JEFFREY E. & MARSHA PERELMAN ' STATE OF ALABAMA
One Cherry Lane DEPARTMENT OF REVENUE
Wynnewood, PA 19096, ' ADMINISTRATIVE LAW DIVISION

Taxpayers, ' DOCKET NO. INC. 01-592

v. '

STATE OF ALABAMA '
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed Jeffrey E. and Marsha Perelman (together ATaxpayers@) for 1993, 1994, and 1995 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on December 5, 2001. Daniel Markstein and Hardwick Walthall represented the Taxpayers. Assistant Counsel Mark Griffin represented the Department at the hearing. Assistant Counsel Jeff Patterson filed the Department=s briefs.

Jeffrey Perelman (individually ATaxpayer@) resided in Pennsylvania and owned 50 percent of Den-Tal-Ez, Inc. during the years in issue. Den-Tal-Ez is a Delaware S corporation headquartered in Pennsylvania. The other 50 percent was owned by a trust. The corporation had three operating divisions, two in Pennsylvania and one in Alabama. All three divisions manufactured and sold different types of dental-related products. The Pennsylvania divisions were profitable. The Alabama division was not.

The corporation filed Alabama S corporation returns on a separate accounting basis during the subject years, and thus reported only the losses from its Alabama division on the returns. The Department determined that the three divisions of the corporation were unitary, and allocated and apportioned the corporation=s income to Alabama pursuant to the Multistate

Tax Compact (AMTC@), Code of Ala. 1975, ' 40-27-1, et seq.[1] The resulting tax liability was passed through 100 percent to the Taxpayers, individually.

ISSUES

The issues in this case are:

(1) Is Alabama constitutionally prohibited from apportioning the income of the corporation=s two Pennsylvania divisions to Alabama? That issue turns on whether the Pennsylvania divisions were unitary with the corporation=s Alabama division;

(2) If the three divisions were unitary, should the corporation still be allowed to report its Alabama liability on a separate accounting basis pursuant to the MTC equitable relief provision, ' 40-27-1, Art. IV, &18;

(3) If the three divisions were unitary, and the corporation cannot file on a separate accounting basis, should 50 percent of the tax owed to Alabama be passed through to the trust that owned 50 percent of the corporation; and,

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[1]The MTC was adopted in Alabama effective in 1977. *State, Dept. of Revenue v. MGH Mgt., Inc.*, 627 So.2d 408 (Ala.Civ.App. 1993) The MTC generally adopts the allocation and apportionment rules established in 1957 by the Uniform Division of Income for Tax Purposes Act (AUDITPA@). Those rules require that a multistate corporation must apportion its business-related income among the various states in which it does business using a three-factor formula of payroll, property, and sales. Nonbusiness or investment income is generally allocated directly to the corporation=s state of commercial domicile.

(4) If the Taxpayers are liable for additional tax, should a portion of the interest that has accrued on the liability be abated because of undue delay by the Department?

FACTS

The Taxpayer=s father purchased Syntex Dental Products, Inc. and changed its name to Den-Tal-Ez, Inc. in 1986. The corporation was headquartered in Pennsylvania, and had three operating divisions. The Custom Air division was located in Pennsylvania, and manufactured and sold dental-related vacuum systems. The Star Dental division was also located in Pennsylvania, and manufactured and sold dental-related drills and other hand pieces. The Den-Tal-Ez equipment division (Alabama division) was located in Bay Minette, Alabama, and manufactured and sold patient chairs, lights, and other dental-related capital equipment. The divisions sold their products to various distributors throughout the United States, who in turn sold the products to dentists.

The Taxpayer purchased Den-Tal-Ez and other unrelated corporations from his father in January 1990. He also formed JEP Management, Inc. (JEP) at that time. JEP provided cash management, accounting, and other services to Den-Tal-Ez and the other unrelated corporations owned by the Taxpayer.

The corporation elected S corporation status in 1991, and also petitioned the Department to allow it to file its 1991 Alabama return using separate accounting.[2] The Department rejected the corporation=s use of separate accounting by letter dated January 8,

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[2]Under separate accounting, a corporation=s liability in the taxing state is determined only on the corporation=s income and expenses relating to its activities within the state. See generally, J. Hellerstein & W. Hellerstein, *State Taxation* &8.03 (3d ed. 2001).

