Fields, a skincare products company, and originally apportioned their resulting capital gain income to Ohio under Ohio Rev. Code Ann. section 5747.212, which according to the tax commissioner "requires a taxpayer to apportion income from the sale of [their] equity interest, using the entity's apportionment ratio, if the taxpayer owns at least 20 percent of the entity at any time during the three-year period ending on the last day of the taxpayer's taxable year."[24]

But in seeking a refund of the tax paid, the taxpayers argued that section 5747.212 was unconstitutional, and they contended that they should have instead allocated the income to California as nonbusiness income under section 5747.20.[25] In doing so, they relied on *Corrigan*, where the Ohio Supreme Court determined that section 5747.212 violates the due process clause of the 14th Amendment to the U.S. Constitution, at

[13] *Id.*

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

[15] *Id.*

[16] *Id.*

[17] *Welch*, Dkt. No. C339531.

[18] *Id.* (quoting 830 Mass. Code Regs. section 62.5A.1(3)(c)(8)).

[19] *Nielsen*, DTA No. 818817.

[20] *Welch*, Dkt. No. C339531.

[21] 830 Mass. Code Regs. section 62.5A.1(3)(c)(8).

[22] *Welch*, Dkt. No. C339531.

[23] *Rayant v. Harris, Tax Commissioner of Ohio*, Appeal No. 2024-477 (Final Determination Letter Mar. 28, 2024).

[24] *Id.*

[25] *Id.*; Ohio Rev. Code Ann. section 5747.20.

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least as applied to the taxpayer in that case.[26] The court cited the "bedrock principle" of the due process clause, which is that "a State may not tax value earned outside its borders," and found that Ohio's assessment of tax could not "be sustained under the basic due-process test for the exercise of proper tax jurisdiction."[27]

In *Rayant*, however, the Ohio tax commissioner was not persuaded, initially stating that "the Tax Commissioner lacks jurisdiction to determine a statute's constitutionality," that "legislative enactments of the Ohio General Assembly are entitled to a strong presumption of constitutionality," and that the "Ohio Supreme Court . . . adheres to the presumption the Tax Commissioner's application of state tax laws is constitutional."[28] Then, the commissioner explained that while section 5747.212 was found to be unconstitutional as applied in *Corrigan* specifically, it was not found to be unconstitutional on its face, and therefore the commissioner viewed "the holding in *Corrigan* [to have] no bearing on this matter."[29] Thus, the commissioner concluded that section 5747.212 was presumed to be "constitutional and . . . properly applied to the claimants' capital gains, as reflected on their original return."[30]

But perhaps of greater significance for our purposes are the tax commissioner's comments about how the facts in the two cases are "materially different," as the taxpayers had different relationships with their respective companies.[31] While Corrigan was "an investor who was not involved in the active management of his company," Fields founded Rodan & Fields, "developed products for the company, acted as a spokesperson for the company . . . is featured prominently on the company's website," and was an active investor.[32] Also, the taxpayers were board members before and after the sale and received a large guaranteed payment from Rodan & Fields.[33]

This looks a bit like what we saw in *Welch*, so you might expect that this is the part of our article where we criticize the Ohio case. But not so fast. Ohio's ability to tax a nonresident on the gain from the sale of stock under section 5747.212 — misguided as it may be — is at least enshrined explicitly in the state's tax law. And under that law, unlike the Massachusetts regulation, there is no requirement that the gain from the sale of an intangible asset be connected to a business or be part of a taxpayer's compensation for services. Now, it could be that the Ohio statute is still unconstitutional by taxing nonresidents, or at least certain nonresidents, on a gain from the sale of an intangible asset, as was the case for Corrigan. But the different statutory framework in Ohio makes this a much different conversation than what we have with *Welch* in Massachusetts.

What About New York?

As with many of the issues arising in the state personal income tax context, New York is no stranger to its share of controversy as well. To be sure, New York has already made a few attempts to tax nonresidents on gain from the sale of intangible assets. A 2009 law allows the state to tax nonresidents on the gain from the sale of stock or a partnership interest if more than 50 percent of the assets of the entity constitute real property in New York.[34] And don't get us started on New York's more recent effort to tax nonresident partners on the gain from the sale of partnership interests — we already tackled that in this column a few months ago.[35]

But we also have a more recent case where the state probably got it right. In *Matter of Adams,* the question concerned whether a nonresident could be taxed on dividend income.[36] Adams lived in Connecticut and was employed by a company

[26] *Corrigan v. Testa*, 73 N.E.3d 381 (Ohio 2016); *see* Timothy P. Noonan and Joshua K. Lawrence, "Could Ohio's Latest Due Process Case Spell Trouble for New York?" *State Tax Notes*, July 11, 2016, p. 117.

[27] *Corrigan*, 73 N.E.3d at 386 (citation omitted).

[28] *Rayant*, Appeal No. 2024-477.

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] N.Y. Tax Law section 631(b)(1)(A)(1). As discussed in our 2016 *Corrigan* article, we wondered whether this legislation could be subject to attack using a rationale similar to what was argued in *Corrigan*.

[35] *See* Noonan and Joseph F. Tantillo, "Empire Zone Strikes Back: A New Hope in an Apportionment Battle," *Tax Notes State*, Mar. 4, 2024, p. 663.

[36] *Matter of Adams*, DTA No. 850026 (N.Y. Div. Tax App. 2024).

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that granted him company restricted stock units (RSUs).[37] He sourced his RSU income to New York based on his New York workday percentage in the year each stock vested, but "did not treat any of the dividend income from his ownership of [company] common stock as New York source income subject to tax."[38] The Division of Taxation disagreed, arguing for a grant-to-vest date allocation method for the RSU income and asserting tax on the dividend income reported on Adams's "forms W-2 on the basis that this was part of [his] compensation package and should be properly allocated to New York."[39]

The Division of Tax Appeals agreed with the Division of Taxation's proposed grant-to-vest date allocation method for the RSU income, stating that RSUs, "like stock options, stock appreciation rights and restricted stock, are a form of equity-based compensation."[40] But the ALJ agreed with Adams that the dividend income was not New York-source income.[41] The judge reasoned that both Adams and his employer's general counsel "provided uncontroverted testimony that the stock that generated such dividends had vested at the time the dividends were issued [and there] is nothing . . . to support the conclusion that this dividend income was earned as a result of a business, trade or profession carried on in New York."[42] Thus, the ALJ found the dividend income to be "clearly not taxable to a nonresident taxpayer."[43]

We concur. Even though the taxpayer's dividend income came from RSUs that the Division of Taxation argued were part of the taxpayer's compensation package, New York stuck to the notion that intangible income that is not employed in a New York trade or business is not New York-source income, even if the entity itself is a New York business.

Coming to a State Near You?

In state tax administration, the bandwagon is a popular vehicle. As states like New York and Ohio pass legislative measures to expand their ability to tax nonresidents, we can expect other states to take notice, especially if New York and Ohio can survive attacks to these aggressive statutory measures. And as states like Massachusetts attempt to stretch or bend existing legislation to reach previously untouchable nonresident income, other states may notice and get creative, too. One thing is for sure: Taxpayers who think they found warmer weather and lower taxes by moving to Florida may soon learn that they may get to enjoy only one of those things. ■

[37] *Id.*

[38] *Id.*

[39] *Id.*

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

[41] *Id.*

[42] *Id.*

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

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