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INSIGHT: Taxpayer Appeals Loss in Rare Constitutional Challenge to Composite Return Statute

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Cases challenging the constitutionality of state pass-through entity (PTE) nonresident owner withholding or composite return statutes are extremely rare. However, a recent Alabama Circuit Court decision, *Black Eagle Minerals, LLC v. Alabama Department of Revenue*, Case No. CV-2018-900328.00 (Cir. Ct. Montgomery County, Ala., July 27, 2020), highlights why such challenges may be more common when PTE composite returns are mandatory.

The case shows a deep fissure in the constitutional jurisprudence addressing jurisdiction to tax nonresident owners, and the dual nature of pass-through entity taxes as simultaneously being taxes on the entities and on their owners. Perhaps the Alabama appellate courts will soon offer some clear guidance.

The Long Shadow of International Harvester

The U.S. Supreme Court decision most cited in support of the states' power to impose withholding taxes on the nonresident owners of an entity doing business within their borders is *International Harvester Co. v. Wisconsin Department of Taxation*, in which the U.S. Supreme Court held a state does not violate the Due Process Clause when it taxes an entity by taxing income earned in the state when that income is distributed to its shareholders as a dividend. However *International Harvester* is misunderstood for at least two reasons.

First, the tax in *International Harvester* was applied to both resident and nonresident shareholders; so there was no claim of discrimination against nonresidents, leaving the case to be decided solely on Due Process Clause grounds. As a result, there are unanswered Commerce Clause questions surrounding the powers sanctioned by *International Harvester*.

Second, the Court allowed the state to, in effect, tax the nonresident owners by imposing a tax on the corporation itself as doing business in the state. The case did not allow states to directly tax nonresident owners if they did not otherwise purposefully avail themselves of the benefits and protections of the taxing state. *See Shaffer v. Heitner*; *cf. Corrigan v. Testa* (finding PTE's in-state business activity sufficient purposeful availment to tax nonresident owner's distributive share of PTE income, but insufficient to tax capital gain from sale of interests in that PTE).

Nonresident Withholding Tax or Entity Tax?

Where a nonresident owner of a PTE has earned income in a state but has not purposefully availed itself of the benefits of the taxing state, the Due Process Clause leaves the state essentially two options to tax the income: withholding or an entity-level tax. Additionally, the state could require the nonresident owner to ''consent'' to that state's tax jurisdiction by filing a one-time or periodic agreement to file returns and pay tax. Otherwise, the entity itself becomes liable. The U.S. Supreme Court held in *Travis v. Yale & Towne Mfg. Co.*, that a state did not violate the Due Process Clause by requiring a corporation to withhold and remit tax from nonresident workers' earnings. It also held that withholding state income tax only from nonresident wages does not unconstitutionally discriminate against nonresidents because it does not actually increase their tax burden. However the discrimination claims in *Yale & Towne* were decided under the Equal Protection Clause, not the Commerce Clause; by the time the case reached the Supreme Court, the litigants had abandoned their Commerce Clause argument.

The other alternative for states to collect their tax from nonresident owners is an entity-level tax. *International Harvester* offers states little protection against a claim of Commerce Clause discrimination, because it was not decided on Commerce Clause grounds. Thus, an entity-level tax imposed only on entities with nonresident owners would be facially discriminatory.

However, certain taxes that facially discriminate against interstate commerce are permitted under the compensatory tax or complementary tax doctrine best articulated in *Oregon Waste Systems Inc. v. Dept. Environmental Quality of the State of Oregon*. For a state to successfully assert this doctrine it must show: (1) there is an intrastate burden for which the tax is attempting to compensate; (2) the tax on interstate commerce roughly approximates, but does not exceed, the tax on intrastate commerce; and (3) the events on which interstate and intrastate taxes are imposed are substantially equivalent to one another.

Mandatory Withholding

Within those constraints, states have the right to tax PTE income having a source within the state, but often lack jurisdiction over the PTE's nonresident owners to enforce collection of the tax. Most states that impose an income tax (and that do not impose an entity-level tax on PTEs) address the jurisdictional difficulties involved with collecting tax from nonresident owners by imposing mandatory withholding obligations on PTEs. Some states, such as California, generally impose a withholding obligation on payments to nonresident individuals and entities of income from within the state. For example, California Code of Regulations 18862-4 requires withholding of tax at the source for payments greater than $1,500 of California source income made to nonresident individuals and non-California business entities, subject to certain exceptions.

More often, states require withholding of their tax on the distributive share of nonresident owners, whether or not paid. In some states, such as Nebraska, for example, this withholding requirement exists for nonresident individual owners, but not for corporate owners. *See, e.g.*, Nebraska Revised Statutes Sections 77-2727(4) and 77-2734.01(5). In many other states, including New York, the withholding requirement includes corporations. *See, e.g.*, N.Y. Tax Law Section 658(c)(4); New York TSB-M-04(1)I (Feb. 25, 2004); New York Form CT-2658: Report of Estimated Tax for Corporate Partners.

