Constitutional Nexus Principles for Partners and Members of Passthrough Entities

By Zach Gladney and Charles Wakefield*

Zach Gladney and Charles Wakefield review the constitutional nexus principles for partners and members of passthrough entities.

Nexus issues for partners and members of passthrough entities are increasingly a topic of focus for the states. General partners and managing members assume an active role in the business operations of the passthrough entity and thus are typically subject to tax in the states were the passthrough entity is doing business. However, the issue of taxability becomes much less clear when limited partners and non-managing members hold a passive interest in the passthrough entity. Limited partner and non-managing member interests in passthrough entities are analogous to holding the stock of a corporation, which is understood not to create nexus for the owner of the stock. Nevertheless, states are asserting nexus over partners by imputing the partnership's in-state activities to the out-of-state partners, sometimes regardless of how passive the interest in the partnership may be.

Whether nexus of the partnership should flow through to the partner is a complex, fact intensive analysis that more often than not implicates the U.S. Constitution, which courts are typically better equipped to resolve than administrative agencies. While courts are generally more neutral in their evaluation of a taxpayer's case than administrative agencies, there is always risk that different judges will have different views on the extent to which the Constitution limits a state's ability to reach beyond its borders to impose tax on out-of-state taxpayers. This is particularly true in the passthrough entity context, where there is very little compatibility on a state-by-state basis in the application nexus principles.

For example, in the *Matter of Shell Gas Gathering Corp.*,[1] the New York Tax Appeals Tribunal upheld an ALJ's determination that two non-resident corporate members of an LLC doing business in the state were subject to the state's corporate

ZACH GLADNEY is a Partner and **CHARLES WAKEFIELD** is a Senior Associate in Alston & Bird LLP's New York office.

franchise tax due to their receipt of New York-sourced income. The issue arose based on the division's regulations that expressly provide that if a partnership is doing business in the state, then all of the corporate general partners are subject to tax under Article 9-A of the Tax Law. The burden was then on the taxpayers to show that they have been unconstitutionally assessed. The taxpayers argued that their interest was passive and thus did not satisfy the constitutional nexus standards; however, the tribunal disagreed and held that the LLC members were like a general partner interest and taxable in the state not because of their presence in the state, but because of the presence of the LLC in which they owned a membership interest.

In contrast to New York's law-over-facts line of passthrough nexus decisions, New Jersey courts have taken a more reasoned approach in evaluating limited partner/member nexus issues. In *BIS LP Inc. v. Director, Division of Taxation*,[2] the New Jersey Superior Court, Appellate Division held that a foreign corporation's interest in a limited partnership doing business in New Jersey did not create nexus for purposes of New Jersey's Corporate Business Tax. The Division of Taxation argued that the non-resident limited partner had nexus with the state because it derived taxable receipts from a partnership doing business in the state and the limited partner and the partnership were a unitary business. However, the court held that the two were not integrally related and that the limited partner was merely a passive investor with no control or potential to control the partnership. However, in *Village Super Market of PA Inc. v. Director, Division of Taxation*,[3] the New Jersey Tax Court held that a 99-percent limited partner was taxable because all of the limited partner's business was conducted in New Jersey and because it was not a mere holding company. The tax court distinguished *BIS*, and the decision suggested that the tax court had doubts about the economic substance of the limited partner structure.

Like New Jersey, Alabama courts have been more willing to limit the state's authority to tax out-of-state partners under constitutional principles. In *Lanzi v. Alabama Department of Revenue*,[4] the Alabama Department of Revenue assessed tax against the distributions received by a Georgia resident, who was a limited partner in a family-operated partnership, created under the laws of Alabama, which existed to make a profit and to manage and preserve family assets through the buying and selling of bonds, stocks and other securities. In that case, the court held that participation in the limited partnership did not establish that the taxpayer had purposefully availed himself of the benefits of an economic market in the forum state, and therefore the taxpayer had not established minimum contacts within the state for purposes of taxation.

