JOE E. LANZI, III § STATE OF ALABAMA
1223 Cumberland Road DEPARTMENT OF REVENUE
Atlanta, GA 30306, § ADMINISTRATIVE LAW DIVISION

Taxpayer, § DOCKET NO. INC. 02-721

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed Joe E. Lanzi, III ("Taxpayer") for Alabama income tax for 1998 and 2000. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on May 22, 2003. David Wooldridge, Bill Ward, Joe Blackburn, and Donald Johnson represented the Taxpayer. Assistant Counsel David Avery represented the Department. Both parties filed briefs. The Taxpayer filed a reply brief. The Alabama Education Community and the Alabama Society of Certified Public Accountants also filed briefs as *amicus curiae* for the Department and the Taxpayer, respectively.

ISSUES

The Taxpayer resided outside of Alabama during the years in issue. He owned no property, conducted no business, and had no economic ties to Alabama in those years other than a limited partnership interest in an Alabama limited partnership. The issue in this case is whether the Taxpayer is liable for Alabama income tax on the income he received from the limited partnership. Three sub-issues are involved:

(1) Is Alabama prohibited from taxing the Taxpayer by the Due Process and/or Commerce Clause of the United States Constitution, Amendment 14, §1 and Article 1, §8, cl. 3, respectively;

(2) If Alabama is not constitutionally prohibited from taxing the Taxpayer, was the income derived from "property owned or business transacted in Alabama," and thus subject to Alabama's income tax levied at Code of Ala. 1975, §40-18-2(6); and,

(3) If Alabama is not constitutionally prohibited from taxing the Taxpayer and the income was from property owned or business transacted in Alabama, does the Department's position constitute a new interpretation of the applicable law; and, if so, did the Department fail to comply with the Alabama Administrative Procedures Act, Code of Ala. 1975, §41-22-1 et seq., before implementing the new interpretation?

FACTS

The Taxpayer resided in Georgia during the years in issue. He owned a limited partnership interest in Quad-L Limited Partnership, an Alabama limited partnership. Quad-L was formed in 1995 for the purpose of investing the Lanzi family assets. Toward that end, the partnership buys and sells stocks, bonds, and other securities, and consequently receives dividend and interest income, and gains from the sale of those securities.

Quad-L's general partners reside in Birmingham, Alabama. The general partners monitor and manage the partnership's investments, with the help of financial consultants in Montgomery, Alabama. The partnership's assets are held primarily through a Charles Schwab account. Schwab is headquartered in California, and has offices in Alabama and throughout the United States. Transactions in the partnership's Schwab account are initiated either by the general partners or the partnership's financial consultants in Montgomery through the use of a Schwab toll-free 800 telephone number. The partnership also owns a bond portfolio through a broker in Boston, Massachusetts.

The Taxpayer, as a limited partner, does not participate in managing the partnership or its assets. Other than his limited partnership interest in Quad-L, the Taxpayer did not own property, earn income, conduct business, or have any other economic ties in Alabama during the subject years.

Quad-L distributed a pro rata portion of its portfolio income to the Taxpayer during the years in issue. The Taxpayer reported and paid Georgia income tax on that income. He did not file Alabama nonresident returns in either year.

The Department determined that the Taxpayer's income from Quad-L was from property owned or business transacted in Alabama. It assessed the Taxpayer accordingly for the years in issue. The Taxpayer appealed.

The CPA that represented both Quad-L and the Taxpayer in the subject years testified at the May 22 hearing in the case that he has been a CPA in Alabama since 1975, and that to his knowledge the Department had never before taxed a nonresident partner on portfolio income received from an Alabama partnership. When asked at the May 22 hearing if the Department had ever before taxed a nonresident limited partner on such income, the Department's attorney responded – "Yes, I think so. I don't know if there was a whole lot of effort put into it, because we didn't have the funding to have many auditors in here." T. at 54. No evidence was submitted supporting or expounding on that response.

ANALYSIS

Issue (1). The Constitutional Issue.