Several states exempt PTEs from a withholding obligation with respect to certain owners that file exemption certificates or affidavits by which the owner submits to the state's taxing jurisdiction and agrees to file income tax returns. *See, e.g.*, Georgia Compilation Rules and Regulations 560-7-8-.34(2)(g)(1), (g)(3), Form NRW-Exemption; *see also* Nebraska Revised Statutes Sections 77-2727(4) and 77-2734.01(5) (together requiring partnerships, S corporations, and LLCs, to withhold when partner, shareholder, or member, respectively fails to file statement agreeing to file return and pay tax). These exemptions often don't apply to nonresident individuals. *See, e.g.*, Cal. Code Regs. Title 18, Section 18662-4(b) (exempting, among others, residents and certain entities doing business in the state with a permanent place of business in the state, if they file Franchise Tax Board Form 590); 35 Illinois Compiled Statutes Section 5/709.5(c)(1); Illinois Administrative Code Title 86, Section 100.7035(g)(1)(C) (exempting PTEs from withholding on non-individual owners that file valid exemption certificates); Illinois General Information Letter IT 08-0013-GIL (April 14, 2008) (clarifying that no nonresident individuals may be exempted from withholding).

As an alternative to requiring withholding, most states allow PTEs to file composite returns for their nonresident owners. Like PTE nonresident withholding statutes, composite return statutes generally require PTEs to pay that state's income tax on the distributive share of participating nonresident owners, typically at the highest applicable individual or corporate income tax rate. *See, e.g.*, New York Compilation of Codes, Rules & Regulations, Title 20, Section 151.17(g); Ohio Revised Code Section 5747.08(D). Many states allow nonresident owners to file an individual return and receive a refund of any over-collected tax. *See, e.g.*, Ohio Rev. Code Section 5747.08(D)(1)(c) (permitting nonresident owner to file refund claim); Michigan Department of Treasury, Update (Sept. 1, 2020) (recognizing filing to claim refund of overpaid composite tax).

The crucial differences between income tax withholding on nonresident owners and composite returns are that: (1) the composite return is nearly always elective; and (2) filing a composite return typically satisfies the income tax filing obligation of a nonresident owner, provided the owner has no other income from the taxing state. *See, e.g.*, California Revenue and Taxation Code Section 18535(a); Michigan Revenue Administrative Bulletin 2004-1 (Apr. 5, 2004); Ky. Dep't of Revenue, 2019 Form 740NP-WH, NRWH Instructions. Composite return statutes are generally welcomed by taxpayers and taxing authorities alike. They ease the compliance burden associated with filing and processing numerous state income tax returns for nonresident owners with relatively small tax liabilities across many states. For a helpful chart of the different ways that states impose tax on nonresident owners or the entity itself, see Bloomberg Tax & Accounting *2020 Survey of State Tax Departments*, pp. 284-286.

Opposite Extremes

Other states, such as Alabama, not only allow composite returns—they require them. *See* Ala. Code Section 40-18-24.2. In these states, which also include Indiana, Louisiana, and for entities with more than 50 owners, Vermont, if the composite return satisfies the nonresident owner's income tax filing obligation, the tax effectively becomes a tax on the entity. Ind. Code Section 6-3-4-12(i); La. Rev. Stat. Ann. 47:201.1(A)(1); La. Admin. Code Section 61:I.1401; Vt. Stat. Ann. 32 Section 5920(b); Vt. Stat. Ann. Section 5914(b). But unlike the entity-level taxes in states such as New Hampshire, Texas, and Tennessee, or even those of more recent vintage, often described as ''SALT cap workarounds,'' such as in Connecticut, Rhode Island, Wisconsin, New Jersey, or Maryland, this composite tax is imposed on and measured only by the share of state-source income attributable to nonresidents. And because the statute is mandatory, rather than elective, the nonresident owners and PTEs themselves cannot be said to have waived any claims of discrimination on the basis of being nonresidents. That Alabama imposes a mandatory composite reporting obligation on pass-through entities, and that its Department of Revenue, Administrative Law Division, affirmatively ruled the state's composite tax is levied on the entity itself, sets the stage for the Commerce Clause discrimination challenge at issue in *Black Eagle Minerals*. *See Tsitalia, LLC v. Ala. Dep't of Rev.*, Dkt. No. BIT. 12-492, Alabama Department of Revenue (ADOR), Administrative Law Division (Feb. 1, 2013) (upholding the constitutionality of the composite statute, concluding that ''while the tax is measured by the nonresident's distributive share of the entity's income, it is levied on the in-state entity.'')

