BY DANIEL A. KITTLE

NFL Players Prevail in Pair of Ohio Supreme Court "Jock Tax" Cases

Two recent Ohio Supreme Court decisions turned the spotlight on the taxation of professional athletes. Sometimes referred to as "jock taxes" or "rock star taxes," the income tax ordinances at issue allow cities to tax the income of nonresident professionals—such as athletes or entertainers—earned from performances during their short visits to the cities.

In allocating income for these taxes, most host cities apply a "duty-days" method. The duty-days method multiplies the athlete's income by the percentage of work days spent in the taxing city versus the athlete's total work days everywhere. In the cases at issue, the city of Cleveland, on the other hand, allocated income based on a "games-played method." As its name suggests, the games-played method multiplies the athlete's income by the percentage of games played in Cleveland versus games played everywhere.

Two retired National Football League players prevailed in challenging Cleveland's games-played method. In *Hillenmeyer v. Cleveland Board of Review*, 2015 WL 1934760 (Ohio Apr. 30, 2015), the Ohio Supreme Court held that the games-played method was unconstitutional because it did not reasonably associate the amount of compensation taxed with the athlete's work actually performed within the city. The court reasoned that the games-played method overstated the amount of work actually performed in Cleveland because it failed to take into account hundreds of additional non-game days when athletes performed work outside the city. Instead, the court directed the city to apply the "duty-days" approach followed by most cities in allocating athletes' income.

DANIEL A. KITTLE (KittleD@LanePowell.com) is an attorney with the law firm of Lane Powell PC in Seattle, Washington.

In a companion case released the same day, *Saturday v. Cleveland Board of Review*, 2015 WL 1934818 (Ohio Apr. 30, 2015), the Ohio Supreme Court also held in favor of the taxpayer, although for different reasons based on a slightly different set of facts. In *Saturday*, a former NFL player from a visiting team challenged Cleveland's ability to tax his income when he never actually traveled to the city with his team due to an injury. The court agreed that taxing the player's income was improper, holding that the city's ordinance and related regulation only permitted the city to tax income for work actually performed in or attributable to Cleveland. Simply put, the player's absence from Cleveland meant that Cleveland could not tax his income.

Cities are often delegated broad authority to adopt methods to allocate or apportion income. However, as these cases illustrate, such authority is not without limitation. Cities and taxpayers alike must remain mindful of the limitations imposed not only by the enabling state statute or city ordinance, but also by the U.S. Constitution. In general, methods that result in taxation of extraterritorial activity are disfavored.

At the same time, these cases serve as a reminder to taxpayers to remain aware of each city's income tax regime. Even a short one-day visit to a city can subject professionals to income tax liability.

***Hillenmeyer:* Games-played allocation method violates Due Process Clause.** Hunter Hillenmeyer, a former linebacker for the Chicago Bears, played one game in Cleveland against the Browns each year in 2004, 2005, and 2006. During that time period, he played approximately nineteen games per year (including preseason games) outside of Cleveland. This meant that Hillenmeyer was in Cleveland for 5% of his team's games each year.

In allocating Hillenmeyer's income, Cleveland employed a regulation that allocated his income based on the "games-played" method—i.e., the percentage of games played in Cleveland versus games played everywhere. Hillenmeyer filed refund claims with Cleveland challenging this approach for tax years 2004, 2005, and 2006 on various grounds, asserting that Cleveland's games-played method violated Ohio state law, a Cleveland city ordinance, and the Equal Protection Clause and Due Process Clause of the U.S. Constitution.

Hillenmeyer advocated for Cleveland's adoption of the "duty-days" method that is followed by most other cities. Applying the duty-days method, which allocates income based on the number of days worked in Cleveland versus the number of days worked everywhere, Hillenmeyer's income allocated to Cleveland would have been lower. For instance, during his visits to Cleveland, Hillenmeyer was present in the City for just two work days each year (one travel day and one game day) compared to 160-plus work days outside Cleveland. This meant that Hillenmeyer was in Cleveland for only about 1.2% of his total work days during the season.