Pennsylvania has also addressed the constitutional limits of nexus in the context of passthrough entities. In *Wirth v. Commonwealth*,[5] the Pennsylvania Supreme Court, upheld the Commonwealth Court's decision that a non-resident who invested in a limited partnership that maintained an office building in Pittsburgh was liable for personal income tax on the gain the partnership earned from the cancellation of debt when the building was foreclosed on. In that case, the court determined that the taxpayer had waived his Commerce Clause nexus arguments because his brief had only addressed the minimum contacts, due process nexus standard. Under the due process standard, the taxpayer had the requisite minimum contacts because he had invested in a limited partnership whose primary purpose was to own and manage property in Pennsylvania and had therefore purposefully availed himself of the opportunity to invest in Pennsylvania real estate. However, the court did not address the distinction between limited and general partnership interests.

The states' differing approaches to analyzing the same basic set of facts creates substantial uncertainty for multi-state businesses that have a passthrough entity structure. However, with the adoption of economic nexus principles, and recent changes at the federal level to the partnership audit and assessment regimes, the nexus landscape is likely to become even more complex. Because the economics of the partnership pass through to the partners, states are becoming increasingly aggressive in asserting that the nexus of the partnership also flows through to the partner. As a result of this increased attention on establishing economic nexus based on the passthrough of nexus, partners and members will likely see an increase in audit activity, leading to an increase in assessments. This increase in activity will likely be consistent for general partners as well as for many limited partners and members that are entirely passive investors in the passthrough entity as the states test the constitutional limitations of "passthrough nexus." This will likely be true even where the circumstances indicate that the partner does not have sufficient contacts with the state to satisfy the constitutional nexus standards under the Commerce and Due Process Clauses.

So what can partners/members do to avoid protracted and costly nexus disputes? When partners and members are defending against nexus assertions, state statutes on what qualifies as "doing business" in the state are a good place to start. For example, in California, taxpayer wins in *Swart Enterprises Inc. v. FTB* and *Appeals of Amman & Schmid Finanz*,[6] have been decided on the basis of the standard for doing business in the state as defined by state statute and prior case law interpreting the statute. However, in most instances taxpayers must rely on the Commerce and Due Process Clauses when defending against flow-through nexus assertions. Under the Commerce Clause, taxpayers may argue that their interest in the partnership or LLC is of such a nature that they themselves do not have substantial nexus with the state even though the partnership is doing business in the state. Under the Due Process Clause, taxpayers may argue that they have not "purposefully availed" themselves of the in-state market, typically because their interest may be so passive that they are only concerned with the return on investment and have not themselves directed their activities into the state merely by investing in a partnership doing business in the state.

When audits arise, taxpayers are best situated to address nexus and apportionment issues if the partner or member agreements properly reflect the partners' interest in the partnership, especially where the documentation can effectively demonstrate that the partnership interest is a purely passive investment vehicle that does not include an active role in the business or management of the partnership. If the partnership and operating agreements fully and accurately characterize the passive nature of the interest in a passthrough entity, taxpayers will be better equipped to defend against audit issues and can avoid unnecessary and expensive state tax controversies.

Taxpayers can also minimize the risk of unnecessary state tax controversies by applying an intentional and consistent strategy among the states for whether they have nexus by virtue of holding an interest in the passthrough entity. With an intentional strategy in place, taxpayers are best able to avoid the temptation to file state tax returns for informational or minimum tax purposes in states where the partner or member does not have constitutional nexus.

ENDNOTES

* Zach Gladney can be reached at *zach.gladney@alston.com* and Charles Wakefield can be reached at *charles.wakefield@alston.com*.

1 *In the Matter of Shell Gas Gathering Corp.* (DTA Nos. 821569 and 821570 (Sept. 23, 2010)).

2 *BIS LP Inc. v. Director, Division of Taxation*, No. A-1172-09T2, N.J. Superior Ct., App. Div. (Aug. 23, 2011).

3 *Village Super Market of PA Inc. v. Director, Division of Taxation*, No. 021002-2010, N.J. Tax Court (Oct. 23, 2010).

4 *Lanzi v. Alabama Department of Revenue*, 968 So. 2d 18 (Ala. Civ. App. 2006), *cert. denied* (Ala. 2007).

5 *Wirth v. Commonwealth*, 95 A.3d 822 (Pa. 2014).

6 *Swart Enterprises Inc. v. FTB* 212 Cal.Rptr.3d 670 (Cal. Ct. App. 2017) and *Appeals of Amman & Schmid Finanz,* No. 96-SBE-008 (Cal. State Bd. Equal. April 11, 1996).