Black Eagle Minerals LLC—Synopsis

Black Eagle Minerals was shaping up to be a major ADOR victory, but was appealed shortly before the expiration of the appeal period by the taxpayer, with new co-counsel. Thus, the decision in favor of the ADOR by the Montgomery County Circuit Court is not yet final, but is a matter of public record. The case involved a rare but full-on challenge to the constitutionality of Alabama's composite return statute, Alabama Code Sections 40-18-24.2 and -24.3. Enacted in 2008, the statute requires LLCs, limited partnerships, and certain other Subchapter K entities to annually file with the ADOR a return and pay income tax at a flat 5% rate on the distributive shares of Alabama-source income flowing through to their nonresident owners. Unlike several other states (e.g., neighboring Georgia), withholding of the income tax from those distributive shares is permitted, but not required. The entity is granted the option. *See* Ala. Code Section 40-18-24.2(c)(1).

The taxpayer, Black Eagle Minerals, LLC, is a Virginia-domiciled LLC, receiving passive income from a quarry that it owned in Alabama, while none of its members were Alabama residents. The parties stipulated that the LLC had no employees or assets in the state and did not exercise managerial control over the quarry operations. The taxpayer apparently filed composite returns with the ADOR for 2009 through 2011 but didn't remit any Alabama income tax with those returns. After receiving final assessments for each of 2008 through 2011, the taxpayer filed four separate notices of appeal with the Alabama Tax Tribunal, challenging the constitutionality of the statute both facially and on an as-applied basis. The taxpayer limited its constitutional grounds to the Commerce Clause, arguing that the statute discriminated against interstate commerce because the statute—and therefore the entity-level tax—only applies if the entity has one or more nonresident owners.

As mentioned, the case is rare because it involved a constitutional challenge to a state composite return statute, but it also appears to be the first, thorough self-analysis by the Tribunal of the limits of its own power to rule on the validity of a state taxing statute. When the Tribunal was established in 2014, the Alabama Legislature codified the limits of the executive branch agency's purview. Ala. Code Section 40-2B-2(g)(6) states that the Tribunal doesn't have the power to ''declare a statute unconstitutional on its face,'' but it *can* rule on the constitutionality of a state statute *as applied to a particular taxpayer*. The taxpayer challenged the composite return statute on both grounds, but focused on its as-applied challenge when the ADOR argued that the Tribunal lacked jurisdiction to even hear the appeal.

Chief Judge Patterson agreed with the ADOR, even though the Tribunal's predecessor—the ADOR's Administrative Law Division—had entertained a similar challenge to the composite statute, and upheld its validity, citing *International Harvester*. *See Tsitalia LLC v. Ala. Dep't of Revenue*, supra. Judge Patterson dismissed the appeal for lack of jurisdiction but the taxpayer appealed to the circuit court of Montgomery County, Alabama. Circuit courts in Alabama may hear appeals from the Tax Tribunal on a *de novo* basis and can entertain both types of constitutional challenges.

The trial court decided the case entirely on the record developed at the Tribunal below, along with additional briefs of the parties, which the authors reviewed. The judge ruled in favor of the validity of the statute without detailed analysis, citing a series of Alabama cases that presume an Alabama statute to be constitutional and place a heavy burden on the party challenging the statute. However, in what may be considered *dictum*, but at the urging of the ADOR, the ruling added that no discrimination existed here, but *if* the court had ruled on the application of the Commerce Clause to the composite statute, the statute would have been upheld based on the ''complementary tax'' doctrine, citing *Oregon Waste*. The ADOR had argued in its circuit court brief that the taxpayer's ''fatal error'' was that it ''completely ignore[d] the existence of Alabama's income tax on individuals,'' while the individual income tax ''is precisely the type of tax that *Oregon Waste* is designed to exempt from the Commerce Clause prohibitions.'' *Black Eagle Minerals, LLC,* Reply Brief of ADOR at p.6.

In short, the court seemed to agree with the ADOR that the composite statute is merely an enforcement mechanism for certain (not all) PTEs having one or more nonresident partners or members, when ''the Department's usual methods to enforce compliance are likely to be severely limited or completely ineffective.'' *Black Eagle Minerals, LLC,* Reply Brief of ADOR at p.7. And that same logic is likely why we've seen so few published constitutional challenges to these types of statutes. Indeed, the authors were unable to locate any published decision, outside the Alabama judicial system, involving a challenge to the constitutionality of these statutes. True, there are several decisions, beginning with the seminal decision in *Travis v. Yale & Towne Mfg. Co.* in 1920, that involve statutes imposing withholding and remittance obligations on wages, dividends, or oil and gas royalties, but none focused on PTEs and taxing the distributive shares of or distributions to their nonresident owners.

Now that the taxpayer has appealed, perhaps the Alabama appellate courts will shed further light on the proper constitutional analysis applicable to these statutes as well as to nonresident owner withholding statutes. This is a case to watch.

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