TANNER & GUIN, LLC 2711 UNIVERSITY BLVD. TUSCALOOSA, AL 35401-1465,	§ §	STATE OF ALABAMA ALABAMA TAX TRIBUNAL DOCKET NO. BIT. 14-502
Taxpayer,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Tanner & Guin, LLC ("Taxpayer") for 2012 business income tax. The Taxpayer appealed to the Administrative Law Division, now the Tax Tribunal, pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on February 19, 2015. Jay and Jonathan Guin represented the Taxpayer. Assistant Counsel Craig Banks represented the Department.

The Taxpayer is a law firm based in Tuscaloosa, Alabama. The Taxpayer began a merger with a Columbus, Mississippi law firm, Nichols, Crowell, Gillis, Cooper & Amos, PLLC, in 2012. Instead of engaging in a statutory merger, the parties agreed to admit four of the five members of the Mississippi firm as new members of the Taxpayer's firm. The Taxpayer officially changed its name to Tanner, Guin, and Crowell, LLC, effective October 1, 2012.

The Mississippi attorneys continued to practice in Mississippi in 2012. The Taxpayer made guaranteed payments to those attorneys in 2012 based on their individual billings and collections during the year. The Taxpayer issued each of the Mississippi attorneys a K-1 for 2012. As stated in the Taxpayer's notice of appeal at 3 – "For the 2012 tax year, (the Taxpayer) issued to each of the Columbus attorneys a K-1 because they'd been treated as partners on the books of (the Taxpayer). . . ."

The merger ultimately failed, and the parties entered into a formal termination agreement in May 2013.

The Taxpayer failed to file a 2012 composite income tax return (Form PTE-C) pursuant to Code of Ala. 1975, §40-18-24.2(b)(1) and remit the Alabama tax due on the guaranteed payments made to the nonresident Mississippi attorneys in 2012. The Department subsequently assessed the Taxpayer for the tax due on the guaranteed payments. This appeal followed.

The Taxpayer argues that it was not required to file a 2012 composite return because the Mississippi attorneys were employees of the Taxpayer, and not partners. It further contends that Alabama has specifically incorporated or adopted federal law for income tax purposes. It asserts that under federal law, and specifically, 26 C.F.R. §1.707-1(c), guaranteed payments are not a part of a partner's distributive share of a partnership's income, in which case the Taxpayer was not required to report the guaranteed payments to the Mississippi attorneys on a composite return.

The Department contends that because the Taxpayer treated the Mississippi attorneys as partners for tax purposes in 2012, it is now estopped from claiming that they were not partners. It also asserts that the limited exclusion in 26 C.F.R. §1.707-1(c) of guaranteed payments from being included as part of a partner's distributive share does not impact Alabama's nonresident composite return scheme. The Department's brief on the above issues reads as follows:

<u>The Taxpayer Treated the Mississippi Attorneys as Partners</u>

> First, for purposes of taxation, the Taxpayer claimed that the Mississippi attorneys were partners for the 2012 tax year. As evidence of this tax treatment, the Taxpayer issued the Mississippi attorneys K-1s for the 2012

tax year and treated them as partners for its 2012 tax return. Because the Taxpayer claimed that the Mississippi attorneys were partners for purposes of its 2012 tax return, the Taxpayer is now estopped from denying that fact. "[A] taxpayer may not be heard to challenge his prior election of the existence of a business entity for tax purposes once the existence of that entity becomes inconvenient. See McManus v. C.I.R., 583 F.2d 443, 447 (9th Cir. 1978) ('A taxpayer is estopped from later denying the status he claimed on his tax returns.'); Maletis v. United States, 200 F.2d 97, 98 (9th Cir.1952) ('The burden is on the taxpayer to see to it that the form of business he has created for tax purposes, and has asserted in his returns to be valid, is in fact not a sham or unreal.')."

In its answer, the Taxpayer attempts to avoid the preclusive impact of estoppel by pointing to two cases in which the Federal Courts considered factors other than the tax returns in determining whether an individual was actually a partner in a pass-through entity. See Crescent Holdings, LLC v. Comm'r., 141 T.C. No. 15 (2013); Cahill v. Comm'r, T.C. Memo 2013-220 (2013). Both of these cases, however, are inapposite.