Cleveland denied Hillenmeyer's refund claims, and Hillenmeyer appealed to the city's Board of Review and then to the Ohio Board of Tax Appeals. The Board of Tax Appeals upheld the refund denial but specifically indicated that it lacked jurisdiction to consider Hillenmeyer's constitutional challenges. Hillenmeyer then sought review by the Ohio Supreme Court.

No violation of state law, city ordinance, or the Equal Protection Clause. Hillenmeyer first argued that the regulation

violated state law and the city's own ordinance because those authorities required the city to take into account "***all*** qualifying wages." Hillenmeyer asserted that the games-played method failed to take into account all of his qualifying wages by calculating his Cleveland income only based on games played, not all other activities generating his wages.

The state high court rejected this argument because both the ordinance and the statute provided the city with broad discretion in allocating wages to Cleveland. According to the court, a "home-rule" statute granting authority to a municipality to impose taxes can only be restricted by a clear, affirmative statutory restriction. Because the statute here contained no such express restriction, the court said, the municipality was free to allocate income at its discretion.

Hillenmeyer also asserted that the games-played method of allocation violated the Equal Protection Clause of the U.S. Constitution because professional athletes and entertainers were excluded from a 12-day grace period under Ohio law, which provided an exemption for nonresidents performing services in Cleveland for 12 days or fewer. The statute expressly excluded professional athletes and entertainers from this exemption. Hillenmeyer argued that this disparate treatment violated his equal protection rights.

The court disagreed, holding that the distinction between other service providers and professional athletes and entertainers provided a rational basis to justify exclusion from the 12-day grace period. The court reasoned that professional athletes "are typically highly paid," and "their work is easy to find," which allows cities to "earn significant revenue with comparative ease." The court's justification here seems problematic because it suggests that a taxpayer's income level or a city's ability to easily raise revenue could justify any discrimination against taxpayers.

The court also justified the distinction with a more plausible reason, citing the "larger public burdens relating to police protection and traffic and crowd control" incurred by a city when a professional athlete or entertainer visits. Additionally, the court stated that Ohio cities had already been imposing local taxes on entertainers and athletes when the 12-day period was enacted, and protection of such a "reliance interest" by the city in taxing those activities is another rational basis for the disparate treatment.

"Games-played" method is unconstitutional, but "duty-days" method is not. Ultimately, the Ohio Supreme Court struck down Cleveland's "games-played" method because it violates the constitutional due process rights of NFL players. The court held the Due Process Clause of the U.S. Constitution prohibits cities from taxing nonresidents unless "the income actually arises" in the city and the city has "authority" over the income. For service income, the court stated, this means that taxation "must be based on the location of the taxpayer when the services were performed."

The court distinguished the ***allocation*** of compensation from the ***apportionment*** of business income. While income from a unitary trade or business may be apportioned by a general formula, the court stated, compensation is allocated to one location or another using a "simpler rule" based on "the place where the employee performed the work." In allocating income based on where an employee performs the work, the court held, the Due Process Clause requires an allocation method that "reasonably associates the amount of compensation taxed with work the taxpayer performed within the city."

Here, the court concluded that Cleveland's games-played allocation method violated the Due Process Clause because it imposed an "extraterritorial tax" on Hillenmeyer. Specifically, the court held that the games-played method "foreseeably imposes Cleveland income tax on compensation earned while Hillenmeyer was working outside Cleveland."

The court explained that by applying the games-played method, Cleveland failed to allocate income based on the actual portion of Hillenmeyer's work performed in Cleveland. The games-played formula failed to take into account the remaining 140-plus days of the year when Hillenmeyer was working outside Cleveland but not playing in a game. For instance, the games-played formula failed to take into account Hillenmeyer's required work at team meetings, practices, mini-camps, game-preparation, film review, and many other aspects of an NFL player's required work. According to Hillenmeyer's contract with the Chicago Bears, his compensation was based not only on playing games on weekends, but also on all of the other mandatory non-game "duty days." This meant that the games-played formula allocated some of Hillenmeyer's income to Cleveland that was not earned due to Hillenmeyer's Cleveland activities.

