ALCO STANDARD CORPORATION Post Office Box 834 Valley Forge, Pennsylvania 19482,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. INC. 94-335
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed income tax against Alco Standard Corporation, Inc. ("Taxpayer") for the fiscal years ending September 30, 1990, September 30, 1991, and September 30, 1992. The Taxpayer appealed to the Administrative Law Division, and a hearing was conducted on February 15, 1995. Joanne Fusco represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

This case involves the method by which the Taxpayer, a foreign corporation, should be required to compute the interest expense deduction allowed foreign corporations at Code of Ala. 1975, §40-18-35(a)(2). Specifically, did the Department properly prorate the Taxpayer's interest expense deduction to Alabama using Department Reg. 810-3-31-.02(1)(a)5.(i).

The Taxpayer is a foreign corporation that operated in Alabama and numerous other states during the years in issue. The Taxpayer filed Alabama income tax returns for the subject years and reported negative taxable income and thus no tax due in each of the years. As discussed later, the negative income amounts resulted because the Taxpayer claimed a large interest deduction in each year.

The beginning figure on the Alabama foreign corporation income tax return is the federal net income figure reported on the corporation's federal tax return. In arriving at federal net income, a corporation is allowed to deduct its total interest expense incurred during the subject year. The Taxpayer in this case deducted interest expense in arriving at federal net income of approximately $117,000,000.00 in 1990, approximately $82,000,000.00 in 1991, and approximately $113,000,000.00 in 1992.

A foreign corporation is allowed to deduct only a portion of its total interest expense for Alabama purposes because only a portion of its total income is reported to and taxed in Alabama through allocation and apportionment. Consequently, in computing its Alabama interest deduction, a corporation is required to determine what portion of total interest claimed on the federal return cannot be allowed in Alabama. The non-allowable interest is then added back to apportionable income as a reconciliation adjustment on the Alabama return. The method by which non-allowable interest must be prorated to Alabama is the issue in this case.

The Taxpayer in this case failed to prorate and add back any interest as an adjustment on its Alabama returns for the subject years.

The Department audited the Taxpayer and prorated interest pursuant to the ratio set out in Reg. 810-3-31-.02(1)(a)5.(i).

That regulation provides that "interest expense shall be prorated to non-business assets by multiplying total interest expense by the ratio of average cost of the non-business assets to the average cost of the total assets".

The Department then added back to apportionable income in each year that portion of the interest expense not allowable in Alabama as determined under the regulation. The Department also removed non-business dividends and non-business capital gains from apportionable income. Those adjustments are, of course, not disputed by the Taxpayer. The final assessments in issue are based on the above adjustments.

Although the Taxpayer failed to prorate and add back any interest to its Alabama returns for the subject years, the Taxpayer's representative concedes that some adjustment or add-back of interest is appropriate. However, the Taxpayer argues that the method set out in Reg. 810-3-31-.02(1)(a)5.(i) is not authorized by statute and must be rejected. Rather, the Taxpayer contends that the statutory formula for prorating interest set out in §40-18-35(a)(2) must be followed.

The Department argues that Reg. 810-3-31-.02(1)(a)5.(i) is a reasonable method for determining what portion of a foreign corporation's total interest expense should be allowed in Alabama.

Both parties make various technical arguments as to why the regulation either does or does not properly prorate interest to

Alabama. However, there is no need to address those arguments because the Taxpayer is correct that the statutory formula set out in §40-18-35(a)(2) must be followed, not the regulation.