1992. The corporation claims it was not aware of the letter until late-1993. Consequently, the corporation filed its 1991 and 1992 Alabama S corporation returns using separate accounting.

The Department audited the corporation, rejected the 1991 and 1992 separate accounting returns, and instead apportioned the income of the corporation=s three operating divisions to Alabama under UDITPA. However, the Department never assessed the corporation for those years. Because it was never assessed for 1991 or 1992, the corporation assumed that the Department had accepted its separate accounting returns for those years, and consequently also filed its 1993 through 1995 Alabama returns using separate accounting. Because the corporation=s Alabama division incurred losses in those years, the returns reported negative income to Alabama, which resulted in no pass-through income to the Taxpayers.[3]

The Department audited the corporation for 1993 through 1995, again rejected the corporation=s use of separate accounting, and again apportioned the corporation=s income to Alabama under UDITPA. The resulting tax due was passed through and assessed 100 percent to the Taxpayers, individually.

Relevant facts concerning the organization and operations of the corporation and its

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[3]The tax liability of an Alabama S corporation is passed through pro rata to the shareholders of the corporation, see generally, Code of Ala. 1975, ' 40-18-160, et seq.

divisions during the subject years are set out below:

Approximately 20 people worked at the corporation=s headquarters in Pennsylvania, including the president, the vice president of sales and two sales managers, the vice president of marketing and two product managers, the comptroller, and various accounting personnel. Those individuals assisted the three operating divisions with marketing information, advertising, credit information, and collection services. The general manager of the Alabama division talked with the corporate president weekly concerning the division=s operations. He also talked with the sales and marketing vice presidents and their staff two or three times a month concerning market conditions, product lines, etc. Central office personnel and other costs were passed to and paid by the operating divisions.

JEP provided cash management and other services to Den-Tal-Ez and the other unrelated corporations owned by the Taxpayer. JEP Aswept@ the cash from the Taxpayer=s various businesses each day. It also Aloaned@ operating capital at the prime rate to any of those businesses, as needed. JEP commingled the funds from the various businesses, and made the appropriate debit or credit accounting entries. JEP managed Den-Tal-Ez=s 401(k) plan, its employee insurance plan, and its liability insurance. JEP charged Den-Tal-Ez for those services, which in turn passed the costs to its three operating divisions.

Other than the above described services provided by corporate headquarters and JEP, the three operating divisions functioned as stand-alone businesses. A general manager was responsible for the overall operation of each division, including the hiring and firing of employees. The Alabama division operated its own research, engineering, and design departments, and developed its own products. The division=s inventory department purchased

the raw materials and pre-made components needed to manufacture its products. The manufacturing department then manufactured the products at the Bay Minette facility. The shipping department delivered the finished products to the customers, who were billed by the division=s billing department in Bay Minette.

The Alabama division maintained its own telecommunications and computer systems, and had independent customer service and technical service departments. The division also did its own pricing, handled its own personnel training, performed its own payroll and accounting services, and retained local attorneys to handle any legal problems relating to the Alabama facility.

The Alabama division did not share personnel, materials, or information with the Pennsylvania operating divisions, or otherwise communicate with those divisions. Each division had its own toll-free 800 number. There was no overlapping of products or product lines between the divisions. Products sold by one division could not be returned to or serviced by another division.

The Alabama division and the Custom Air division did share a 20 to 25 person sales force during the subject years. Those salesmen sold the products of the two divisions to some of the same distributors (as did Star Dental), although to different departments within the distributors= operating structures. The salesmen were paid on a strict commission basis by the divisions.

ANALYSIS

Issue (1) Were the corporation=s Pennsylvania divisions part of the corporation=s unitary business being conducted in Alabama?

