STATE OF ALABAMA, DEPARTMENT OF REVENUE, vs. INTERGRAPH CORPORATION One Madison Industrial Park Huntsville, AL 35807-0001, Taxpayer.	§ § § § § § §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION DOCKET NO. F. 91-171

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed foreign franchise tax against Intergraph, Inc. (Taxpayer) for the years 1987 through 1991. The Taxpayer appealed to the Administrative Law Division and was represented by Gail Peters, Gene Bowman, Burton Mader and Kay Jacobson. Assistant counsel Dan Schmaeling represented the Department.

Alabama's foreign franchise tax is an excise tax on the privilege of doing business in Alabama and is measured by the "actual amount of (a foreign corporation's) capital employed in Alabama." See, §232 of 1901 Alabama Constitution and Code of Ala. 1975, §40-14-41(a). The ultimate issue in this case is whether the Department correctly computed the Taxpayer's capital employed in Alabama for the subject years, and if not, by what method should the Taxpayer's capital be computed.

An overview of the Alabama franchise tax and how it is administered by the Department will help in understanding the case.

Prior to 1961, "capital" was not defined by statute for franchise tax purposes. Rather, capital employed in Alabama was

defined by the courts as "the property of the corporation that is within the state, and is used in business transacted within the state . . ."State v. Travelers Insurance Company, 53 So.2d 745, at 748. That is, a foreign corporation's capital was equal to the value of its physical assets located and employed in Alabama. That method for measuring capital is known as the summation method, i.e., the sum of the corporation's property in Alabama.

"Capital" was defined by statute for the first time by Act 912 in 1961. That definition is set out at §40-14-41(b) and includes various incorporeal items such as surplus, profits, indebtedness, etc., which are not physically located at any one place. Consequently, after 1961 capital was no longer defined as a corporation's physical assets located and used in Alabama, but rather, by the various intangible items set out in §40-14-41(b).

The 1961 Act defined capital but did not provide a method for determining how much of a foreign corporation's capital was employed in Alabama. Section 40-14-41(d) states that capital employed in Alabama shall be determined in accordance with generally accepted accounting principles (GAAP). However, GAAP does not provide a method for determining what percentage of a corporation's total capital is employed in any particular state.

In response to the problem, the Department developed the apportionment method set out on Schedules C and D of the franchise

tax return.[1]

Schedule C includes eight items of financial information applicable to most corporations, i.e., sales, payroll, etc. Schedule D sets out seven broad business categories, each of which specifies the different items from Schedule C that best reflect the business activities of that type of corporation. During the years in issue, the Department required all foreign corporations to select their Schedule D category based on the corporation's primary activity in Alabama. The Schedule C items applicable to the Schedule D catagory were then applied to arrive at the percentage of overall capital to be apportioned to Alabama.

The Department subsequently required all foreign corporations

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[1] The origin of Schedules C and D is unclear. Apparently, they were developed by a joint committee of Department officials and business representatives in the late 1950s or early 1960s. The Schedules have remained relatively unchanged over the years. For the reader's convenience, a copy of page 3 of the 1991 franchise return, which includes Schedules C and D, is attached.

to apportion capital to Alabama using Schedules C and D on the return. However, the Department also continued to use the summation method almost interchangeably as an alternative to the return. Schedule D stated during the years in issue that capital would be apportioned according to the return "unless it is apparent that it (the return) produces an unfair or inequitable result". See page 3 of 1991 return attached.

The Department has never issued guidelines for determining when "it is apparent" that a return "produces an unfair or inequitable result". Rather, the Department either accepts or rejects a return on a case-by-case, subjective basis. If the Department determines that a return does not accurately reflect capital employed in Alabama, or if a corporation objects that its return overstates capital, the Department will recompute the corporation's capital using the summation method and then attempt to reach a mutually acceptable capital figure with the corporation using summation as the primary guideline.

Prior to 1988, if the Department determined that a return was not accurate, the summation method was applied and capital was either increased or decreased accordingly. However, in 1988 this administrative law judge rejected the summation method in State v. Comdisco, Docket No. F. 87-224.[2] Consequently, while the

[2] In Comdisco, the Department rejected the taxpayer's use of the allocation formula on the return as unfair and inaccurate and instead used the summation method to increase the taxpayer's

Department still relies on the summation method as a guideline, after Comdisco summation is actually used by the Department only if it results in less capital employed in Alabama than the return. Also, summation will be accepted only if the Department is satisfied that the financial information provided by the corporation is accurate and complete.

The specific facts relating to the Taxpayer are as follows:

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capital base. I rejected the summation method as follows: "Further, the summation method does not reflect a corporation's capital employed within Alabama as defined by the statute. Rather, it constitutes in effect a tax on the corporation's property within Alabama. . . The summation method, which would have been proper under pre-1961 case law, does not reflect capital as set out in the above statute (Section 40-14-41(b)) and should not be used as presently computed by the Department." Comdisco is still on appeal in circuit court.

The Taxpayer is headquartered in Huntsville, Alabama but was incorporated outside of Alabama and thus is a foreign corporation for Alabama franchise tax purposes. The Taxpayer operates in all 50 states and is engaged in the business of manufacturing, selling and leasing computers and providing computer services.