After rejecting the games-played formula, the court adopted the duty-days formula advocated by Hillenmeyer and employed by most other cities. The court reasoned that the duty-days approach was consistent with the Due Process Clause because it "properly includes as taxable income only that compensation earned in Cleveland." Consequently, the court remanded the matter and instructed Cleveland to issue a refund to Hillenmeyer by multiplying his taxable compensation by the percentage of work days he spent in Cleveland versus the number of his work days everywhere.

In addition, the court rejected Cleveland's claim that Hillenmeyer waived his right to challenge the constitutionality of the city's regulation by appealing to the Board of Tax Appeals—instead of Ohio's lower courts—because the Board of Tax Appeals is precluded from addressing constitutional issues. The court acknowledged that the Board of Tax Appeals cannot resolve constitutional issues, but the court held that taxpayers ***may*** raise constitutional issues at that level, and the Board of Tax Appeals will serve as a "forum for presentation of evidence" to establish a record for a court to decide the constitutional issues on appeal.

***Saturday*: No taxation for activity outside Cleveland.** The companion case, *Saturday v. Cleveland Board of Review*, involved slightly different circumstances but also resulted in a refund of income tax for a visiting NFL player. On November 29-30, 2008, the Indianapolis Colts traveled to Cleveland and defeated the Browns, 10-6, in what the Ohio Supreme Court described as a "dismal" game. Jeffrey Saturday, a center for the Colts, failed to make the trip due to calf and knee injuries. Instead, Saturday remained in Indianapolis for two days of team-mandated rehabilitation work.

Nonetheless, the Colts withheld more than $3,000 in Cleveland income tax from Saturday's paycheck in 2008. Saturday filed a refund claim with Cleveland for that tax. Cleveland's Central Collection Agency denied the refund, and a city board of review upheld that decision. The Ohio Board of Tax Appeals also upheld the decision but declined to address any constitutional arguments. An appeal reached the Ohio Supreme Court.

Tax only applies if player is in Cleveland. As noted above in the *Hillenmeyer* summary, the Cleveland ordinance only applied to income from "work done or services performed or rendered within the City or attributable to the City." The city's regulation at issue, however, extended the tax to

"compensation earned for ***games*** that occur in the taxing community."

Cleveland argued that Saturday's compensation from the Colts was based on playing the game in Cleveland, even though Saturday was not present for the game. The state high court rejected that argument, noting that NFL players are contractually obligated to provide services to their teams from the beginning of the preseason through the end of the postseason, including mandatory mini-camps, practice sessions, and rehabilitation for injuries. In light of those circumstances, the court held that the regulation must be narrowly construed to permit taxation "only when the player was actually present at the Cleveland game and earning compensation for his presence at the game." As a result, Cleveland could not tax Saturday for income received based on activities he performed outside Cleveland.

Potential ambiguity construed in taxpayer's favor. The court also noted that the city's games-played formula for allocating income contained a potential ambiguity. In both the numerator and the denominator, the formula included games where the athlete was "excused from playing because of injury or illness." In other words, the numerator was the number of games played in Cleveland—including games the athlete "was excused from playing because of injury or illness"—while the denominator was the number of games played everywhere, also including games the athlete "was excused from playing because of injury or illness."

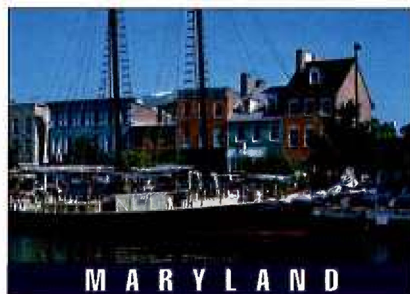
Cleveland argued that the illness or injury excuse allowed the city to tax Saturday when he failed to play in Cleveland due to his injury. The court rejected the argument, noting that ***if*** Saturday had ***traveled to Cleveland*** and been "excused from playing" while in Cleveland, ***then*** the regulation might support Cleveland's interpretation. But the court pointed out that the regulation was silent as to what to do when the athlete was "not even in the city where the game is being played."

Noting this ambiguity, the court relied on two canons of statutory interpretation to rule in Saturday's favor and against Cleveland. First, any doubts about the interpretation of a tax statute or ordinance must be resolved in the taxpayer's favor and against the taxing authority. Here, this required the court to construe the potential ambiguity in Cleveland's regulation against the city and in favor of Saturday.

