

ALABAMA APPEALS COURT REVERSES COURSE ON SOURCING OF NONRESIDENT INCOME

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As economic uncertainty continues to tighten state coffers, state taxing agencies are becoming increasingly aggressive in fighting for taxpayer dollars. The case of *James E. Prince, Jr. v. State of Alabama Department of Revenue* presents an interesting example.

Just three years earlier, in 2007 and during the economic boon, the Alabama Court of Civil Appeals (“Appeals Court”) considered a case with identical facts (to those in *Prince*), in *Lanzi v. Alabama Dep’t of Revenue*, 968 So.2d 18 (Ala. Civ. App. 2006), *cert. denied* April 13, 2007, Ala. Sup. Ct. 1051475. In *Lanzi*, the Appeals Court held that the Alabama Department of Revenue violated a nonresident’s right to due process by trying to source to Alabama the income that the nonresident received as a partner in a limited partnership. The Appeals Court held that the ordinary income that a nonresident earns from an Alabama entity is not subject to Alabama income tax. *Lanzi*, 968 So.2d at 22. The Appeals Court relied on Alabama precedent set out in *Anniston Sportswear v. State*,¹ and by the U.S. Supreme Court in *Shaffer v. Heitner*.² In *Anniston Sportswear*, the Alabama Supreme Court held that income from intangible assets must be sourced, for tax purposes, to the state of residence of the owner of the intangible. *Id.* at 782.

Factual Background in *Prince*

Mississippi resident James Prince Jr. sold stock of an Alabama corporation. Some evidence exists that the parties intended, for federal income tax purposes, that the sale be taxed under Internal Revenue Code § 338(h)(10).³ However, the record contains no evidence that the

¹ 151 So.2d 778 (Ala. 1963)

² 433 U.S. 186 (1977)

³ Pursuant to § 338(h)(10), a purchaser of the stock of a corporation may elect to treat the stock purchase as a purchase of the underlying assets of the corporation, so as to obtain a stepped-up basis in the assets for depreciation

parties ever made such a valid election. Moreover, even if the election under Section 338 had been made, such would not change the result -- the gain on the sale of the stock by a nonresident is not subject to Alabama income tax.

James E. Prince, Jr., has lived in Mississippi all of his life. Mr. Prince's business interest was in the area of oil and gas.

In 1996, Mr. Prince invested in an Alabama company – Zebra.Net, Inc. – that was unrelated to his oil and gas business. Zebra.Net was an internet service provider. It was owned and operated by two Alabama residents. The two Alabama shareholders of Zebra.Net sought an infusion of cash for Zebra.Net's continued operation. Mr. Prince agreed to invest in Zebra.Net. In return, Mr. Prince received common stock, and Mr. Prince became a one-third minority shareholder in Zebra.Net.

The two Alabama shareholders managed the day-to-day activities of Zebra.Net. Mr. Prince did not operate Zebra.Net.

In 1999, Mr. Prince and the two Alabama shareholders sold their Zebra.Net stock to a third-party corporation. The sale took place in Georgia, and the transaction involved only the sale of stock, which Mr. Prince had held in Mississippi. Mr. Prince did not sell any Zebra.Net assets.

Mr. Prince's sale of Zebra.Net stock resulted in a gain. Mr. Prince reported the gain on his 1999 federal and Mississippi income tax returns, and paid income tax at both levels.

Zebra.Net had elected to be treated as an "S" corporation, pursuant to I.R.C. § 1362(a). Thus, for 1999, Zebra.Net filed an S corporation tax return with the Alabama Department of Revenue. Zebra.Net included K-1 forms for each of its three shareholders, *i.e.*, the two Alabama residents and Mr. Prince. The K-1 forms contained the operating income of Zebra.Net that was

purposes. There is no direct benefit to the seller of stock in such an election, but the sellers are required to consent to the election. Even non-selling shareholders are required to consent.

attributable to each shareholder for 1999. The K-1 forms also contained the capital gain that was realized from the shareholders' sale of the stock of Zebra.Net.

The Alabama Tax Assessment and Mr. Prince's Administrative Appeal

In March 2005, the Alabama Department of Revenue ("the Department") entered a final assessment of individual income tax against Mr. Prince for 1999. The Department entered the assessment, because Zebra.Net filed an Alabama return, including a K-1 form, and because Mr. Prince had not filed an Alabama nonresident return.

Mr. Prince appealed the assessment to the Department's Administrative Law Division. Mr. Prince noted the longstanding maxim that an investor must pay income tax on investment income in his or her state of residence. Mr. Prince submitted that he had fulfilled his reporting obligations to his home state, Mississippi, and had no obligation to Alabama.

The Alabama administrative law judge ("ALJ") stated that "the income in issue was derived from the sale of *assets* of an Alabama S corporation" The ALJ then ruled that the income of Mr. Prince from the sale of his *stock* was "taxable in Alabama." The ALJ directed Mr. Prince to file Alabama returns. After Mr. Prince filed the Alabama nonresident returns, the ALJ reduced the assessment, and Mr. Prince appealed to the Montgomery Circuit Court ("Trial Court").