Section 40-18-35(a)(2) allows a deduction for all interest paid by a corporation, and reads in pertinent part as follows:

> ". . . in the case of a foreign corporation, the proportion of such interest which shall be deductible shall be a portion of such interest determined by the ratio the amount of its gross income from sources within the State of Alabama bears to the amount of its gross income from all sources both within and without the State of Alabama;"

The above statute provides a clear statutory method for prorating a foreign corporation's interest expense to Alabama. If a regulation is contrary to the plain language of a statute, the regulation must be rejected and the statute followed. Ex parte City of Florence, 417 So.2d 191 (Ala. 1982). The Alabama Supreme Court in Ex parte Jones Manufacturing Company, Inc., 589 So.2d 208 (Ala. 1991), at page 210, stated as follows:

> "The provisions of a statute will prevail in any case of a conflict between a statute and an agency regulation. *Ex parte State Dep't of Human Resources*, 548 So.2d 176 (Ala. 1988). An administrative regulation must be consistent with the statutes under which its promulgation is authorized. *Ex parte City of Florence*, 417 So.2d 191 (Ala. 1982). An administrative agency cannot usurp legislative powers or contravene a statute. *Alabama State Milk Control Bd. v. Graham*, 250 Ala. 49, 33 so.2d 11 (1947). A regulation cannot subvert or enlarge upon statutory policy. *Jefferson County Bd. of Ed. v. Alabama Bd. of Cosmetology*, 380 So.2d 913 (Ala.Civ.App. 1980)."

In the Department's defense, §40-18-35(a) does provide that "the proper apportionment and allocation of deductions of such

foreign corporations with respect to the income arising from sources within and without the State of Alabama shall be determined under the rules and regulations prescribed by the department of revenue;". However, a specific statute relating to a specific subject is regarded as an exception to and must prevail over a general statute relating to a broad subject. Ex parte Jones Manufacturing Co., Inc., supra, at page 211. Consequently, §40-18-35(a)(2), which gives a specific formula that must be followed in prorating interest to Alabama, must control over the general provision that allows the Department to issue regulations relating to the apportionment and allocation of a deduction. Section 40-18-35(a)(2) must govern as to its specific field of operation, i.e. the proration of interest.

An argument can also be made (by either the Taxpayer or the Department) that the gross income formula set out in §40-18-35(a)(2) does not "fairly reflect the net income of the corporation attributable to its operations in Alabama", as mandated by §40-18-35(a). But again, the plain language of §40-18-35(a)(2) must control.

Department Reg. 810-3-31-.02(1)(a)5.(i) clearly conflicts with the formula set out in §40-18-35(a)(2), and is accordingly rejected.[1] The Department is directed to recompute the Taxpayer's

[1]A Department regulation or policy was also rejected in the following Administrative Law Division cases where the regulation or policy conflicted with a statute. In State v. Arch of Alabama, Inc., Docket No. F. 90-173 (decided July 22, 1994), the Department's policy of allowing corporations to net intercompany receivables against payables for franchise tax purposes was

interest expense deduction for the years in issue in accordance with the formula set out in §40-18-35(a)(2).

The Taxpayer's representative submitted her computations based on the §40-18-35(a)(2) formula as Exhibits A and A-1 to her brief. The Department should review Exhibits A and A-1 (and contact the Taxpayer's representative for clarification if necessary), and

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rejected as not allowed by statute; In State v. American Fructose Decatur, Inc., Docket No. F. 94-125 (decided December 14, 1994), Department Reg. 810-2-3-03, which allowed a franchise tax deduction from capital for investments in foreign corporations, was rejected because it was not allowed or supported by statute (see also, State v. TRMI Holdings, Inc., Docket No. F. 94-177 (decided January 11, 1995), involving the same issue.); In Union Bank and Trust Co. v. State, Docket No. Inc. 94-401 (decided June 16, 1995), Department Reg. 810-9-1-.04(3)a. was rejected because it allowed financial institutions a credit for sales tax paid that was not authorized by statute.

thereafter notify the Administrative Law Division of (1) the adjusted interest expense deduction that should be allowed in each year, and (2) the Taxpayer's adjusted liability in each year. A Final Order setting out the Taxpayer's liability will then be entered. The Final Order, when entered, may be appealed by either party to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered June 23, 1995.

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BILL THOMPSON
Chief Administrative Law Judge