The Due Process and Commerce Clauses of the U.S. Constitution both require that there must be a nexus or connection between a state and the taxpayer or transaction it seeks to tax. There is a "fundamental requirement of both the Due Process and Commerce

Clauses that there be 'some definite link, some minimum connection between a state and the person, property, or transaction it seeks to tax.'" *Allied-Signal, Inc. v. Director, Div. of Taxation*, 112 S.Ct. 2251, 2258 (1992), quoting *Miller Bros. v. Maryland*, 74 S.Ct. 535, 539 (1954); see generally, J. Hellerstein & W. Hellerstein, State Taxation (3d ed. 2001), at ¶6.01, et seq.

A taxpayer's physical presence in a state is not required for due process purposes. Rather, the taxpayer must only have such "minimum contacts" with the state that subjecting the taxpayer to the state's taxing jurisdiction "does not offend 'traditional notions of fair play and substantial justice.'" *International Shoe v. Washington*, 66 S.Ct. 154, 158 (1945), quoting *Milliken v. Meyer*, 61 S.Ct. 339, 343 (1940). The Due Process Clause is satisfied if the taxpayer "purposefully avails itself of the privilege of conducting activities within the forum State," *Worldwide Volkswagen Corp. v. Woodson*, 100 S.Ct. 559, 567 (1980), citing *Hanson v. Denckla*, 78 S.Ct. 1228, 1240 (1958), or the taxpayer has "purposefully directed" its activities toward the state. *Burger King Corp. v. Rudzewicz*, 105 S.Ct. 2174, 2182 (1985). See also, *Asahi Metal Industry Co., Ltd. v. Superior Court of Cal., Solano County*, 107 S.Ct. 1026 (1987).

The Commerce Clause also requires a "substantial nexus" between the taxing state and the taxpayer or activity it seeks to tax. *Complete Auto Transit, Inc. v. Brady*, 97 S.Ct. 1076 (1977).[1] The Supreme Court has recognized that the jurisdictional requirements of

---

[1] The Court held in *Complete Auto* that a state tax will withstand a Commerce Clause challenge if the "tax (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to services provided by the State." *Complete Auto*, 97 S.Ct. at 1079.

Due Process Clause nexus and Commerce Clause substantial nexus are closely related. "The *Complete Auto* test, while responsive to Commerce Clause dictates, encompasses as well the due process requirement that there be a 'minimal connection' between the interstate activities and the taxing state, . . ." *Trinova Corp. v. Michigan, Dept. of Treasury*, 111 S.Ct. 818, 828 (1991).

In *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), the Court for the first time distinguished between Due Process Clause nexus and Commerce Clause substantial nexus. While again recognizing that the concepts were similar and sometimes overlapping, the Court held that the Clauses were "analytically distinct." *Quill*, 112 S.Ct. at 1909. The Court subsequently affirmed its prior holdings that for due process purposes, the physical presence of the taxpayer in the state is not required. "Applying these (due process) principles, we have held that if a (foreign taxpayer) purposefully avails itself of the benefits of an economic market in the foreign state, it may subject itself to the state's in personam jurisdiction even if it has no physical presence in the state." *Quill*, 112 S.Ct. at 1910.

For Commerce Clause purposes, however, the Court affirmed its holding in *National Bellas Hess, Inc. v. Dept. of Revenue*, 87 S.Ct. 1389 (1967), that at least for sales and use tax purposes, substantial nexus requires that a taxpayer must have a physical presence in the state. *Quill*, 112 S.Ct. at 1911-1916.

Since *Quill*, there has been an ongoing national debate as to whether *Quill's* Commerce Clause physical presence test also applies to income and other business activity taxes. Various state courts have ruled that physical presence is required for

business activity taxes, while some have ruled otherwise.[2] Numerous articles pro and con have also addressed the issue.[3]

The Administrative Law Division has held that the *Quill* physical presence test also applies to Alabama's income and franchise taxes. See, *Dial Bank v. State of Alabama*, Inc. 95-289 & F. 95-308 (Admin. Law Div. 1/4/99); *Cerro Copper Products, Inc. v. State of Alabama*, F. 94-443 (Admin. Law Div. 12/11/95); and *9.4% Manufactured Housing Contract Pass-Through Certificate Series 1989A v. State of Alabama*, Corp. 95-162 (Admin. Law Div. 12/11/95). The primary rationale relied on in those cases was that different constitutional standards should not apply for sales and use tax purposes as opposed to income and other business activity taxes.