Second, courts impose an "implied condition" that tax statutes "have no extraterritorial effect." Saturday's absence from Cleveland on game day in November 2008 and his performance of rehabilitation duties in Indianapolis "raise a strong suggestion that the imposition of Cleveland tax would constitute extraterritorial taxation."

Based on these interpretations, the court held that neither Cleveland's ordinance nor its regulation permitted the city to impose tax on Saturday for work performed outside of Cleveland. The court declined to reach Saturday's constitutional arguments, invoking the principle that courts prefer to avoid constitutional issues if a case can be decided based solely on the statute, ordinance, or rule.

Nonetheless, even if the court had declined to invalidate Cleveland's tax based solely on the regulation and ordinance, the court presumably would have struck down the city's tax on constitutional grounds anyway. Based on the related *Hillenmeyer* opinion, the court would have ordered the city to apply the "duty-days" test to allocate Saturday's income to Cleveland instead of the "games-played" test. In 2008, Saturday did not work any duty days in Cleveland because he was absent when the Colts traveled there. Accordingly, he would have owed no income tax to the city.



Out-of-State Subsidiary Has Maryland Nexus Based on In-State Activities of Parent Company

States continue to push the boundaries of constitutional nexus requirements in raising revenue from corporate taxpayers. Recently, in *ConAgra Brands, Inc. v. Comptroller*, the Maryland Tax Court upheld Maryland's imposition of tax on an out-of-state intangibles holding company based on the in-state activities of its corporate parent—even though the holding company had no employees, agents, representatives, or property in Maryland and did not conduct any business in the state.

The court relied in part on the unitary business principle, which allows states to apportion income of a group of related companies with functional integration, centralized management, and other similar factors. However, the court noted that the unitary business principle alone does not allow a state to directly tax an out-of-state subsidiary based solely on its parent's in-state activities. Relying on the Maryland Court of Appeals' controversial 2014 opinion in *Gore Enterprise Holdings, Inc. v. Comptroller*, 437 Md. 492 (Md. Ct. App. 2014), the court stated that an out-of-state subsidiary can be constitutionally subject to tax based on its parent's in-state activities if the subsidiary lacks "economic substance separate from its parent."

The Maryland Tax Court's decision is potentially troubling because it gives taxpayers relatively little guidance regarding when an out-of-state company lacks "economic substance separate from its parent." For instance, the taxpayer in this case not only held all of the intellectual property for the ConAgra corporate family, but it also managed, controlled, and marketed all of the corporate family brand names and trademarks. The court's holding seems to suggest that any company performing the majority of its operations for related corporate affiliates might not have "economic substance separate from its parent." It is difficult to determine how far-reaching the economic substance test will go, but *ConAgra* suggests its reach could be extensive.

Background. The taxpayer, ConAgra Brands (Brands), is a Nebraska corporation formed to centrally manage and protect all of the intellectual property used by the ConAgra Foods corporate family. ConAgra Foods is one of the largest food producers in North America. Brands is wholly owned by ConAgra, Inc. (ConAgra).

Between 1996 and 2003, Brands had no employees, agents, or representatives in Maryland, owned no property in Maryland, and conducted no business in Maryland. Nonetheless, Maryland assessed

Brands more than $3 million in unpaid income tax from 1996 through 2003 based on the Maryland activities of ConAgra, Brands' corporate parent. Brands appealed the assessment to the Maryland Tax Court.

Nexus based on lack of independent economic substance. The court began its analysis by reciting the basic constitutional requirements for state taxation under the Due Process Clause and Commerce Clause. As the court noted, the Due Process Clause only requires some "minimal connection" between the taxing state and the person, property, or transaction subject to tax. The Commerce Clause requires substantial nexus, fair apportionment, lack of discrimination against interstate commerce, and a fair relation to the services provided by the state.

However, the court failed to specifically analyze how these constitutional concepts applied to Maryland's ability to tax Brands. Instead, the court focused on the unitary business principle, which permits states to consider related businesses as a single "unit" for income tax purposes. Unitary businesses are then taxed based on the portion of a company's income derived from the state using an apportionment formula. The court noted that the characteristics of functional integration, centralized management, and economies of scale tend to establish a unified business.

