Sooner Rather Than Later: Oklahoma Court of Civil Appeals Upholds Distinct Withholding Requirements For Nonresident Royalty Owners

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As we await the U. S. Supreme Court’s guidance on whether states may provide an exemption for interest earned solely on bonds issued by the state\(^1\), another state-specific distinction is challenged and upheld in \textit{Panhandle Producers And Royalty Owners Association v. Oklahoma Tax Commission}, 162 P.3d 960 (Okla. Civ. App. 2007). In the more recent case, the Oklahoma Court of Civil Appeals ruled that an Oklahoma statute requiring income tax withholding on royalty payments made to nonresidents did not violate the Privileges and Immunities, Equal Protection or Commerce Clauses of the United States Constitution. Rejecting the constitutional challenges to the statute, the Oklahoma Court held that payors of oil and gas royalties could be required to withhold income tax from the royalty payments to nonresidents, even though similar withholding was not required for Oklahoma residents.

Background

Panhandle Producers and Royalty Owners Association ("PPROA") is a trade association representing royalty owners in Texas, Oklahoma and Kansas. In order to maintain jurisdiction, PPROA was joined in its suit by Cambridge Producers, Ltd. and Thomas R. Cambridge (collectively referred to as the "Plaintiffs"). The Plaintiffs sought a declaratory judgment that Section 2385.26 of the Oklahoma Statutes imposed disparate taxation based upon the state of residence in violation of the Privileges and Immunities, Equal Protection and Interstate Commerce Clauses of the United States Constitution. Plaintiffs argued that the statute was unconstitutional because the statute required withholding on royalty payments to nonresidents, but allowed Oklahoma residents to pay those taxes when they filed their income tax returns. The Oklahoma Tax Commission (the “OTC”) countered that the statute was constitutional as it did not impose different tax rates based upon residency but instead was only a different method of collecting the taxes due.

Section 2385.26 requires payors of oil and gas royalties to withhold 5% of such amounts and remit the withholding to the OTC. The statute exempts from the withholding requirements those royalty payments made to residents of Oklahoma and

\(^1\) Department of Revenue of Finance and Admin. Cabinet, 127 S.Ct. 2451, 2007 WL 1461084 (U.S. May 21, 2007) (No. 06-666).
allows nonresidents credit towards their Oklahoma tax liability for the amounts withheld as well as refunds of amounts withheld in excess of any taxes owed.

The Oklahoma Court began its analysis by reviewing basic principles of statutory construction. In assessing the constitutionality of any given statute, the Oklahoma Court noted certain fundamental tenets which must be respected. First, a legislative act is presumed to be constitutional and will be upheld unless it is clearly, palpably and plainly inconsistent with the Constitution. In addition, statutes, whenever possible, should be construed so as to uphold their constitutionality. In assessing statutes, the Oklahoma Court noted that it would not look to the Constitution to determine whether the legislature was authorized to do an act but rather to see whether that act was prohibited. Finally, the Oklahoma Court noted the United States Supreme Court’s mandate that, in taxation, even more than in other fields, the legislature possesses the greatest freedom in classification. It was against this backdrop that the Oklahoma Court analyzed the Plaintiffs’ constitutional challenges to the statute.

The Constitutional Challenges

In attacking the withholding statute, the Plaintiffs argued that the statute discriminated in two ways. First, through the withholding mechanism, nonresident taxpayers were deprived of the time value of money for the period of time between the time that the taxes were withheld and remitted to the OTC and the time of any receipt of those funds via refunds. The Plaintiffs argued that by withholding income taxes from royalty payments made to nonresidents while allowing Oklahoma residents to pay those taxes at the time of filing their income tax returns, Oklahoma resident royalty owners enjoyed the use of the tax money up until the time they filed their income tax returns. In contrast, nonresidents are deprived from using those same tax dollars to their advantage prior to the time their tax returns are filed.

The Plaintiffs’ second argument was that the statute discriminated against nonresidents by requiring them to file tax returns to claim refunds of overpaid withholding while Oklahoma residents with low incomes were not similarly required to file returns. The Plaintiffs argued that, due to the low threshold (Oklahoma source income of $1,000 or more) for which nonresidents must file returns, virtually all nonresident royalty owners will be required to file returns to gain a refund of the withheld amounts. In contrast, Oklahoma residents who have not had amounts withheld will not face this burden as long as their gross income is less than $16,400 (the amount above which Oklahoma residents must file income tax returns). The Plaintiffs argued that the remedy to this situation was to require withholding on payments to all royalty owners, not just nonresident royalty owners.

Privileges and Immunities and Equal Protection Clause Analysis

The United States Constitution prohibits states from enforcing laws that “abridge the privileges or immunities of citizens of the United States" or laws that deny individuals
“equal protection of the laws.” The Oklahoma Court concluded that these constitutional provisions did not invalidate the Oklahoma statute at issue.

The Oklahoma Court began its analysis on these points by reviewing a previous Oklahoma Attorney General’s opinion that determined that the withholding statute at issue was constitutional based upon prior United States Supreme Court precedent. In that case, the Supreme Court upheld a New York statute which directed employers to withhold income taxes from the wages of employees who worked in New York but lived outside the State. At the time of the Supreme Court’s decision, New York did not have a similar withholding statute affecting the wages of its residents. The Supreme Court found that the withholding statute was constitutional under both the Privileges and Immunities and Equal Protection Clauses of the Constitution.