After studying the issue further, I am no longer convinced that the Supreme Court intended the *Quill* physical presence test to apply beyond sales and use tax. In affirming

---

[2] For cases holding that *Quill's* physical presence test also applies to business activity taxes, see, *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 3d Dist., 2000); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W. 3d 831 (Tenn. Ct. App. 1999). For cases holding that *Quill* is limited to only sales and use tax, see, *Borden Chemicals & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (2000); *Gore Enterprises Holding Co. v. Director of Revenue*, 99-2856 R.I.

[3] For articles supporting the case that *Quill* applies to business activity taxes, see, D. Smith, *Comments to the Multistate Tax Commission Re: 'Factor Presence Nexus Standard,'* State Tax Notes, Sept. 30, 2002, at 1043; D. Smith & S. Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, State Tax Notes, Sept. 9, 2001, at 787; H. Hyans & A. Nogid, *Income Tax Nexus: Revisiting Geoffrey Seven Years Later*, State and Local Tax Insights, Summer 2000. For articles to the contrary, see, D. Bucks & F. Katz, *Explanation of the Multistate Tax Commissioner's Proposed Factor Presence Nexus Standard*, State Tax Notes, Sept. 30, 2002, at 1037; M. Mazerov, *Should New Limits on State Corporate Profits Taxes be a Quid Pro Quo for the State's Ability to Tax Internet Sales? The Business Activity Tax Nexus Issue*, State Tax Notes, Sept. 17, 2001, at 889; M. Fatale, *State Tax Jurisdiction and the Mythical 'Physical Presence' Constitutional Standard*, Tax Lawyer, Vol. 54, No. 1, at 105.

the physical presence rule, the Court primarily relied on the principle of *stare decisis* and the mail order industries' fixed reliance on the rule previously established in *Bellas Hess*. As concluded by Professor Walter Hellerstein in his treatise co-authored with his late father – "It is by no means apparent that these pragmatic considerations would justify a bright-line physical-presence standard with respect to other taxes." J. Hellerstein & W. Hellerstein, *supra*, at ¶6.02(2). See also, J. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, State Tax Notes, Feb. 13, 1995 (*Quill's* Commerce Clause physical presence test should not be extended beyond the sales and use tax area).

The Supreme Court's statements in *Quill* also indicate that physical presence is not required for other type taxes. The Court stated that "we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, . . ." *Quill*, 112 S.Ct. at 1914, and "in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, . . ." *Quill*, 112 S.Ct. at 1916.

I recognize the various arguments as to why the physical presence test should also apply to business activity taxes, i.e. it is incongruous to apply different constitutional standards to different type taxes, a taxpayer not physically present in a state does not receive services for which a state can ask something in return, taxation without physical presence constitutes taxation without representation, etc. Some physical presence proponents also argue that the Supreme Court has never found Commerce Clause nexus without some form of physical presence. "Moreover, the United States Supreme Court has never held in any state tax case that the nexus requirement of the Commerce Clause was satisfied in the absence of a taxpayer's physical presence in the state." H. Hyans & A.

Nogid, *supra*, at n. 3. However, the Supreme Court's statements in *Quill* that it has never applied a physical presence test to other type taxes must be taken at face value.[4]

If a taxpayer's physical presence in a state is not required, then what contacts are sufficient to establish Commerce Clause "substantial nexus" outside of the sales and use tax area? Arguably, the Supreme Court's pre-*Quill* cases would apply that did not distinguish between Due Process Clause and Commerce Clause nexus. In that case, some form of economic activity or presence in the taxing state would be sufficient, as long as the taxpayer has "minimum contacts" with the state and interstate commerce is not unduly burdened. That must be decided on a case-by-case basis.