Proceedings before the Trial Court and the Appeals Court

The parties submitted and argued cross-motions for summary judgment. The Trial Court entered a one-paragraph "Final Order" granting summary judgment for the Department. Despite the fact that the issue was before the Trial Court on motions for summary judgment, the Trial Court made a "finding" that the parties to the stock sale had made a valid election pursuant to Internal Revenue Code § 338(h)(10). The Trial Court continued by stating that it would be

“illogical” to allow Mr. Prince to source the gain to his state of residence “in order to obtain tax benefits where they suit him in either system.” The Trial Court did not elaborate on what “benefits” Mr. Prince supposedly received by reporting his gain to the IRS and to his home state of Mississippi.

Mr. Prince appealed to the Alabama Court of Civil Appeals (“Appeals Court”) and, in a rare move, the Appeals Court conducted oral argument. In its opinion, the Appeals Court agreed that the facts mirrored those in *Lanzi*. *Prince v. State Dep’t of Revenue*, ___ So.3d ___, 2010 WL 1837773 (Ala. Civ. App. 2010), at page 27. However, the Appeals Court stated that *Lanzi* was a non-binding “plurality decision.” *Id.*⁴

Mr. Prince sought a rehearing, reasoning that the U.S. Supreme Court and Alabama Supreme Court cases relied upon in *Lanzi*, if not *Lanzi* itself, support Mr. Prince’s position. Mr. Prince argued that the Appeals Court must, pursuant to Ala. Code § 12-3-16, follow precedent of the Alabama Supreme Court, by which the gain would not be subject to Alabama income tax. The Appeals Court overruled the application for rehearing.

In May 2010, Mr. Prince filed a petition for writ of certiorari with the Supreme Court of Alabama. The petition is pending as of publication.

The Substantive Legal Issue Raised in *Prince*

Prince addresses whether a state (Alabama, here) can impose income tax on the gain from the sale of stock that occurs outside Alabama. Two Alabama appellate cases support Mr. Prince’s argument that tax on the gain is due only in Mississippi and not in Alabama.⁵

⁴ A plurality opinion is “an opinion lacking enough judges’ votes to constitute a majority, but receiving more votes than any other opinion.” *Black’s Law Dictionary* (8th Ed. 2004).

⁵ In its appellate brief and in oral argument before the Appeals Court, the Alabama Department of Revenue stated that Mr. Prince may be able to seek a refund in Mississippi. The dissent in the decision of the Civil Court of Appeals noted the frustration when one state lays claim to tax revenues after the date has passed for seeking credit from the state of residence. As noted by the dissenting opinion, Mr. Prince paid Mississippi income tax on the gain in 2000, but the Alabama Department of Revenue did not initially assess Mr. Prince until November 2004. And, although

First, Mr. Prince relied on a 1963 decision of the Alabama Supreme Court in *Anniston Sportswear Corp. v. State, supra*. In *Anniston Sportswear*, the Alabama Supreme Court held that income from intangible assets should be sourced, for tax purposes, to the state of residence of the owner of the intangibles. *Id.* at 782.

Second, Mr. Prince reported his gain in line with the 2006 decision in *Lanzi v. Alabama Dept. of Rev.*, where the Alabama Court of Civil Appeals recognized and applied the rule in *Anniston Sportswear* that the income that a taxpayer receives from intangible personal property is taxable in the taxpayer's state of residence. *Lanzi*, 968 So.2d 18, 22 (Ala. Civ. App. 2006), *cert. denied* April 13, 2007, Ala. Sup. Ct. 1051475. In *Lanzi*, the Appeals Court held that the imposition of income tax on distributions paid to a nonresident based on the nonresident's limited partnership interest in an Alabama limited partnership violated that nonresident's right to due process. *Id.* at 22.

The Appeals Court also noted that the *Anniston Sportswear* rule has two exceptions, (1) when the taxpayer establishes a "commercial domicile" in Alabama, and (2) when the intangible property acquires a "business situs" in Alabama. *Lanzi*, 968 So.2d at 22. But, neither exception applied in *Lanzi*.⁶

In *Prince*, however, the Appeals Court disregarded its recent decision in *Lanzi* and the underlying Supreme Court decision in *Anniston Sportswear*. The Appeals Court's explanation for refusing to follow *Lanzi* was that the *Lanzi* decision was a plurality decision and not binding law. The Appeals Court did not address *Anniston Sportswear*.

Mississippi law provides for a three-year statute of limitations period for income-tax refund claims, such period "has long since expired" and Mr. Prince will have to pay state income tax in Mississippi and Alabama, unless reversed. *Prince*, 2010 WL 1837773 *____.

⁶ The Department never argued for the application of either exception in the *Prince* case.

Mr. Prince's Cert Petition

Mr. Prince has asked the Alabama Supreme Court to review the Appeals Court's decision in light of the fact that the Appeals Court failed to apply the sourcing rule stated by the Supreme Court in *Anniston Sportswear*. Also, Mr. Prince challenges granting summary judgment to the Department, because the record lacks evidence of a valid election pursuant to IRC § 338(h)(10). Mr. Prince's petition is pending.