The Taxpayer filed its 1987, 1988 and 1989 Alabama foreign franchise tax returns using category 2 on Schedule D as a corporation primarily engaged in both manufacturing and sales within Alabama. The Department initially accepted the returns as filed.

The Taxpayer learned before filing its 1990 return that the Department sometimes accepted alternative methods for computing capital employed in Alabama. The Taxpayer contacted the Franchise Tax Division and was informed that the standard three factor income tax formula of property, payroll and sales was sometimes accepted.[3] Based thereon, the Taxpayer filed its 1990 franchise tax return using the income tax factors from its 1988 Alabama income tax return. The Taxpayer also filed amended franchise returns and requested refunds for 1988 and 1989 using the income tax apportionment factors.

The Department determined that the Taxpayer could not use the income tax factors and consequently denied the refunds. The

[3] Those factors are allowed on Schedule D, category 3 for a corporation primarily engaged in sales.

Taxpayer contacted the Department in August, 1990 to find out why. In discussing the matter with the Department, the Taxpayer learned for the first time that capital could also be computed using the summation method.

The Taxpayer subsequently prepared amended returns based on what it understood to be the summation method and submitted the returns to the Department at a meeting in September, 1990. The Department acknowledged at the meeting that both the income tax factors and the summation method were sometimes accepted as alternatives to the return, but only if the Department was satisfied that the return was incorrect and the alternative method more accurately reflected capital employed in Alabama.

Nonetheless, the Department rejected the amended returns because the Taxpayer had not correctly used the summation method. The Department agreed that the Taxpayer could use the summation method if correctly computed, but only if the Department was satisfied that the Taxpayer's financial data was accurate. The Department audited the Taxpayer for that purpose in October, 1990.

Before completing the audit, the Department asked the Taxpayer to submit two sets of refund petitions for 1988 and 1989, one using the income tax factors and one using the correct summation method. The Taxpayer prepared and filed the petitions in December, 1990.

The Department subsequently rejected the Taxpayer's use of both the income tax factors and the summation method and

consequently denied the refunds in June, 1991. Instead, the Department accepted the Taxpayer's 1988 and 1989 returns as originally filed using category 2 on Schedule D. The Department rejected the summation method because it did not consider the Taxpayer's financial information to be complete or accurate.[4] The Department also rejected the Taxpayer's original 1990 return based on the income tax factors and assessed additional tax for that year, again using category 2 on Schedule D.

The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on September 24, 1991. The Department reaudited the Taxpayer after the hearing to see if the issues in dispute could be settled.

The reaudit failed to settle the case. Rather, as a consequence of the reaudit the Department determined that the Taxpayer was involved primarily in manufacturing only, not manufacturing and sales, and thus should have filed under category 1 on Schedule D, not Category 2.[5] As a result, the Department eliminated the sales factor and recomputed (increased) the Taxpayer's liability for 1988, 1989 and 1990 accordingly. The

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[4] How the summation method should be computed and why the Department disputed the Taxpayer's financial date was discussed at length at the second hearing on June 25, 1992.

[5] The Department considered the Taxpayer as engaged primarily in manufacturing only in Alabama because 100% of its manufacturing was in Alabama but only 13% - 15% of its overall sales. For dollar amounts see footnote 8, infra, and transcript of June 25, 1992 hearing, at pgs. 47-50.

Department also included 1987 and 1991 in the audit and assessed additional tax for those years, again using category 1 on Schedule D.

The first question is whether the Department can compute a foreign corporation's capital employed in Alabama using an apportionment formula.

The Alabama Supreme Court rejected the use of an apportionment formula for franchise purposes in State v. Travelers Insurance Company, supra. However, Travelers is no longer applicable because it was decided prior to 1961 when capital was still defined by case law as a corporation's physical assets located and used within Alabama. The definition of capital changed by statute in 1961 and since that time capital has been defined as the various intangible items listed in §40-14-41(b). Consequently, the summation method is no longer valid and the only reasonable method for computing a foreign corporation's capital employed in Alabama is through an apportionment formula. Apportionment formulas are widely accepted as the most accurate method for computing a multistate corporation's income or franchise tax liability in a particular state. Container Corporation of America v. Franchise Tax Board, 103 S.Ct. 2933; Moorman Manufacturing Company v. Bair, 98 S.Ct. 2348. The logic is that a corporation earns income, creates value, or employs capital within a state in proportion to its business activities within the state. Thus, any apportionment formula that

fairly reflects a corporation's business activities within a state will also fairly reflect the corporation's capital employed within that state.

The next issue is whether the Alabama return fairly apportions capital to Alabama.

No particular apportionment formula is required. Goldberg v. Sweet, 109 S.Ct. 582. Rather, a formula will be upheld if it fairly and reasonably apportions the corporation's business activities to the taxing state. Moorman, supra.

Most states use the standard formula of sales, property and payroll for both income and franchise tax purposes because those factors "appear in combination to reflect a very large share of the activities by which value is generated". Container, at 2949. Alabama uses the three factors almost exclusively for corporate income tax purposes.