Turning to this case, there is no question that a state has jurisdiction to tax a nonresident on income derived from property owned or business transacted by the nonresident in the state. *Shaffer v. Carter*, 40 S.Ct. 221 (1920). The issue in this case, however, is whether Alabama has jurisdiction to tax a nonresident whose only connection with Alabama is his limited partnership interest in an Alabama limited partnership. The Department argues that the Taxpayer has nexus with Alabama because the limited partnership has nexus with Alabama. "The (constitutional) test is whether or not the entity earning the income has 'minimum contacts' with Alabama rather than the nonresident partner that is allocated the tax burden of the entity." (emphasis in original.) Department's Brief at 16. In other words, the Department asserts that for nexus purposes the presence and activities of Quad-L in Alabama must be passed through or attributed to the Taxpayer.

---

[4] This finding does not necessarily mean that the taxpayers in *Cerro Copper* and *9.4% Manufactured Housing* had nexus with Alabama. The taxpayer in *Dial Bank* otherwise had nexus with Alabama through its ownership of tangible property it leased in Alabama.

I disagree.

Before 1997, Alabama generally recognized the aggregate theory of partnerships. See, *Ford v. Mitchem*, 298 So.2d 34 (Ala. 1974). Under the aggregate theory, which is rooted in the common law, a partnership is an aggregation of its partners, and the partners are deemed to own the partnership's property and be doing the partnership's business. In that case, the activities and presence of a partnership in a state can be attributed to a nonresident partner who is availing himself of the benefits of the state through the partnership, and thus is subject to the state's taxing jurisdiction.[5]

Alabama law changed when it adopted the entity theory of partnerships pursuant to the Uniform Partnership Act of 1996, Code of Ala. 1975, §10-8A-101, et seq., effective January 1, 1997. Code of Ala. 1975, §10-8A-201 provides that a "partnership is an entity distinct from its partners." That provision also applies to limited partnerships. Code of Ala. 1975, §10-9B-1205.[6] The 1996 Act further provides that the property of a partnership belongs to the partnership, and not to the partners individually. Code of Ala. 1975, §10-8A-203.

---

[5] This is consistent with the Administrative Law Division's holding in *State of Alabama v. Allen*, Inc. 88-211 (Admin. Law Div. 6/15/89), in which a Florida limited partner in an Alabama limited partnership was held liable for Alabama income tax on royalty income derived from Alabama sources. Although not discussed, it was assumed that the Florida limited partner was the owner of the partnership's property, and had nexus with Alabama through her interest in the Alabama partnership. As indicated, this is consistent with the aggregate theory of partnerships that applied in Alabama before 1997.

[6] The Taxpayer argues that §10-8A-201 does not apply in this case because the partnership did not affirmatively elect to be governed by the 1996 Act, citing Code of Ala. 1975, §10-8A-1106. I agree with the Department, however, that §10-9B-1205 controls over §10-8A-1106. See, Department's Brief at 14-16.

Because a partnership is a separate entity under current Alabama law, the presence and activities of a partnership in Alabama cannot be attributed to its nonresident partners for nexus purposes. Separate legal entities must be recognized as such for tax purposes. *State v. Capital City Asphalt, Inc.*, 437 So.2d 1288 (Ala.Civ.App.), aff'd, 437 So.2d 1291 (Ala. 1983).

Under the entity theory of partnerships, a partnership and its partners are analogous to a corporation and its shareholders.[7] It is axiomatic that a nonresident's ownership of stock in a corporation doing business in a state, without more, does not subject the shareholder to the state's taxing jurisdiction. *Shaffer v. Heitner*, 97 S.Ct. 2569 (1977). In *Shaffer*, the Supreme Court held that nonresident shareholders and directors in a Delaware corporation were not subject to Delaware's jurisdiction because they had not "purposefully availed themselves of the privilege of conducting activities within the forum State (cite omitted) in a way that would justify bringing them before a Delaware tribunal. Appellants have simply had nothing to do with the State of Delaware. Moreover, appellants had no reason to expect to be hauled before a Delaware court." *Shaffer*, 97 S.Ct. at 2586.

