

K&W PRODUCERS, LLC	§	STATE OF ALABAMA
1821 27 TH AVENUE S.		ALABAMA TAX TRIBUNAL
HOMEWOOD, AL 35209-1962,	§	
		DOCKET NO. BIT. 12-811
Taxpayer,	§	
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

FINAL ORDER

The Revenue Department assessed K&W Producers, LLC (“Taxpayer”) for 2010 income tax. The Taxpayer appealed to the Tax Tribunal pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. The case was submitted for decision on a joint stipulation of facts and briefs. Darrell Cartwright represented the Taxpayer. Assistant Counsel David Avery represented the Department.

The facts as stipulated by the parties are as follows:

- (1) K & W Producers, LLC is an Alabama limited liability company.
- (2) K & W Producers, LLC had Members who resided in Alabama, Texas, Florida, and Mississippi. Some of the Members are not individuals.
- (3) K & W Producers, LLC ‘s Members who resided in Alabama solicited sales from Alabama customers only.
- (4) K & W Producers, LLC’s Members who resided in Mississippi solicited sales from Mississippi customers only.
- (5) K & W Producers, LLC’s Members who resided in Florida solicited sales from Florida customers only.
- (6) When any Member (regardless of residence) solicited a sale, the sales documents were sent to the manufacturer’s (Striker) corporate offices in Kalamazoo, MI for approval, which would either approve the sale or decline to approve the sale.
- (7) If the sale was approved, the commission from the sale was paid to K & W Producers, LLC. K & W Producers, LLC distributed Guaranteed

Payments to its Members, based at least in part on these commissions, to the Member responsible for soliciting the sale.

(8) K & W Producers, LLC had revenues of \$8,146,962 in 2010 and made Guaranteed Payments to its Members in the amount of \$8,158,822. K & W Producers, LLC was responsible for the operation of its business offices in Homewood, Alabama and made payments of insurance for its Members which are included in the Guaranteed Payments totals.

(9) K & W Producers, LLC deducted the "Guaranteed Payments" as a business expense on its 2010 Form 65 thereby creating a loss for the year. A copy of the original electronic Form 65 and a copy of the return as amended by the Department are attached. The Taxpayer did not file a 2010 Form PTE-C.

(10) The Department of Revenue calculated the 2010 Form PTE-C liability for the Taxpayer by including the "Guaranteed Payments" to non-resident Members as distributable income. A copy of the 2010 Form PTE-C prepared by the Department is attached.

(11) Most, (but not all) of the Taxpayer's non-resident owners failed to file nonresident Alabama income tax returns and report their "guaranteed payments" received from the Taxpayer for 2010, the year at issue. The liability calculated on the Form PTE-C does not include liabilities for non-resident Members that reported the 2010 "Guaranteed Payments" to Alabama.

The Taxpayer argues that the income earned by its nonresident members in 2010 was earned 100 percent outside of Alabama, and thus should not be subject to Alabama tax. The Taxpayer's Brief, at 2, reads as follows:

For purposes of analysis, K & W should be viewed much like a payroll processing company, like ADP. Their purpose is to aggregate revenue from the various states, pay the members' health insurance, and remit their commissions. It is merely a flow-through conduit designed to remit and pay earned by the individual producers or members.

The non-resident members reside in states other than in Alabama, and have no connection with Alabama, other than receiving their commission checks printed from the state of Alabama, along with health insurance deductions, similar to a payroll processing company. Accordingly, almost none of the non-resident members filed an Alabama income tax return, since they had no Alabama income, and did not reside in Alabama. This is critically important,

as it relates to the application of the Alabama Form PTE-C filing scheme, as the impact of an adverse ruling to the Taxpayer would result in an unconstitutional taxing of income over which Alabama has no connection. These out-of-state residents who solicit and make sales solely out-of-state, and who earn 100% of their income solely from out-of-state sources, should not be so subjected to income tax within the state of Alabama.

I disagree with the above argument because Alabama is taxing the Taxpayer, an Alabama LLC with nexus with Alabama, and not the Taxpayer's nonresident members. The Revenue Department's now-defunct Administrative Law Division, now the Tax Tribunal, addressed this same issue in *Tsitalia LLC v. State of Alabama*, Docket BIT. 12-492 (Admin. Law Div. 2/1/2013), as follows:

The issue is not, however, whether Alabama has jurisdiction to tax nonresident owners of a pass-through entity. Rather, the issue is whether Alabama can require the pass-through entity over which the State clearly has jurisdiction to report and pay Alabama tax on the nonresident's distributive share of the entity's Alabama-sourced income. Clearly, it can.