For income tax purposes, Alabama requires multistate corporations to allocate and apportion their income to Alabama under the MTC. See, *supra* n. 1. However, a state may not tax a corporation=s income earned outside the state that is unrelated to its in-state activities. AUnder both the Due Process and Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, >tax value outside its borders.=@ *Container Corp. of America v. Franchise Tax Board*, 103 S.Ct. 2933, 2939 (1983), citing *ASARCO, Inc. v. Idaho State Tax Comm=n*, 102 S.Ct. 3103, 3109 (1982). Rather, there must be Asome definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.@ *Allied-Signal, Inc. v. Director, Division of Taxation*, 112 S.Ct. 2251, 2258 (1992), quoting *Miller Bros. v. Maryland*, 72 S.Ct. 535, 539 (1954). A. . . [I]n the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.@ *Allied-Signal*, 112 S.Ct. at 2258, quoting *Quill Corp. v. North Dakota*, 112 S.Ct. 1904, 1909 (1992). That is, the business activity from which the out-of-state income was earned must be sufficiently related to the corporation=s unitary business being conducted in the state. That is the unitary business principle, which the U.S. Supreme Court has described as Athe linchpin of apportionability in the field of state income taxation.@ *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 100 S.Ct. 1223, 1232 (1980).

Broadly speaking, a business is unitary if its components, either separate subsidiary corporations or divisions within a single corporation, are so operationally related and

interdependent as to constitute a single business enterprise.[4] Because the various interstate components of a unitary business contribute to the production of the business=overall income, such income may be apportioned to the various states in which the business operates. However, a state may not tax income derived from an out-of-state activity unrelated to the corporation=s in-state business that constitutes a Adiscrete business enterprise.@ *Allied-Signal*, 112 S.Ct. at 2259, citing *Mobil Oil*, 100 S.Ct. at 1234.

The scope of a unitary business is not defined in Alabama by statute or Department regulation. Alabama=s courts also have never addressed the issue. The issue has, however, been the subject of numerous decisions of the U.S. Supreme Court and courts in other states.

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[4]Alabama is a separate return state, and thus does not allow and cannot require the filing of combined, unitary returns by related corporations, absent extraordinary circumstances. See, *Dravo Corp. v. State of Alabama*, Corp. 96-418 (Admin. Law Div. 2/5/02). Consequently, as a practical matter the unitary business principle is relevant in Alabama only for purposes of determining if separate divisions or activities of a single corporation are unitary, as in this case.

Beginning with *Mobil Oil* in 1980 and ending with *Allied-Signal* in 1992, the Supreme Court issued a series of opinions defining the constitutional bounds within which a state can tax extraterritorial income under the unitary business principle.[5] Those cases hold that the relevant inquiries in deciding if the components of a business enterprise are unitary are whether there is an Aexchange or transfer of value, which may be evidenced by functional integration, centralization of management, and economies of scale.@ *Allied-Signal*, 112 S.Ct. at 2257, quoting *Container Corp.*, 102 S.Ct. at 2940. The Supreme Court also recognized, however, that there is a wide range of acceptable tests for determining if an enterprise is unitary, *Container Corp.*, 102 S.Ct. at 2933, and that a state is free to develop its own test, as long as it is within the constitutional bounds set by the Court. Numerous state courts have done so.

At one end of the spectrum, the California Supreme Court has articulated a broad Athree unities@ test, which focuses on (1) unity of ownership, (2) unity of operations, and (3) unity of use. *Butler Bros. v. McColgan*, 111 P.2d 334, aff=d 62 S.Ct. 701 (1942). At the other

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[5]The other cases are *Container Corp., supra*; *F.W. Woolworth Co. v. Taxation and Revenue Dept.*, 102 S.Ct. 3128 (1982); *ASARCO, supra.*

end of the spectrum, Louisiana has adopted a restrictive view of the scope of a unitary business. *Texas Co. v. Cooper*, 107 So.2d 676 (1959). For an excellent discussion of the issue and the approaches taken by the courts in various states, see, Hellerstein, *supra* n. 2, at &8.09.

In his treatise, Professor Hellerstein criticizes both the broad California approach and the narrow Louisiana approach, and instead persuasively argues for an intermediate approach - the basic operational interdependence test. Hellerstein, *supra* n. 2, at &8.09(4). That test focuses on whether there is a substantial flow of materials and operational services and information between the segments of a business enterprise, with less emphasis on centralized management and the providing of common administrative services by a parent corporation or a corporate headquarters.

