FIFTEENTH DANIEL REALTY INVESTMENT CORPORATION Post Office Box 385001 Birmingham, Alabama 35238,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
FOURTEENTH DANIEL REALTY INVESTMENT CORPORATION Post Office Box 385001 Birmingham, Alabama 35238,	§	DOCKET NOS. F. 94-339 F. 94-386 F. 94-424 F. 94-425
DANIEL REALTY INVESTMENT CORP. MEADOW BROOK ONE Post Office Box 385001 Birmingham, Alabama 35238,	§	
DANIEL REALTY INVESTMENT CORP. Post Office Box 385001 Birmingham, Alabama 35238,	§	
Taxpayers,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed franchise tax against Fourteenth Daniel Realty Investment Corporation for the years 1991, 1992 and 1993, against Fifteenth Daniel Realty Investment Corporation for the years 1990 through 1993, against Daniel Realty Investment Corporation Meadowbrook One for the years 1990 and 1993, and against Daniel Realty Investment Corporation for the years 1990 through 1994. The above entities are hereafter referred to jointly as "Taxpayers". The Taxpayers appealed the final assessments to the Administrative Law Division. The cases were consolidated and heard together on December 6, 1994. Tom Mahoney, Jr. represented the Taxpayers. Assistant Counsel Beth Acker represented the

Department.

This case involves two issues:

(1) The primary issue is whether certain promissory notes issued to the Taxpayers by the Taxpayers' parent corporation, Daniel Realty Corporation, should be included as capital for Alabama franchise tax purposes pursuant to Code of Ala. 1975, §40-14-41(b). Specifically, should those notes be included as "surplus" under §40-14-41(b)(2);

(2) The second issue is whether the Department should make certain adjustments to the Taxpayers' retained earnings account in each year.

The Taxpayers are all wholly-owned subsidiaries of Daniel Realty Corporation. The Taxpayers were all formed for the sole purpose of being a corporate general partner in certain real estate limited partnerships. To satisfy the net worth requirements of Revenue Procedure 72-13, the parent corporation, Daniel Realty Corporation, issued to each Taxpayer a promissory note equal to at least ten percent of the total contributions to the partnership.

The notes were issued between 1979 and 1985, and are zero interest bearing and payable on demand. None of the notes have every been paid, and, according to the Taxpayers, none will ever be paid. The notes were issued for the sole purpose of complying with the net worth requirements of Revenue Procedure 72-13.

For accounting purposes, when the Taxpayers received the notes, they debited notes receivable and credited their paid-in-

capital accounts. However, the Taxpayers excluded the notes from capital in filing their franchise tax returns for the subject years. The Department audited the Taxpayers, included as capital the full amount of the paid-in-capital and retained earnings accounts, which included the notes receivable, and based thereon entered the final assessments in issue.

The Department argues that the notes cannot be netted out or deducted from surplus, citing State v. Arch of Alabama, Inc., Admin. Docket No. F. 90-173, decided July 22, 1994. The Arch of Alabama, Inc. case held that intercompany receivables are not allowed by statute as a deduction from capital, and thus a foreign corporation cannot be permitted to reduce its capital base by netting or deducting intercompany receivables against intercompany payables. The Department thus argues that the notes in issue cannot be deducted from the Taxpayers' surplus accounts in computing capital.

The Taxpayers contend that this case does not involve an unauthorized deduction from capital, as did Arch of Alabama, Inc.. Rather, the Taxpayers argue that the issue here is whether the notes must be included in capital in the first place as a part of "surplus and undivided profits" under §40-14-41(b)(2). The Taxpayers argue that generally accepted accounting principles ("GAAP") must be followed, and that under GAAP the notes should not be included in surplus, and thus should not be included in the

Taxpayers' capital base.

"Capital" is defined for Alabama franchise tax purposes at §40-14-41(b). Subparagraph (b)(2) includes in capital all "surplus and undivided profits" of a foreign corporation.

"Surplus and undivided profits" is not defined for franchise tax purposes. However, §40-14-41(c) provides that "total capital as herein defined . . . shall be determined in accordance with generally accepted accounting principles appropriate in the particular case, . . .". GAAP should thus be used as an aid in determining or defining the specific items of capital set out in §40-14-41(b). West Point Pepperell v. Department of Revenue, 624 So.2d 579 (Ala.Civ.App. 1992), cert. denied Ex parte State Department of Revenue, 624 So.2d 582 (Ala. 1993); see also, Arch of Alabama, Inc., supra.

I agree that the issue in this case is not whether the notes receivable can be allowed as a deduction from the Taxpayers' capital base. Rather, the issue is whether the notes should be included in the capital base as "surplus and undivided profits" pursuant to §40-14-41(b)(2). GAAP must be followed in making that determination.

From the authorities submitted by the Taxpayers, specifically Financial Accounting Standards Board Emerging Issues Task Force, Issue No. 85-1, the notes in issue should not be included as surplus under GAAP. Consequently, the notes should not be included

as capital under §40-14-41(b)(2).

Concerning the second issue, the Taxpayers contend that the Department inadvertently failed to properly compute retained earnings during the subject years. The Taxpayers, as requested by the Department, have submitted financial statements to the Department showing all year end adjustments. The Department should review the Taxpayers' financial statements and inform the Administrative Law Division of its position concerning the retained earnings issue. Appropriate action will be taken by the Administrative Law Division at that time.

This Opinion and Preliminary Order is not an appealable order. The Administrative Law Division will, at the appropriate time, enter a Final Order in the case. The Final Order, when entered, may then be appealed by either party to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered June 28, 1995.

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BILL THOMPSON
Chief Administrative Law Judge