"It is well established that nexus with a corporation does not automatically establish nexus over an out-of-state shareholder." M. McLoughlin & W. Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-The-Box*, The State and Local Tax Lawyer, Vol. 8, June 2003, at n. 3. The same applies to a partnership

---

[7] The Department acknowledges the similarity between corporations and partnerships as entities separate from their shareholders and partners. "A corporation like a partnership, (see, Code of Ala. 1975, §10-8A-201) is an entity distinct from its partners or shareholders." Department's Answer at 3.

and its partners if the state recognizes the separate entity theory of partnerships, as does Alabama. This is especially true concerning limited partners, who under Alabama law have no control over the partnership's activities and are not liable for the partnership's debts. Code of Ala. 1975, §10-9B-303.

> These positions (that nonresident partners have nexus with a state based on the partnership's activities in the state) are based on the aggregate theory of partnership, which considers the partner to be doing the business of the partnership and to have an ownership interest in partnership property. As stated above, the UPA (Alabama's old partnership statute), which adopts the aggregate approach would provide support for this position. However, in those states that have adopted the RUPA (Code of Ala. 1975, §10-8A-101 et seq.), which embraces more of an entity approach to partnerships, one may argue that the states should treat the partnership interest like an investment in a corporate entity . . . Similarly, states that follow the ULPA (Code of Ala. 1975, §10-9B-101 et seq.) would find little support in that act for holding that out-of-state limited partners have nexus based on application of the aggregate theory.

M. McLoughlin & W. Hellerstein, *supra*, at 24.[8]

The federal courts have also held that the physical presence and activities of a limited partnership in a state cannot be attributed to an out-of-state limited partner for jurisdictional purposes. *Marriot PLP Corp. v. Tuschman*, 904 F.Supp. 461 (D.C. Md. 1995), (4th Cir. 1996) ("Shareholders in a corporation do not subject themselves to personal

---

[8] For other authority and cases supporting the above holding, see, P. Lowry & J. Vasquez, *When is it Unconstitutional for States to Tax Nonresident Members of Limited Liability Companies?*, State Tax Notes, May 19, 2003; J. Haas, *Passthrough Nexus? Nexus Issues for Nonresident Corporate Partners, Members, and Shareholders*, State Tax Notes, May 12, 2003, at 561 ("The acts under which these (passthrough) entities are formed establish the separate nature of the entity from its owners. . . For limited partners, there is the provision that the limited partner is not liable for the actions of the partnership . . . Nexus attribution runs afoul of these well-established concepts." Haas, *supra*, at 563.); E. Fay & S. Amitay, *Attention LLC Members: Is Nexus a Foregone Conclusion?*, State Tax Notes, Sept. 10, 2001, at 821; P. Peabody, *Asserting Jurisdiction Over Nonresident LLC Members in the State Arena*, J. Multistate Tax'n., July 2000, at 6.

jurisdiction in the forum in which the corporation was formed (cite omitted). . . The same rationale applies to limited partners who, like shareholders, are passive investors with limited liability (cite omitted). . . ." *Marriot PLP*, 904 F.Supp. at 466); *Construction Aggregates, Inc. v. Senior Commodity Company*, 86 F.Supp. 1176 (E.D. Tex. 1994) ("And it strains reason to infer that anyone buying a limited partnership interest as a passive investment in a Texas limited partnership impliedly consents to or expects to be hauled into court . . . in Texas." *Construction Aggregates*, 860 F.Supp. at 1180); see also, *Sher v. Johnson*, 911 F.2d 1357 (9th Cir. 1990).

The Department cites *Borden Chemicals*, *supra*, at n. 2, and *Agley v. Tracy*, 719 N.E.2d 951 (Ohio 1999) in support of its position. In *Borden Chemicals*, an Illinois court held that a nonresident's limited partnership interest in an Illinois limited partnership provided the minimum contacts necessary to subject the nonresident to tax in Illinois. The court also attributed the partnership's presence in Illinois to the nonresident partner. *Borden Chemicals*, 726 N.E.2d at 81.

