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Alabama Appellate Court Rules that Alabama Lacked Jurisdiction to Tax Nonresident Limited Partner

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The Alabama Court of Civil Appeals, in *Lanzi v. Department of Revenue* (No. 2040298, June 30, 2006) recently ruled that Alabama lacked the jurisdiction to impose its personal income tax on a nonresident whose only connection with Alabama was his investment as a limited partner in an Alabama limited partnership.

Background

The taxpayer, a Georgia resident, was a limited partner in an Alabama limited partnership. The partnership had been formed to manage the Lanzi family's investment assets. The taxpayer's parents, who were Alabama residents, were the general partners who monitored and managed the partnership's assets with the help of financial consultants located in Alabama. The taxpayer did not participate in managing the partnership or its assets and, aside from his partnership interest, did not own property, conduct business or have any other economic connection to Alabama during the tax years at issue. The taxpayer did not file an Alabama income tax return, but instead reported his share of the partnership's income on his Georgia income tax returns. Following an audit, the Alabama Department of Revenue ("DOR") assessed personal income taxes against the taxpayer.

The issue in this case was whether Alabama could tax a nonresident on his allocable share of the partnership's income. The taxpayer asserted that the assessment of Alabama personal income tax against him was not authorized under the Alabama statute and that it was invalid because it violated the Due Process Clause and the Commerce Clause of the U.S. Constitution. The DOR contended that the assessment was both statutorily authorized and constitutional.

The Administrative Law Judge ("ALJ") ruled in favor of the taxpayer, finding the imposition of Alabama income tax on the taxpayer to be unconstitutional. The DOR appealed the ALJ's order and the Alabama circuit court reversed the ALJ's order, concluding that the imposition of Alabama income tax on the taxpayer was constitutional. The taxpayer then appealed to the Alabama appellate court.

Court's Analysis Focuses on Federal Constitution

The appellate court's decision quickly glossed over the relevant Alabama statutory provisions before launching into the constitutional analysis. The court first noted that,

under the Due Process Clause, in order for a state to exercise jurisdiction over a nonresident taxpayer, the taxpayer must have sufficient “minimum contacts” with the taxing state. After noting that physical presence was not required under the Due Process Clause, the court cited to the U.S. Supreme Court’s decision in *Shaffer v. Heitner*, 433 U.S. 186 (1977), for the proposition that ownership of stock of a domestic corporation, without more, does not subject a nonresident shareholder to the state’s judicial jurisdiction.

Concluding that a nonresident’s limited partnership interest was “directly analogous” to a nonresident’s stock ownership, the appellate court concluded that Alabama could not subject the taxpayer to tax based on his ownership of a limited partnership interest.

Implications of the *Lanzi* Decision

The *Lanzi* decision adds another well-reasoned voice to the debate over whether a state can constitutionally tax a nonresident partner or a nonresident LLC member. It is not entirely clear whether the appellate court would have ruled any differently if the partnership had been engaged in the active conduct of a business in Alabama as opposed to being purely an investment partnership. Language in the decision suggests that this would not have mattered.

Most states contend that they have the constitutional authority to impose a state tax on nonresident partners (and LLC members). While the constitutional issue has not been addressed in many state courts, a few state courts have concluded that the imposition of state income tax on nonresident partners is constitutionally valid.¹ The debate over whether a state can constitutionally tax nonresident partners remains unresolved in many states.

Several states have rendered the debate largely moot, at least in the case of individual partners. Perhaps in recognition of the constitutional infirmity of their position and perhaps in light of the difficulty of collecting taxes from nonresident partners directly, states have devised alternative means of collecting income taxes on a nonresident partner’s share of partnership income. Some states subject partnerships to an entity-level tax on the portion of their taxable income attributable to nonresident partners. Other states do so, but only if the nonresident partners fail to file consents submitting to the state’s taxing jurisdiction or if the nonresident partners fail to file personal income tax returns reporting their allocable share of partnership income. Other states simply require partnerships to withhold tax on the nonresident partner’s allocable share of the partnerships’ income.

As a practical matter, the impact of the *Lanzi* decision in Alabama will also be limited. Alabama has since enacted laws which require partnerships that have income from property owned, or business conducted, in Alabama to file composite returns and pay tax on behalf of nonresident partners. An exception to this requirement applies if the partnership has filed with the DOR agreements by nonresident partners to be subject to

¹ See e.g., *Borden Chemicals & Plastics, L.P. v. Zehnder*, 726 N.E. 2d 73 (Ill. App. 2000).

Alabama's jurisdiction and to file returns and pay tax on their distributive share of Alabama source income.■



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