Blog Post

# On Shaky Ground: Are Pass-Through Entity Withholding Statutes Constitutional?

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Taxpayers routinely use pass-through entities (PTEs) such as limited partnerships, limited liability companies, or S corporations to conduct multistate business. Because most states conform to federal law, there is no entity-level tax on the PTE. Instead, states seek to tax the owners of the PTE on the income received – or passed-through – from the PTE. However, over recent years, state taxing authorities have wrestled with thorny jurisdictional issues when pursuing nonresident PTE owners. Nonresident owners argue that it is the PTE that is engaged in business in the taxing state – not them. As a result, nonresidents contend, the Due Process Clause and the Commerce Clause of the U.S. Constitution make clear that the state is without power to assert taxing jurisdiction.

How do the states avoid this constitutional conundrum? This is where withholding statutes come in. State law will require that the PTE doing business in the state withhold, report, and remit a percentage of each distribution made to nonresident owners. The withholding percentage is linked to the highest marginal income tax rate in the state. The nonresidents must file income tax returns with the state and are permitted to seek a credit for the amounts withheld by the PTE. In effect, by employing this approach, the states have recruited

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each PTE to act as a withholding agent for the taxing authority.

The states rely on the 1944 decision of the United States Supreme Court in *International Harvester Co. v. Wisconsin Department of Taxation* as constitutional support for the state withholding statutes. In that case, the Court concluded that a state law requiring in-state corporations to deduct a percentage of each dividend received by nonresident shareholders was a constitutional exercise of the state's taxing power.

In a recent case, *Black Eagle Minerals, LLC v. Alabama Department of Revenue*, Docket Nos. BIT 12-1229 and BIT 11-975, the taxpayer has challenged the state's withholding statute arguing that it reflects a clear violation of the Commerce Clause. So, what about *International Harvester*? The taxpayer argues that the 1944 precedent solely dealt with a challenge under the Due Process Clause – not the Commerce Clause. Further, the taxpayer notes that the Wisconsin statute at issue in *International Harvester* applied to both nonresident and resident shareholders. The Alabama withholding statute, not unlike other states, requires withholding only if the PTE has nonresident owners.

*Black Eagle Minerals* is currently on appeal to the Alabama Tax Tribunal. Given the similarity between the Alabama withholding statute and those of other states, this case certainly bears watching. Stay tuned.

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