In *Agley*, an Ohio court held that nonresidents that owned stock in an S corporation doing business in Ohio were subject to Ohio's taxing jurisdiction. The court found that the taxpayers, "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." *Agley*, 719 N.E.2d at 953.

Borden Chemicals does not apply because Illinois apparently follows the aggregate theory of partnerships. As discussed, Alabama now follows the entity theory, which requires that a partnership and its partners must be recognized as separate entities.

Agley also should not be followed because the court failed to address the separate entity status of the S corporation and its shareholders. The U. S. Supreme Court's holding in *Shaffer v. Heitner* was ignored.

The Department's case also is not supported by the holding in *International Harvester Co. v. Dept. of Treasury*, 64 S.Ct. 1019 (1944), which the Illinois court primarily relied on in *Borden Chemicals. International Harvester* holds that a state can tax income earned in the state that is to be distributed to a nonresident. However, the taxpayer required to withhold and remit the tax in *International Harvester* was the in-state corporation over which the state had jurisdiction, not the out-of-state shareholder. *International Harvester* does not hold that a state has jurisdiction to directly tax a nonresident shareholder with no other ties to the state. The Supreme Court held just the opposite in *Shaffer v. Heitner*.

The Department also cites *Department of Revenue v. Sledge*, 528 S.E.2d 260 (2000), in support of its position. The facts in *Sledge* are to a point similar to this case. Tennessee residents with no other connection to Georgia owned a limited partnership interest in two Georgia limited partnerships. The partnerships were managed by general partners in Georgia, and invested solely in securities. The Georgia Court of Appeals held that Georgia income tax was due on the nonresident limited partners' income from the partnerships.

Sledge can be distinguished, however, because Georgia law required the in-state partnerships to withhold Georgia tax from the nonresidents' share of the partnerships' profits. That is clearly authorized by the Supreme Court's holding in *International Harvester*, and, as discussed below, Alabama law also now requires partnerships and other

subchapter K entities to withhold Alabama income tax from distributions to nonresidents under certain circumstances. See, *infra*, at 16. But just as *International Harvester* does not hold that a state can directly tax a nonresident shareholder, *Sledge* does not hold that a state has jurisdiction to directly tax a nonresident limited partner with no other ties to the state, as the Department is attempting to do in this case.

The U.S. Supreme Court has held that a third party's activities in a state may be attributed to a nonresident taxpayer for nexus purposes under certain circumstances. See, *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 107 S.Ct. 2810 (1987); *Scripto, Inc. v. Carson*, 80 S.Ct. 619 (1960). But for *Tyler Pipe* and *Scripto* to apply, the in-state party must be acting on behalf of or representing the nonresident in furtherance of the nonresident's business in the state. That did not occur in this case because Quad-L, not the Taxpayer, was conducting business in Alabama. Quad-L also was not acting as agent for the Taxpayer because the Taxpayer, as a limited partner, was not liable for the debts or actions of the partnership.

> Few cases address the question of whether a partnership operates as an agent or representative of the partners in order to create nexus for the corporate partners. However, such an argument might be difficult to make in regard to corporate limited partners at least when the facts revealed that the limited partners were passive investors and the partnership, as a matter of substance, could not be considered the in-state representative or agent of the partners under the "entity" theory of partnerships. If a state were to advance the argument that the partnership is acting as an in-state representative for the limited partners, thereby establishing nexus over the limited corporate partner, the Supreme Court's opinions in *Scripto* and *Tyler Pipe* would constitute the controlling constitutional authority. In those cases, the Court held that where an out-of-state entity has representatives in the state that help establish the market for the out-of-state entity, the in-state representatives' nexus will be attributed to the out-of-state entity. Thus, if the limited partnership solicits sales, for example, on behalf of an out-of-state corporate limited partner, the state would have a strong position to assert attributional nexus. However, a state would have difficulty making an

> attributional nexus argument for the limited partner based solely on the fact that the limited partnership is doing business in the state, at least when the state is relying on the entity theory rather than the aggregate theory of partnerships for its assertion of nexus.