There is a fundamental fact difference between the Taxpayer's current appeal and the situations presented in Crescent Holdings and in Cahill. In both Crescent Holdings and in Cahill, an individual was challenging his status as a partner of a pass-through entity. In each case, the entity had issued a K-1 to the individual and treated the individual as a partner on the entity's tax return. In each case, the individual had no control over whether the entity claimed him as a partner on its tax return and issued him a K-1. Thus, because the individual did not make the decision regarding the entity's tax return or its decision to issue a K-1, it is perfectly logical to allow the individual to avoid estoppel and use other evidence to attempt to prove that he was not a partner. In this case, the Taxpayer chose to classify the Mississippi attorneys as partners on its 2012 tax return and to issue K-1s to the Mississippi attorneys. The Taxpayer was in full control of its tax treatment of the Mississippi attorneys, and, therefore, the Taxpayer should now be estopped from denying that tax treatment. See Blonien v. C.I.R., 118 T.C. No. 34 (prohibiting, in a later proceeding, a partnership from claiming that an individual was not a partner when it had claimed that the individual was a partner on its tax return).

Secondly, the Taxpayer treated the Mississippi attorneys as partners. The Taxpayer changed its name from Tanner & Guin, LLC, to Tanner, Guin, and Crowell, LLC – adding the name of one of the Mississippi attorneys to the firm name – and held itself out to the public as such. See Department's Exhibit #1. According to Mr. Guin's testimony at the hearing, Mr. Crowell was also added to the Taxpayer's three-member executive committee. Moreover, the Mississippi attorneys were paid in the same manner as the other

partners. Thus, from the evidence before this Court, it appears that the Taxpayer treated the Mississippi attorneys as partners in the Taxpayer's organization.

The Payments are Subject to the Form PTE-C Withholding Requirement, Whether the Payments were Guaranteed Payments to Partners or Part of the Partner's Distributive Share.

First, the guaranteed payments were properly considered as part of the Mississippi attorneys' distributive share for the purposes of the non-resident composite payment return. Alabama law requires that each "pass-through entity shall file with the Department of Revenue, at the time the entity's annual return is required to be filed with the Department of Revenue for each taxable year, a composite income tax return on behalf of its nonresident members and shall report and pay the income tax imposed by this chapter at the highest applicable marginal rate provided in Section 40-18-5 on the nonresident members' distributive shares of the income of the pass-through entity apportioned and allocated at the entity level to this state under Chapter 27 of this title." § 40-18-24.2(b)(1), Ala. Code 1975. For the purposes of filing a Form PTE-C and withholding the associated tax, Department regulation defines what is considered part of a member's distributive share. "Gross income of a nonresident partner of a partnership includes the distributive share of the partnership income (or the loss not to exceed bases), plus any "Guaranteed Payments to Partner." Ala. Admin. r. 810-3-14-.05. Thus, according to Alabama law and Department regulation, the guaranteed payments made by the Taxpayer to the Mississippi attorneys should have been included on a From PTE-C for the 2012 tax year.

The Taxpayer argues that the Department's regulation defining guaranteed payments as part of the partner's distributive share for the purposes of the Form PTE-C requirements conflicts with the treatment of guaranteed payments under the Treasury regulations. The Taxpayer, however, is incorrect – no conflict exists between the Department's regulation and the Treasury regulation. The limited exclusion of guaranteed payments from being considered as part of a partner's distributive share does not impact Alabama's Form PTE-C filing scheme. 26 C.F.R. §1.707-1(c) states, in pertinent part:

> "Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable

> year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of § 1.706–1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses)."

The Internal Revenue Service treats guaranteed payments differently from distributive share payments for certain limited purposes because the two types of payments have different potential tax implications for the partnership and the partner. This is not an issue with the requirements of section 40-18-24.2(b)(1), as the consolidated filing scheme is designed to function as a system of tax withholding rather than a system intended to determine the precise amount of tax owed by the individual partner. See § 40-18-24.2(b)(2)(stating that "[a] nonresident member that has been included in a composite income tax return filed pursuant to this section may file its own Alabama income tax return and shall receive credit for Alabama income tax paid on the member's behalf by the pass-through entity). Therefore, the limited exclusions offered in the Treasury regulation are not applicable to the state of Alabama's consolidated nonresident partner filing scheme. 26 C.F.R. § 1.706-1 goes on to state that "[f]or the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income." Thus, it is only for narrowly defined purposes that the Internal Revenue Service considers a guaranteed payment as separate from the partner's distributive share. The narrow exclusion in the Internal Revenue Service regulations poses no conflict with the Department's regulation related to the filing of a composite return for nonresident members of a pass-through entity. The requirement created by section 40-18-24.2(b)(1) to file a consolidated return for nonresident partners of a pass-through entity and to remit tax to the Department is wholly a creation of the Alabama legislature. There is no Federal counterpart to the state's nonresident partner consolidated filing scheme. Thus, for the purposes of the state's consolidated filing requirement, which is in essence a withholding scheme rather than an attempt to determine the precise amount of tax owed by each partner, the state's filing scheme falls under the broad "all other purposes" portion of 26 C.F.R. § 1.701-1(c).