> The recognition that an enterprise is not unitary unless, among other things, there is a substantial interdependence of basic operations among the various affiliates or branches of the business provides a quantifiable, objective test of the unitary business.
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> For example, if the only link between segments of a business (whether or not separately incorporated) lies in the common management, legal, financial, and other centralized services that organizations under common control typically employ, and if there are no substantial flows of products, operational services, or operational intangibles that make a determination of income on a separate geographic basis difficult if not impossible, the business segments would not be unitary.

Hellerstein, *supra* n. 2, at &8.09(4)(d).

The operational interdependence test was adopted by the Arizona Court of Appeals in *State ex rel. Arizona Dept. of Revenue v. Talley Industries, Inc.*, 893 P.2d 17 (App. 1994).

Talley was the parent corporation of 25 subsidiary corporations located both inside and outside of Arizona. Talley performed a variety of services for the subsidiaries, including tax preparation, accounting, personnel training, and employee benefits. Talley also acted as a central banker for the subsidiaries, and its corporate officers served as directors and supervised the operation of the subsidiaries. There was, however, no exchange of materials, products, information, or other operational ties between the Arizona subsidiaries and those located in other states.

Extensively citing the Hellerstein treatise, the Arizona Court held that the out-of-state subsidiaries were not part of Talley=s unitary business in Arizona because there was no substantial operational interrelationship between the subsidiaries.

> Notwithstanding the above (relationship between the parent and the subsidiaries), the record establishes no substantial interrelationship between the subsidiaries. There were no transfers of materials, products, goods, technological data relating to products, processes, machinery, or equipment by subsidiaries operating wholly outside Arizona to subsidiaries with operations in Arizona. Also, virtually no flow of product and no vertical or horizontal integration of business operations exists between the subsidiaries with, and those without, income-producing factors and business operations in Arizona. No basic operational ties existed between the two Arizona real estate subsidiaries and any other Talley subsidiary.

Talley, 893 P.2d at 17, 19.[6]

The Tennessee Court of Appeals also followed the operational interdependence test in *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460 (Tn. 1996). In that case, Dreyfus conducted business through seven trading groups. Six of the groups traded commodities.

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[6]For a more recent Arizona case affirming *Talley* and the operational interdependence test, see *F.W. Woolworth Co. v. Arizona Dept. of Revenue*, 1998 Ariz. Lexis 693 (App. 1997).

One of the commodity groups was in Tennessee. The seventh group was a bond trading group in Connecticut.

Tennessee included the Connecticut bond trading group as part of Dreyfus= unitary business in the State. The Tennessee Court of Appeals disagreed, holding that Afor a business to be unitary, there must be a substantial interrelationship or interdependence among its basic operations.@ *Dreyfus*, 933 S.W.2d at 469, citing *Talley*, 893 P.2d at 24. The Court found that no such interrelationship existed.

> The Bond Trading Group has no operational relationships with the Louis Dreyfus Corporation=s six commodities groups. Its business activities are discrete from the other groups. In addition, its offices are geographically separated from the other corporate offices; it uses separate telecommunications and computer systems; and it maintains separate financial relationships that are not available to the other groups. It does not share employees with the other groups or participate in common training programs, and its employees do not rotate to and from the commodities groups. The Bond Trading Group could easily exist and operate without the commodities groups. It neither depends on nor contributes to the business operations of the commodities groups, especially (the Tennessee based commodities group).

Dreyfus, 933 S.W.2d at 470.

The Department argues in this case that Den-Tal-Ez=s three operating divisions were unitary because (1) they all manufactured and sold dental-related products, (2) corporate headquarters provided common marketing and administrative services to each division, (3) the divisions had common ownership, and (4) the funds from the divisions were commingled and used to make loans to the Alabama division. But under the pragmatic operational interdependence test, those facts are not controlling.

The fact that the three divisions all sold dental products is irrelevant. Otherwise, one could argue that General Motors and Ford are unitary. What is relevant is whether the

underlying operations of the divisions were interrelated.

