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Insights Into Recent Regulatory, Judicial and Legislative Developments

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## State Taxation of Nonresident Limited Partners May Be Unconstitutional

On June 30, 2006, the Alabama Court of Civil Appeals held that Alabama's attempted taxation of a nonresident limited partner's distributive share of partnership income violated the Due Process Clause of the U.S. Constitution. See *Lanzi v. Ala. Dept of Revenue*, No.2040298, 2006 Ala. Civ. App. LEXIS 406 (Ala. Civ. App. June 30, 2006).<sup>1</sup> This decision reversed the lower court's holding that the tax was constitutional.

### Lanzi and the Due Process Clause

In general, the Due Process Clause requires that, in order for a person to be subject to a state's taxing jurisdiction, the person must have certain "minimum contacts" with the state such that the state's exercise of jurisdiction does not offend "traditional notions of fair play and substantial justice." See *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945). Although it is well established that a state has jurisdiction to tax a nonresident on income derived from property owned or business transacted by the nonresident in the state, courts have split as to whether a state may tax a nonresident where the nonresident's only contact with the state is the ownership of an interest in a partnership or LLC that is conducting business in the state.

In holding that such contacts were insufficient to confer tax jurisdiction on the state, the Alabama Court of Civil Appeals relied on the U.S. Supreme Court's decision in *Shaffer v. Heitner*, 433 U.S. 186 (1977). In that case, the Court held that nonresident shareholders of a Delaware corporation were not subject to Delaware's jurisdiction because they had not "purposefully avail[ed themselves] of the privilege of conducting activities within [Delaware] in a way that would justify bringing them before a Delaware tribunal." *Id.* at 216 (citations omitted). The *Lanzi* court held that "[a] nonresident's interest in a limited partnership is directly analogous to a nonresident's ownership of stock in a corporation; thus, by analogy, a nonresident's limited-partnership interest in a limited partnership domiciled within a state, without more, should not subject the nonresident limited partner to the state's taxing jurisdiction." See *Lanzi*, 2006 Ala. Civ. App. LEXIS 406.

### The Lanzi Dissent

Judge Pittman dissented in the *Lanzi* case, arguing that *Shaffer* is distinguishable because it involved a shareholder derivative action rather than the imposition of income taxes on a nonresident equity owner of the company. In the latter situation, Judge

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<sup>1</sup> It is also possible that a state's taxation of a nonresident limited partner may violate the Commerce Clause. However, the *Lanzi* court did not address the potential Commerce Clause concerns.

Pittman contended – consistent with the lower court’s opinion – that the nonresident would reasonably expect to benefit from the state’s protection of his interest in the company, and therefore knowingly assumed the risk that Alabama may tax that income. Judge Pittman also suggested that Alabama’s assertion of tax jurisdiction was not unconstitutional because the taxation of income was directly related to the nonresident’s investment purpose in acquiring an interest in an entity doing business in Alabama, whereas the cause of action in *Shaffer* – a shareholder derivative action – was unrelated to the nonresident’s purpose in acquiring his interest in that case. In support of his position, Judge Pittman cited two cases which held that a tax imposed on nonresident S corporation shareholders did not violate the Due Process Clause despite the fact that the shareholders had no contacts with the state other than their ownership of stock. See *Agley v. Tracy*, 719 N.E.2d 951, 953 (Ohio 1999) (holding that nonresidents that owned stock in an S corporation doing business in Ohio were subject to Ohio’s taxing jurisdiction because 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”); *Kulick v. Dep’t of Revenue*, 624 P.2d 93 (Or.), *appeal dismissed*, 454 U.S. 803 (1981) (same).

### **Other Cases Upholding the Constitutionality of State Taxation of Nonresident Members of Pass-Through Entities**

Other cases have reached a similar result. For example, in *Borden Chemicals & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), the taxpayer was a limited partner in a partnership operating in Illinois. The taxpayer had no connection with Illinois other than its interest in the partnership. The taxpayer argued that the imposition of the Illinois personal property replacement income tax on the distributable income of the taxpayer from the partnership violated the Due Process Clause of the U.S. Constitution.<sup>2</sup> The Illinois Appellate Court stated that Illinois’ assertion of jurisdiction was for the sole purpose of taxing the distributable income received by the taxpayer; since that income was earned in Illinois, the court concluded that the assertion of personal jurisdiction was “clearly” related to and arose out of the taxpayer’s contacts with Illinois. Hence, the court held that subjecting the taxpayer to the tax on that income did not violate the Due Process Clause.

Similarly, in *Weil v. Chu*, 515 N.E.2d 908 (N.Y. 1987), the New York Supreme Court held that nonresident partners in a law firm conducting business in New York had a “sufficient nexus” with New York based solely on their partnership interests in the law firm to justify the state’s taxation of their partnership income under the Due Process Clause.