Alabama's Form PTE-C withholding requirements are designed to withhold tax from potentially apportionable payments made by a pass-through entity to its non-resident members. For the withholding requirement, it does not matter whether the member will ultimately apportion all of the income to Alabama – it matters only that the income is potentially apportionable. The entire purpose of the withholding requirement is to encourage non-resident members of pass-through entities to file Alabama income-tax returns, so that

> the State can collect the proper amount of tax that is due. To exclude guaranteed payments to partners from the withholding requirement would subvert the entire purpose of the law, as it would allow a pass-through entity to structure its payments to a non-resident member in such a way as to avoid the withholding and, ultimately, to allow the non-resident member to avoid filing an Alabama income-tax return or paying income-tax to Alabama. The guaranteed payments made to the Mississippi attorneys represent business income to the Mississippi attorneys. As business income, it is potentially apportionable to Alabama when the member files his or her income-tax return.

Department's Brief at 1 – 4.

I agree with the Department that because the Taxpayer purposefully elected to treat the Mississippi attorneys as partners in 2012 for tax purposes, it is bound by that election for purposes of Alabama's nonresident composite return scheme. I also agree that the Taxpayer's guaranteed payments to the Mississippi attorneys were a part of the distributive share paid to those partners for purposes of the nonresident composite return scheme.

If a partner in an Alabama pass-through entity resides outside of Alabama and has no contacts with Alabama other than being a nonresident partner in the entity, the State may not be able to assess and collect the Alabama tax due on the entity's income that is distributed or paid to the nonresident member or partner. To resolve the problem, the Alabama Legislature enacted the nonresident composite return requirement at Code of Ala. 1975, §40-18-24.2(b)(1). See generally, *Tsitalia, LLC v. State of Alabama*, Docket BIT. 12-492 (Admin. Law Div. 2/1/2013).

The levy is against the Alabama entity, see, Code of Ala. 1975, §40-18-24.2(c)(1), and the entity is required to file a composite return and pay the tax due, even if the nonresident partner is not liable for Alabama tax on the distributive income. In that case, the nonresident can file an Alabama return, receive a credit for the tax paid by the entity on

the nonresident's behalf, see Code of Ala. 1975, §40-18-24.2(b)(2), and obtain a refund of the amount paid.[1]

Alabama's income tax laws are generally patterned after the corresponding provisions in the Internal Revenue Code. *State, Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala. Civ. App. 1994). For example, Code of Ala. 1975, §40-18-15(a)(1) allows an Alabama income tax deduction for all ordinary and necessary expenses, as determined in accordance with (the corresponding IRC section) 26 U.S.C. §162. The above does not mean, however, that all IRC provisions, regulations, and precedents apply.

There is no provision in the IRC comparable to or corresponding with Alabama's §40-18-24.2(b)(1) composite return requirement. Rather, it is an Alabama-specific statute separate and apart from federal law, and must be construed accordingly. The provision also is not intended to and does not compute or otherwise determine a pass-through entity's income tax liability. Consequently, the IRC provisions and related regulations governing the computation of a pass-through entity's items of income, gain, loss, basis, earnings and profits do not apply.

The Department is correct that the composite return provision is in the nature of a withholding provision whereby the entity is required to pay tax on the income paid to a nonresident partner/member. The tax is computed on the total amount paid to a nonresident partner, including any guaranteed payments paid by the entity to the partner.

[1] This case is complicated by the fact that the Mississippi attorneys would receive the refunds of any amounts overpaid by the Taxpayer on their behalf. But whether the Taxpayer may have a claim against the Mississippi attorneys for the refund amounts is between those parties, not the Tax Tribunal.

See, Department Reg. 810-3-14.05(d)(4). The Department thus correctly assessed the Taxpayer on the guaranteed payments to the Mississippi partners in 2012.

The final assessment is affirmed. Judgment is entered against the Taxpayer for tax, penalties, and interest of $8,961.66. Additional interest is also due from the date the final assessment was entered, April 16, 2014.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2B-1(m).

Entered May 4, 2015.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Craig A. Banks, Esq.
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Jonathan Guin, Esq.