> Whether the businesses differ in the nature of their products, lines, and services should be irrelevant in deciding whether unitary apportionment is appropriate. Such an inquiry is not directed to the fundamental question presented in deciding whether a unitary business exists, that is, the extent of interdependence, integration, and interrelation of their basic operations, or, at a minimum, whether there is a Aflow of value@ between the different operations.

Hellerstein, *supra* n. 2, at &8.09(6)(a).

Clearly, the Pennsylvania and Alabama divisions were not operationally related. Each division independently designed, developed, manufactured, priced, marketed, and sold its own products. Importantly, the divisions did not share employees, technology, materials, or information, and otherwise did not contribute to the operations of the other divisions. There was no flow of value between the divisions as required for the divisions to be unitary.

The common marketing and administrative services provided by corporate headquarters also did not establish that the operating divisions were part of a unitary business. Such Ainternal services are not embodied in the product or its delivery to the nonaffiliated customers of the enterprise,@ and thus Amay be properly regarded as merely accessory to the basic operations of the business.@ Hellerstein, *supra* n. 2, at &8.09(4)(b). And as in this case, where the corporation passed the central office expenses pro rata to the three operating divisions, the cost of such services are easily identifiable for separate accounting purposes.

The Alabama division did share a sales force with one of the Pennsylvania divisions, but the salesmen sold the products of the different divisions to different customers, albeit sometimes to different departments of the same distributor. The sales force was also paid on

a commission basis by the two divisions, which again is easily identifiable and assignable for separate accounting purposes.

Common ownership of separate divisions of a single corporation has no bearing on whether those divisions are part of a unitary operation. AUnity of ownership alone does not necessarily indicate that the various components of a business are substantially interdependent on each other.@ *Dreyfus*, 933 S.W.2d at 468.

Finally, the Department emphasizes that the funds of the three operating divisions were commingled by JEP and used to make loans to the Alabama division. That fact does suggest an operational link between the divisions. But JEP managed the cash of all of the Taxpayer=s corporations, not just Den-Tal-Ez. The loans also were at arm=s-length because JEP charged interest at the prime rate. In any case, as recognized by the Oregon Tax Court in *Cox Cablevision Corp. v. Dept. of Revenue*, 12 Or. Tax 219 (1992), A[w]hile centralized financing is a factor to consider, it is a nonoperating function and should receive less weight.@ *Cox Cablevision*, 12 Or. Tax at 226. See also, *Dreyfus*, in which the Tennessee Court of Appeal also rejected centralized financing as establishing a unitary relationship. *Dreyfus*, 933 S.W.2d at 469.

In summary, while all three divisions received some common services and marketing assistance from the corporation=s headquarters, the divisions were not operationally related to each other. The two Pennsylvania divisions were discrete, independent businesses unrelated to the corporation=s Alabama division. Consequently, apportioning the income of those unrelated divisions to Alabama would not accurately reflect that part of the corporation=s

income earned in Alabama, which, after all, is the end goal of factor apportionment. See also, *Danov Corp. v. State of Alabama*, Corp. 97-283 (Admin. Law Div. 12/22/00) (dividend income of a Florida-based corporation not subject to Alabama tax because it was derived from activities unrelated to the corporation=s oil and gas-related activities in Alabama).

Although the two Pennsylvania divisions were not unitary with the Alabama division, those divisions could still be taxed by Alabama if they had independently done business in and had substantial nexus with Alabama in the subject years. For example, if the Pennsylvania divisions= sales forces had called on and made sales to customers in Alabama, and had otherwise conducted business in Alabama beyond the protection of 15 U.S.C. ''381-384 (Public Law 86-272), then Alabama could apportion the income of those divisions, regardless of their lack of a unitary relationship with the Alabama division.

However, the evidence shows only that the three divisions sold their products throughout the United States. There is no evidence whether, and if so to what extent, the Pennsylvania divisions made sales in Alabama, or what other business-related activities those divisions may have conducted in Alabama. Without evidence that the Pennsylvania divisions were independently doing business in and had nexus with Alabama, the income of those divisions cannot be taxed by Alabama.

Issues (2), (3), and (4) are pretermitted by the above holding. The final assessments in issue are dismissed.

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

Entered April 17, 2002.