In *International Harvester Co. v. Wisconsin Dep't of Taxation*, 64 S. Ct. 1060 (1944), the U.S. Supreme Court upheld a Wisconsin statute that required an in-state corporation, International Harvester, to withhold and remit Wisconsin income tax on dividends the corporation distributed to out-of-state stockholders that had no nexus with the State.

The power to tax the corporation's earnings includes the power to postpone the tax until the distribution of those earnings, and to measure it by the amounts distributed. *Company Curry v. McCannless*, 307 U.S. 357, 370. In taxing such distributions, Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers. (cites omitted)

International Harvester, 322 U.S. 435 at 441, 442.

The above rationale also applies concerning Alabama's nonresident composite return and payment provisions. Alabama can constitutionally tax an Alabama pass-through entity based on a nonresident's distributive share of the entity's income.

I agree with the Taxpayer's representative that Alabama's composite return and payment provisions were enacted after *Lanzi* to avoid the jurisdictional problems involved in taxing a nonresident partner or member. But such provisions are clearly constitutional, and while the tax is measured by the nonresident's distributive share of the entity's income, it is levied on the in-state entity.

Tsitalia at 2 – 3.

After *Tsitalia*, the Tax Tribunal decided another case, *Tanner & Guin, LLC v. State of Alabama*, Docket BIT. 14-502 (T.T. 5/4/2015), that also involved the §40-18-24.2(b)(1) composite return filing requirement. In *Tanner & Guin*, the Alabama LLC was a law firm based in Alabama that had nonresident partners. The LLC made guaranteed payments to the nonresident partners, but failed to file a nonresident composite Alabama return, as required by §40-18-24.2(b)(1). The Department assessed the LLC accordingly. The Tribunal affirmed the final assessment, as follows:

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. (footnote omitted)

* * *

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. 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.

Tanner & Guin at 6 – 7.

The Taxpayer argues that *Tanner & Guin* can be distinguished because the LLC in *Tanner & Guin* was an active law firm, whereas it is only a non-operating shell conduit through which income was funneled to the nonresident members. The difference is, however, without a legal distinction. All Alabama LLCs with nonresident members are required to file a nonresident composite return and pay the tax due on its distributions to its nonresident members.

The Taxpayer also contends that substance over form must govern, and that “[t]he economic substance of the transactions at issue is clear – non-resident members sell products and receive commission on the sales they make. The non-resident members earned \$0 income in Alabama. Substantively, no tax is due.” Taxpayer’s Brief at 2 – 3.

I agree with the Department, however, that the Taxpayer’s members chose to operate through the Alabama LLC that received the income in issue and then distributed it to the non-resident members. The members cannot now argue that the form through which they chose to operate should be ignored. As stated by the U.S. Supreme Court in *Comm. Of Internal Revenue v. National Alfalfa Dehydrating & Milling Co.*, 94 S. Ct. 2129 –

“This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, (cites omitted), and may not enjoy the benefit of some other route he might have chosen to follow but did not.” *National Alfalfa*, 94 S. Ct. at 2137.

Finally, the Taxpayer argues that if it is determined that it owes the tax in issue, “[t]he Taxpayer would request that the Court limit the ruling by permitting the non-resident members an extension within which to file an Alabama income tax return.” Taxpayer’s Brief at 4.

Alabama’s nonresident composite return scheme envisions exactly what the Taxpayer is requesting. Code of Ala. 1975, §40-18-24.2(b)(2) provides that if a nonresident member is included on a pass-through entity composite return, the member may also file an Alabama return and receive a credit for the Alabama income tax paid by the entity on the member’s behalf. Consequently, the Taxpayer’s nonresident members may file 2010 Alabama returns, and, after the Taxpayer pays the tax in issue, the members will be allowed a credit for the amounts paid by the Taxpayer on their behalf. If the members had no Alabama-sourced income in 2010, as claimed by the Taxpayer, then they would be entitled to full refunds of the amounts paid by the Taxpayer on their behalf. No extension to file is required or necessary.

The tax and interest as assessed by the Department is affirmed. The penalties are waived for reasonable cause under the circumstances. Judgment is entered against the Taxpayer for \$139,494.69. Additional interest is also due by statute from June 18, 2012, the date the final assessment was entered.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2B-2(m). 6/18/12

Entered August 11, 2015.

BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr

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