Alabama also uses the income tax factors for franchise tax purposes, but only for corporations primarily engaged in selling. See category 3 on Schedule D. Alabama's apportionment method is more specific and requires a corporation to use one of seven different formulas on Schedule D depending on the corporation's primary activity. The reasoning is that corporations employ capital differently, and thus different Schedule C factors should be applied, depending on the corporation's primary business activity. I agree. For example, while the category 3 factors of payroll, inventory (property) and sales may best reflect the

activities of a sales corporation, the category 5 factors of income, total mileage and payroll would more accurately reflect the business activities of a transportation company. Although I cannot confirm that the Schedule C items used by the Department for each Schedule D category most accurately reflect the activities of that type of corporation, the formulas appear reasonable and absent specific evidence to the contrary, the factors and formulas set out on Schedules C and D are upheld.

However, the Department should not use a corporation's primary activity in Alabama in deciding which Schedule D formula to apply.

Choosing which Schedule C factors to apply based on a corporation's primary activity in Alabama and then applying those factors to capital everywhere does not fairly apportion capital to Alabama if the corporation's primary activity in Alabama is different than its primary activity everywhere.[6] Rather, the factors must be based on the corporation's primary activity everywhere.

The Department adopted Reg. 810-2-3-.13 in early 1993 which now requires a corporation to use its primary activity everywhere

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[6] Apportioning capital using a corporation's primary activity in Alabama as opposed to everywhere also probably violates the internal consistency requirement of the Commerce Clause. To be internally consistent, "a tax must be structured so that if every state were to impose an identical tax, no multiple taxation would result". Goldberg, supra, at 589; Container, supra, at 2942. An apportionment formula based on a corporation's primary activity in a particular state would probably result in multiple taxation.

in choosing its Schedule D category. That method most accurately apportions capital to Alabama and thus should also be used in this case.

During the period in issue, category 1 on Schedule D applied to corporations primarily engaged in manufacturing only. Category 2 applied to corporations primarily engaged in manufacturing and sales.[7] The Department initially accepted the Taxpayer's 1987, 1988 and 1989 returns filed under category 2, but changed the Taxpayer to a category 1 corporation after the second audit and thereby eliminated sales as a factor.

[7] Old category 2 was eliminated by Reg. 810-2-3-.13 and there is no longer any category involving more than one primary activity.

"Primarily" is not defined by the Department and there has never been any guidelines for determining if a corporation is primarily engaged in manufacturing only or manufacturing and sales. However, the Taxpayer was substantially engaged in both selling and manufacturing during the years in issue, with sales being the higher figure.[8] Clearly the sales factor must be considered in any formula apportioning capital to Alabama. Accordingly, the Taxpayer should use category 2 on old Schedule D as a corporation primarily engaged in both manufacturing and sales. The Taxpayer's liability for all years should be recomputed accordingly.

The Taxpayer objects that the Department's procedures are vague and arbitrary and that it is being treated unfairly because other corporations were allowed to use summation.

As administrative law judge for the Department, I do not have authority to rule on the constitutional due process and equal protection issues raised by the Taxpayer's arguments. However, I do agree that the Department's procedures are unclear and may lead

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[8] For 1987, the only year for which evidence was introduced, the Taxpayer had total manufacturing of $262,900,000 and total sales of $561,500,000. I am assuming that the figures for 1988-1991 were similiar. See transcript of June 25, 1992 hearing, at p. 48.

to arbitrary and inconsistent results.

The Department should develop standard and specific rules stating how all foreign corporations must compute capital employed in Alabama, and under what circumstances, if any, alternative methods or exceptions must or can be used. I recognize that the franchise tax is a difficult tax to administer. However, a foreign corporation should know with reasonable certainty how its Alabama franchise tax will be computed, and also that all other foreign corporations are being taxed by the same rules.

Apportionment is proper and the apportionment formulas set out on Schedules C and D of the Alabama return are reasonable, especially since a corporation's Schedule D category is now based on its primary activity everywhere. Alternatives or exceptions to the return may be allowed, but only if the alternative method more accurately reflects actual capital employed in Alabama. Again, the Department should promulgate rules explaining what the alternative methods are, how they should be computed, and under what circumstances they can or should be used.

The summation method is not an acceptable alternative because the value of a foreign corporation's property located in Alabama does not reflect actual capital employed in Alabama as defined at §40-14-41(b). Thus, the Taxpayer cannot use summation as an alternative.

The Taxpayer initially filed its 1987, 1988 and 1989 returns

using category 2 on old Schedule D. Those returns should be accepted as filed. The Department should recompute the Taxpayer's liability for 1990 and 1991, again under category 2 on old Schedule D; or, if deemed necessary by the Department, the Taxpayer should file amended returns for 1990 and 1991 using the category 2 factors. The Department should inform the Administrative Law Division of the Taxpayer's liability (or overpayment) for all years, and a Final Order will be entered accordingly. The Final Order when entered may then be appealed to circuit court pursuant to §40-2A-9(g).

Entered October 19, 1993.

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Bill Thompson
Chief Administrative Law Judge