

STATE OF ALABAMA,
DEPARTMENT OF REVENUE,

§

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

§

vs.

§

DOCKET NO. F. 92-350

ARISTECH CHEMICAL CORPORATION
600 Grant Street
Pittsburgh, PA 15230-0250,

§

§

Taxpayer.

§

FINAL ORDER

The Revenue Department assessed Aristech Chemical Corporation (Taxpayer) for franchise tax for the years 1988 through 1991. The Taxpayer appealed to the Administrative Law Division and the matter was submitted on a joint stipulation of facts. Christine M. Curnow represented the Taxpayer. Assistant counsel Dan Schmaeling represented the Department.

This case involves two issues: (1) Should a deferred income tax account be included as capital for franchise tax purposes pursuant to Code of Ala. 1975, §40-14-41(b); and (2) Did the Department properly eliminate a zero inventory factor from the Taxpayer's Schedule D apportionment formula in each year.

The Taxpayer filed Alabama franchise tax returns during the years in issue and apportioned capital to Alabama using category 3 on Schedule D as a corporation primarily engaged in selling. That category requires the use of three factors from Schedule C, sales (Item 2), salaries (Item 6), and inventories (Item 8).

The Taxpayer had no inventory in Alabama and thus had a zero inventory factor in the years in issue. The Department eliminated the zero inventory factor from each return and reapportioned capital using the remaining two factors of sales and salaries. The Department also included deferred income tax as capital on the Taxpayer's 1989 return. The assessment in issue is based on the above adjustments.

The Deferred Income Tax Issue.

This issue was settled by the Alabama Supreme Court in Ex Parte State Department of Revenue (In re: West Point Pepperell, Inc. v. State Department of Revenue), Sup. Ct. No. 1911632, decided on September 10, 1993. In that decision, the Supreme Court let stand the Court of Civil Appeals' ruling that deferred federal income tax accounts should not be included as capital for franchise tax purposes under §40-14-41(b). Accordingly, the deferred income tax account in issue should not be included as capital on the Taxpayer's 1989 return.

The Zero Factor Issue.

"Capital" was first defined by statute for franchise tax purposes by Act 912 in 1961. That Act defined capital, see §40-14-41(b), but did not provide a method for determining what portion of a foreign corporation's overall capital is 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 also does not provide a method for determining what percentage of a foreign corporation's total capital is employed in any particular state.

In response to the problem, the Department developed and started using the apportionment factors and formulas set out on Schedules C and D of the franchise tax return.

The Department does not dispute that the Taxpayer was primarily engaged in sales and thus correctly reported under category 3 on Schedule D. As stated, that category requires the use of the three factors of sales, salaries and inventory in apportioning capital.

However, the Department eliminated the inventory factor from the Taxpayer's returns because the Taxpayer had no inventory in Alabama during the subject years. The Department argues that including a zero factor in the apportionment formula would distort and thus not accurately reflect the actual capital employed by the Taxpayer in Alabama. I disagree.

The factors and formulas set out on Schedules C and D of the Alabama return are a reasonable method by which the Department apportions capital to Alabama. The standard formula of sales, salary (payroll) and inventory (property) used by the Taxpayer in this case is widely used in most states for both income tax 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 Corporation of America v. Franchise Tax Board, 103 S.Ct. 2933.

The Department acknowledges by including the three factor formula on the return that the three factors together accurately reflect the activities of a corporation primarily engaged in sales.

If so, then all three factors must be considered. There is no authority or logical reason why a zero factor should be eliminated from an apportionment formula. Rather, as argued by the Taxpayer, eliminating a zero factor would unfairly and disproportionately increase the amount of capital apportioned to Alabama.

If the Department is allowed to eliminate a zero factor, then a corporation with a zero factor would in some cases have a greater percentage of capital apportioned to Alabama than a corporation with a non-zero factor in that same category. For example, if a corporation has a sales factor of 4.0, a salary factor of 4.0, and a zero inventory factor, the Department would eliminate the inventory factor and divide 8.0 by 2 to arrive at a 4.0 average apportionment factor. However, if the same corporation had a 1.0 inventory factor, which would obviously indicate more business activity (capital employed) in Alabama than a zero factor, the Department would divide the total of 9.0 by 3 to arrive at an average apportionment factor of 3.0. Thus, the corporation with the 1.0 inventory factor would have less capital apportioned to Alabama than the corporation with no inventory in Alabama. Only

when the inventory factor is higher than the average of the other two factors (in the example 4.0) would a corporation with a non-zero inventory factor have more capital apportioned to Alabama than a corporation with a zero inventory factor. The above example clearly illustrates that eliminating a zero factor does not accurately reflect a corporation's activities in Alabama, and thus does not accurately apportion capital to Alabama.

The Department's elimination of the zero inventory factors during the years in issue is rejected.¹ All three factors in the formula must be used in apportioning capital to Alabama. The assessment in issue is dismissed.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered on November 16, 1993.

BILL THOMPSON
Chief Administrative Law Judge

¹ The Department has changed its position and now concedes that a zero factor cannot be eliminated. See Reg. 810-2-3-.12 ER, promulgated in 1992 and changed to permanent Reg. 810-2-3-13 in 1993. The Department's position apparently is that Reg. 810-2-3-.13 should be applied prospectively only beginning in 1992. Obviously I disagree for the reasons stated above.