### **A Potential Inconsistency Between the Due Process Standard Established by the U.S. Supreme Court and the Reasoning of Cases Upholding State Taxation of Nonresidents Under the Due Process Clause**

The reasoning of *Borden Chemicals*, *Weil* and the other cases appears to ignore the critical “minimum contacts” analysis required by the Due Process Clause. In *Bridges v. Autozone Properties, Inc.*, No. 2004-C-814, 2005 La. LEXIS 1510 (La. May 13, 2005), the Chief Justice of the Louisiana Supreme Court suggested that the Court of Appeals – which held that Louisiana’s taxation of dividends received by a nonresident shareholder of a real estate investment trust

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<sup>2</sup> In this case, the taxpayer also asserted that Illinois’ assertion of tax jurisdiction violated the Commerce Clause.

("REIT") doing business in Louisiana did not violate the Due Process Clause – confused the two separate issues of (i) whether a state has authority to impose a given tax and (ii) whether the prospective taxpayer has sufficient contacts with the state to allow that state's courts to exercise personal jurisdiction over that taxpayer in the state's suit to collect the tax. This distinction was apparently recognized by the U.S. Supreme Court in *International Shoe* when it stated that the issues to be decided included:

(1) whether, within the limitations of the due process clause of the Fourteenth Amendment, appellant, a Delaware corporation, has by its activities in the State of Washington rendered itself amenable to proceedings in the courts of that state to recover unpaid contributions to the state unemployment fund exacted by state statutes,...and (2) whether the state can exact those contributions consistently with the due process clause of the Fourteenth Amendment.

326 U.S. at 311.

Arguably, *Borden Chemicals*, the *Lanzi* dissent and other cases – which focused on the state's jurisdiction to tax income earned in the state – were based solely on the state's authority to tax, and overlooked the separate requirement of establishing personal jurisdiction based on the taxpayer's contacts with the state.

Notably, it is rarely, if ever, asserted that personal jurisdiction is satisfied by the mere ownership of stock in a C corporation doing business in that state, either in the tax context or otherwise. Thus, the fact that some courts have been willing to find jurisdiction for shareholders of S corporations and REITs in otherwise similar factual circumstances suggests that the courts were focusing more on the pass-through nature of the corporation than on the requisite "contacts" analysis. If a nonresident S corporation (or REIT) shareholder's only connection to a state was its passive ownership of stock in the corporation doing business in that state, then one may reasonably contend that such shareholder has not satisfied the "minimum contacts" requirement of the Due Process Clause, regardless of the shareholder's motivation in acquiring his shares. On the other hand, if the relevant inquiry is whether the shareholder expects to benefit from the state's protection of his interest, then a state's taxing jurisdiction could be justified in almost any case where the shareholder is aware that the corporation is conducting business in that state. Certainly, shareholders of public companies that do business nationwide would be surprised to learn they could potentially be subject to tax on the dividends they receive in every state in the country.

### **Different Standards for Nonresident Shareholders than for Nonresident Members of Partnerships or LLCs?**

Whether the same conclusion should also apply to nonresident members of an LLC or limited partnership may depend upon whether the LLC or limited partnership is viewed as a "separate legal entity" similar to a corporation. For income tax purposes, an LLC or partnership may be viewed as either a separate entity or an "aggregate" of its members, depending on the context. However, for purposes of personal jurisdiction – which has historically focused on the legal status of the LLC or partnership – LLCs and limited partnerships are generally considered to be distinct legal entities analogous to corporations. Indeed, the *Lanzi* court relied on this analogy to support its holding that a nonresident is not subject to a state's jurisdiction merely by holding a limited partnership interest in a partnership doing business in that state.

Other courts have reached a similar result outside the tax context. *See, e.g., Lynn v. Cohen*, 359 F. Supp. 565, 567 (S.D.N.Y. 1973) (citations omitted) (limited partner not subject to state's jurisdiction because a "limited partnership resembles a corporation more closely than it does an ordinary partnership ... [and] [t]he principal-agent relationship which exists between the partners of an ordinary partnership is not present between the limited and general partners of a limited partnership."); *Klein v. Mega Trading, Ltd.*, 416 So. 2d 866, 866 (Fla. Dist. Ct. App. 1982) (the purchase of a limited partnership interest is "analogous to the purchase of stock in a corporation"). It would seem that an LLC is even more analogous to a corporation than a limited partnership, and thus there should be even less of a basis for a state to claim jurisdiction over a nonresident based solely on the nonresident's ownership of an membership interest in an LLC conducting business in that state.

## Impact of State Legislation Requiring Consent Agreements

Some states have essentially avoided the jurisdictional issue for nonresident S corporation shareholders by requiring that, in order for an S corporation to be recognized for state income tax purposes, each nonresident shareholder must annually execute a consent agreement to pay the income tax on his or her portion of the corporate income. *See, e.g.,* O.C.G.A. § 48-7-27(d); Ala. Code § 40-18-176. A state's requirement that S corporation shareholders consent to jurisdiction may suggest that the state does not believe that, in the absence of such consent, the state would be entitled to tax the income earned by these nonresident members.

However, few states have yet required similar consents for nonresident members of partnerships or LLCs (although Alabama is now a notable exception). Until states begin adopting these types of consent arrangements, decisions such as that in *Lanzi* create potential defenses for nonresident members.

*For more information regarding the Lanzi decision or the state taxation of nonresident members of partnerships or LLCs in general, please contact **Ethan D. Millar** at (404) 881-4252 or [ethan.millar@alston.com](mailto:ethan.millar@alston.com).*

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