However, the court was careful to point out that the unitary business principle ***alone*** cannot establish constitutional nexus to tax an out-of-state subsidiary based solely on the in-state activities of its corporate parent. Rather, Maryland courts also hold that the subsidiary must lack any "economic substance separate from its parent(s)." In other words, if an out-of-state subsidiary is part of a unitary business and lacks economic substance separate from its corporate parent, then Maryland is constitutionally permitted to tax the subsidiary based on the parent's in-state activities.

Brands lacked independent economic substance. Applying the economic substance test, the court concluded that Brands lacked any economic substance apart from ConAgra, its corporate parent. The court noted that ConAgra provided centralized legal services, tax services, accounting, and other corporate management services to all businesses in the ConAgra family, including Brands. The court also pointed out that ConAgra executives were assigned to interlocking boards of directors and served as officers of numerous subsidiaries. "All of Brands' everyday support services . . . were supplied by its corporate parent," the court summarized. In examining this corporate interconnectedness, the court specifically pointed out that one ConAgra officer testified in a deposition that he was "assigned as an officer and director to so many different subsidiaries that he could only recall the names of a few of the subsidiaries to which he was assigned."

In contrast, ConAgra formed Brands to manage, control, protect, and market the ConAgra Foods corporate family portfolio of intellectual property. The "vast majority" of Brands' revenue came from royalty payments from other ConAgra companies for the use of the intellectual property, although the court acknowledged that Brands also licensed trademarks to third parties. The court described the revenue stream from Brands as "entirely circular," and added a comment that Brands was operated "at least in part, as a conduit to shift income out of the reach of Maryland taxing authorities." In addition, Brands had common employees, directors, officers, and stockholders with ConAgra, and relied on corporate personnel, office space, and corporate services from ConAgra.

Based on these factors, the court held that Maryland could constitutionally impose income tax on Brands based on the activities of its corporate parent, ConAgra.

Unfortunately, the court failed to provide any guidance or standard in determining when a subsidiary lacks "economic substance separate from its parent." Based on the court's highly fact-intensive inquiry, any amount of corporate reliance sufficient to satisfy the unitary business principle could potentially subject an out-of-state subsidiary to Maryland tax. Out-of-state taxpayers with in-state affiliates now tread on uncertain constitutional ground.

Blended apportionment formula upheld. After determining that Brands could be taxed based on the in-state activities of its corporate parent, the court also upheld the blended three-factor apportionment formula applied by the state in this case. Because Brands had no recorded Maryland sales, payroll, or property, the state disregarded the standard three-factor formula here because it did not "reflect clearly the income allocable to Maryland."

Instead, the state used an apportionment formula that blended figures from income tax returns of five different ConAgra entities. The court upheld the state's formula, ruling that the taxpayer failed to establish by "clear and convincing evidence" that the blended formula was "unfair."

Although the court's opinion does not provide additional explanation about the burden to establish a fair apportionment formula, this aspect of the opinion appears to impose a substantial burden on taxpayers. The court appears to implicitly defer to the state's decision that the standard apportionment formula was unfair—rather than placing the burden on the state to establish unfairness in the first place, as other states require—and then it forces the taxpayer to establish by "clear and convincing" evidence that the apportionment formula is unfair. The clear and convincing evidence standard is very difficult to satisfy.

Statute of limitations waived by lack of returns filed. The court also rejected Brands' argument that the three-year statute of limitations had expired on Maryland's assessment. Under Maryland law (like many other states), the statute of limitations does not apply at all when a taxpayer has failed to file tax returns.

As the court's opinion suggests, many states take the position that they can reach back indefinitely to assess past-due taxes if the taxpayer has not filed tax returns. Taxpayers can avoid this potentially devastating burden through voluntary disclosure programs.

Interest and penalties waived. Finally, the court waived interest and penalties on Brands' $3 million assessment because it held that Brands had a "reasonable basis for challenging the law and acted in good faith." Citing *Gore* and other cases decided within the last five years, the court rejected the state's argument that "the law was clear" at the time of the assessments. Rather, the court noted that in recent years, the "state of the law has evolved through various court decisions." ■