M. McLoughlin & W. Hellerstein, *supra*, at 36.[9]

Rev. Rul. 96-005, which the Department issued in September 1996, also supports the Taxpayer's case. That Ruling held that a nonresident member of an Alabama LLC was not doing business in Alabama through the LLC for Alabama franchise tax purposes. The Department's rationale was that because under Alabama law an LLC member does not own the LLC property and is not liable for the debts of the LLC, the business activities of the Alabama LLC could not be attributed to the nonresident member.

The Ruling distinguished between an LLC member, which as indicated does not own the LLC's property and is not liable for the LLC's debts, and a partner in a partnership, which under then applicable Alabama law (the pre-1997 aggregate theory of partnerships) was considered the owner of the partnership's property and liable for the partnership's debts. However, under the now applicable entity theory, a limited partner does not have an interest in the partnership's property and is not liable for the partnership's debts. Consequently, under current Alabama law, a nonresident limited partner's tax status is now

[9] The McLoughlin and Hellerstein article, and also some of the articles cited in footnote 8, *supra*, addresses the issue as it applies to corporate limited partners. However, the same rationale should also apply to individual partners. The Due Process Clause applies equally to all "taxpayers," which Alabama law broadly defines to include corporations, individuals, and other entities, see, Code of Ala. 1975, §§40-2A-3(22) (general definition), and 40-18-1(13) (income tax definition). ". . . the *International Shoe* court believed that the (jurisdictional) standard it was setting forth governed actions against natural persons as well as corporations, and we see no reason to disagree." *Shaffer*, 97 S.Ct. at 2579, n. 19.

equivalent to the nonresident LLC member's status in Rev. Rul. 96-005. See also, Rev. Rul. 98-002 for a similar result.

Alabama law allows (and hopefully encourages) individuals to invest in Alabama through a variety of entities, i.e. partnerships, limited partnerships, LLCs, corporations, etc. Each type of entity provides different legal duties, obligations, benefits, and protections to its partners, members, or shareholders. The Taxpayer in this case elected to invest in Alabama through a limited partnership, which under Alabama law is a separate, distinct entity. Alabama law also provides that as a limited partner, the Taxpayer does not own, manage, or otherwise control the partnership's property and is not liable for the partnership's debts or actions. The Taxpayer is thus a passive investor similar to a nonresident shareholder in an Alabama corporation. Given those legal protections, the Taxpayer could not reasonably expect "to be hauled into court" in Alabama. *Construction Aggregates*, 860 F.Supp. at 1180. Contrary to the Department's claim, due process requires that the nonresident individual or entity being taxed must have "minimum contacts" with the taxing state, not the separate entity from which the income flows.

In any case, the Alabama Legislature has effectively resolved the Department's jurisdictional "problem" for tax years beginning after January 1, 2001. Subchapter K entities in Alabama may now file composite returns for its nonresident members or shareholders. Nonresident members or shareholders must also agree to be subject to Alabama's jurisdiction and file Alabama returns and pay tax on their subchapter K income. If an agreement is not filed, or the nonresident fails to pay the tax due, the subchapter K entity is

liable for the tax. See, Code of Ala. 1975, §40-18-24.1.[10] That provision is constitutionally valid because a nonresident may voluntarily submit to a state's jurisdiction, and, as discussed, a state may also require an in-state entity to withhold and pay tax on income earned or sourced in the state that is to be distributed to a nonresident partner or shareholder. *International Harvester*, *supra*.[11]

The above holding does not affect the nature of a partnership as a conduit through which the partnership income passes to the partners for tax purposes, the same as under federal law, 26 U.S.C. §701, et seq. And nonresident partners that otherwise have nexus with Alabama can still be directly assessed by the Department on their pro rata share of partnership income attributable to Alabama. This case holds only that a nonresident limited partner's ownership interest in an Alabama limited partnership does not, by itself, establish the constitutionally required "minimum contacts" necessary for the nonresident to be subject to Alabama's taxing jurisdiction. But as discussed, Alabama can still tax the nonresident's partnership income through the withholding requirements of §40-18-24.1.