In analyzing the New York statute, the Supreme Court referred to its holding in a second case wherein the Supreme Court approved states taxing nonresidents based on income earned in the taxing state. The Supreme Court also found that, as to withholding taxes only from nonresidents, there was no actual discrimination because the tax owed was the same for residents and nonresidents, regardless of the collection method. Finally, the Supreme Court held that the New York withholding statute was a reasonable method of insuring the collection of income taxes from nonresidents and stated that a statute which employs a different collection method for nonresidents but which does not tax nonresidents at a different rate than residents did not violate the Privileges and Immunities and Equal Protection Clauses of the United States Constitution. Based upon this reasoning, the Oklahoma Attorney General found the statute in question to be constitutional.

The Oklahoma Court also looked to other United States Supreme Court case law under the Privileges and Immunities Clause addressing state tax regulations classifying on the basis of residency. In *Lunding v. New York Tax Appeals Tribunal*, 522 US 287 (1998), the Supreme Court reiterated its prior ruling that nonresidents may be required to pay taxes that are not more burdensome in their effect than those imposed on residents. The Supreme Court also determined that different treatment of residents and nonresidents in state tax laws are to be judged by their practical effect rather than by their form. In passing such legislation, the state must first show a substantial reason for the difference and, second, that the different treatment bears a substantial relationship to the objective to be gained from the legislation.

With regard to the Oklahoma withholding statute at issue, the Oklahoma Court found that the OTC’s stated reason for the differing treatment between residents and nonresidents was that it was easier to secure payment of taxes on royalties paid to nonresidents by withholding the taxes before the income leaves the State. Prior decisions in Oklahoma have recognized the fact that, without the withholding mechanism in place, recovery of such amounts from nonresidents who did not file Oklahoma income tax returns would entail significant litigation. Avoidance of that burden is a substantial reason justifying the different treatment. Because the statute in question satisfied the test enunciated by the Supreme Court in *Lunding*, coupled with
the fact that the statute in question did not involve unequal taxing but only a difference in collection methods, the Oklahoma Court found that the Oklahoma statute did not violate the Privileges and Immunities Clause of the United States Constitution.

With regard to PPROA’s Equal Protection claim, the Oklahoma Court agreed with the position of PPROA that Supreme Court caselaw requires that a state show a rational basis for classifying taxpayers on the basis of residency and that such a classification must be reasonable and not arbitrary. Further, the classification must rest on a ground that has a fair and substantial relation to the goal of the statute. In holding that that Oklahoma statute did not violate the Equal Protection Clause, the Oklahoma Court found that the State’s interest in collecting taxes on royalty income before that income left the State provided a reasonable basis for a classification based on residency as contained in the Oklahoma statute.

Commerce Clause Analysis:

In its final contention, PPROA asserted that the dormant Commerce Clause of the Constitution bars any state from passing laws that interfere with interstate commerce. Under Commerce Clause jurisprudence, the Commerce Clause is the source of constitutional limits on the states’ ability to engage in economic protectionism through regulation and taxation of interstate commerce. This implied restriction on state regulation of interstate commerce is known as the dormant Commerce Clause. PPROA argued that a law which overtly blocks interstate commerce at the state’s borders is almost per se invalid and invokes the strictest scrutiny in assessing its constitutionality. As support for this proposition, PPROA relied upon the United States Tenth Circuit Court of Appeals’ decision in Dorrance v. McCarthy, 957 F.2d 761 (10th Cir. 1992).

In Dorrance, the Tenth Circuit addressed the analysis to be used in analyzing whether a state statute violates the dormant Commerce Clause. The Tenth Circuit noted that where a statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, the statute will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the asserted local benefits. The person challenging a statute in this situation bears the burden of showing that the incidental burden on interstate commerce is excessive compared to the local benefit. In contrast, if a statute discriminates against interstate commerce on its face or in its practical effect, the statute is subject to the strictest scrutiny and the burden shifts to the government to prove both the legitimacy of the purported local benefit and the lack of an alternative means to further the local interest with less impact upon interstate commerce.

The Oklahoma Court also recognized that the Supreme Court has set forth its interpretation of the dormant Commerce Clause’s limitations on the states’ power to tax in Quill Corp. v. North Dakota, 504 US 298 (1992). In Quill, the Supreme Court stated that its jurisprudence had evolved into a four part test which must be satisfied in order for a state statute to withstand a Commerce Clause challenge. Namely, the statute must: (1) be applied to an activity with a substantial nexus with the taxing state; (2) be
fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the state.

After examining these authorities, the Oklahoma Court noted that there was an essential distinction between Dorrance and Quill and other cases involving state tax laws challenged on Commerce Clause grounds in that the statute that PPROA challenged does not impose a tax but instead imposes a method of collecting a tax. When pressed at oral argument, PPROA conceded that it had found no cases addressing a tax withholding statute on Commerce Clause grounds. On its own initiative, the Oklahoma Court reviewed numerous statutes from other states which require withholding taxes from nonresidents in various types of transactions and found no cases addressing the constitutionality of those statutes.

Based upon these precedents, the Oklahoma Court found that the OTC had set forth a clear legitimate local purpose for the withholding classification based on residency. Further, the Plaintiffs had not shown that the burden on interstate commerce associated with the withholding was more than incidental or that this burden was excessive compared to the local interest set forth by the OTC. For these reasons, the Oklahoma Court determined that the withholding statute at issue did not violate the Commerce Clause and should be upheld.

**Practical Impact**

A large percentage of states now require withholding of amounts paid to nonresidents related to a variety of transactions. Responsibility for withholding such amounts is typically placed upon the payor even though the amounts withheld are applied against the recipients' tax liabilities.

Failure to withhold and remit the proper amount of withholding can subject payors to large penalties and could lead to audits for a variety of taxes that may not otherwise have been conducted. For these reasons, entities should carefully examine the withholding provisions for all states in which they conduct operations and put procedures in place to assist in identifying and quantifying the amounts to be withheld and remitted. These procedures, once established, generally should not place significant additional compliance burdens on the tax departments of entities paying amounts to nonresidents.