---

[10] As a consequence of §40-18-24.1, a partnership is now a taxable entity in Alabama under certain circumstances. Department Reg. 810-3-24-.01(1)(a) is thus no longer correct in stating that "a partnership is . . . not a taxable entity under Alabama income tax law."

[11] Numerous other states have also enacted similar subchapter K withholding provisions in recent years. See, B. Ely & C. Grissom, *The LLC/LLP Scorecard – 2002 Update*, State Tax Notes, Nov. 18, 2002, at 463. Some states have also for policy reasons exempted the investment income of nonresidents from income tax in the state. See, the *amicus* brief of the Alabama Society of Certified Public Accountants, at 14-17. I agree with the Department, however, that it is for the Alabama Legislature to establish such policy in Alabama through legislation, and not the Administrative Law Division or Alabama's courts.

Issue (2). Was the Income From "Property Owned or Business Transacted" in Alabama?

A full analysis of this issue is pretermitted by the above holding. Briefly, however, because intangible income is generally sourced at the domicile of the owner, the issue turns on whether Quad-L's investment portfolio was owned by the partnership or the partners of the partnership. Under current Alabama law a partnership's property is owned by the partnership, not its partners.[12] Consequently, Quad-L owned the investment portfolio, and the income from the portfolio was thus sourced in Alabama, the partnership's commercial domicile. Likewise, when the income was passed through to the partners for tax purposes, the partners were required to treat the income as being "realized directly from the source from which realized by the partnership." Dept. Reg. 810-3-24-.03(2); see also, 26 U.S.C. §702(b). The income would thus be taxable to the partners as Alabama source income. But as discussed, the Taxpayer, as a nonresident limited partner, could be directly assessed only if he otherwise had the minimum contacts with Alabama necessary to be subject to Alabama's taxing jurisdiction. Owning a limited partnership interest in an Alabama limited partnership, by itself, was insufficient.

The above only applies to partnerships governed by the 1996 Partnership Act, §10-8A-101 et seq., which recognizes the entity theory of partnerships. If it is determined that the 1996 Act does not apply in this case, then arguably the presence and activities of

[12] The Taxpayer argues that Quad-L must be recognized as a separate entity for nexus purposes, but that the Taxpayer should be deemed to own the partnership's property for income tax purposes. The first argument is correct, but as discussed, under current Alabama law a partnership's property is owned by the partnership, not its partners. Section 10-8A-203.

Quad-L in Alabama could be attributed to the Taxpayer for nexus purposes under the common law aggregate theory of partnerships. See, *Allen*, *supra*, at n. 5. But in that case, the Taxpayer would also be deemed to own the partnership's property, and thus the portfolio income would be sourced to and taxable in Georgia, the Taxpayer's state of domicile.

Issue (3). The Administrative Procedures Act.

This issue is also pretermitted by the holding in issue (1). In any case, there is insufficient evidence proving the Taxpayer's claim that the Department had a long-standing policy of not taxing nonresident partners on portfolio income from an Alabama partnership. The testimony of the Taxpayer's CPA to that effect, while believable, is insufficient to prove the point.[13] The Department also failed to present any evidence that it had previously taxed nonresident partners on partnership portfolio income. However, the burden was on the Taxpayer to prove the point, not the Department.

It also could be argued that any change in the Department's position, if in fact a change occurred, was due to the enactment of the 1996 Partnership Act, which changed Alabama law by adopting the entity theory of partnerships. Any change in the Department's position was thus caused by a change in the applicable law, and not by the Department's unilateral administrative change in policy or interpretation of the law, as argued by the Taxpayer.

The final assessments in issue are dismissed.

---

[13] The affidavit of another CPA submitted by *amicus* for the Taxpayer is inadmissible and cannot be considered, although it also would be insufficient to prove the point argued by the Taxpayer.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered September 26, 2003.