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<tr><td>KIMBERLY-CLARK CORPORATION
KIMBERLY-CLARK WORLDWIDE, INC.
3800 Citibank Center Tampa
Building B 2 13
Tampa, FL 33610-9559,</td><td>§

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§</td><td>STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION</td></tr>
<tr><td>Taxpayers,</td><td>§</td><td>DOCKET NOS. CORP. 01-983
CORP. 01-995</td></tr>
<tr><td>v.</td><td>§</td><td></td></tr>
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DEPARTMENT OF REVENUE.</td><td>§</td><td></td></tr>
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FINAL ORDER

The Revenue Department assessed Kimberly-Clark Corporation ("KC") and Kimberly-Clark Worldwide, Inc. ("KCW") for corporate income tax for 1996, 1997, and 1998. KC and KCW (together "Taxpayers") appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. Bruce Ely, Joe Mays, Jr., and Chris Grissom represented the Taxpayers. Assistant Counsel Jeff Patterson and Mark Griffin represented the Department.

ISSUES

KC sold its paper/pulp mill (the "Coosa mill") and KCW sold approximately 375,000 acres of adjacent timberland (the "Coosa timberland") in Alabama in 1997. The issues in this case are:

(1) Did the receipts from the sale of the Coosa mill and Coosa timberland constitute "business income," as that term was defined in Alabama during the years in issue at Code of Ala. 1975, §40-27-1, Art. IV, ¶1(a); and,

(2) If the sale receipts constituted apportionable business income, should they be excluded from the Taxpayers' sales factors pursuant to Department Reg. 810-27-1-4-.18(3)(a) (the "Special Rule")?

FACTS

KC is primarily engaged in the manufacture and sale of tissue and paper-related consumer products. It is also engaged in other businesses, and owns numerous subsidiaries involved in other businesses. During the years in issue, KC and its subsidiaries operated in 42 countries, employed approximately 60,000 employees, and generated annual sales of $12 to $13 billion.

In 1962, KC purchased a pulp and paper manufacturing facility and approximately 375,000 acres of adjacent timberland in East Central Alabama, i.e. the Coosa mill and Coosa timberland. KC harvested the trees from the Coosa timberland to make pulp for use in the Coosa mill. KC reported the income from the Coosa mill and Coosa timberland on its annual Alabama income tax returns as apportionable business income.

In the early 1990's, KC adopted a corporate strategy of concentrating on its consumer products businesses. Consequently, it began selling existing businesses that did not fit that strategic goal, and acquiring other businesses that did.

As part of its long-term strategy, KC acquired Scott Paper Company, Inc. in late 1995. Scott Paper became a wholly-owned subsidiary of KC in December 1995, and changed its name to Kimberly-Clark Tissue Company (“KCTC”) in February 1996. Scott Worldwide, Inc. (“SWI”) was a wholly-owned subsidiary of Scott Paper when it merged with KC. SWI owned and managed approximately 995,000 acres of timberland in Nova Scotia, Canada.

In November 1996, KC formed KCW as a subsidiary of KCTC for the primary purpose of acquiring, managing, and selling timberland. KCW also owned and operated manufacturing facilities in Utah and California. SWI merged into KCW in November 1996.

KC also simultaneously transferred its Coosa timberland to KCTC, and then to KCW, in an IRC §351 tax-free transfer. KCW thus owned both the Coosa timberland and the 995,000 acres of Nova Scotia timberland previously owned by SWI. KCW employees that previously worked for SWI continued to oversee and manage the Nova Scotia timberland. KCW contracted for KC employees to manage the Coosa timberland.

KCW engaged in 30 like-kind exchanges or cash sales of timber from 1996 through 1998. The exchanges and sales each involved from 800 to 1,500 acres. KCW also acquired approximately 520,000 acres of timberland in South Alabama (the "Mobile timberland") in 1998. It sold the Mobile timberland to an unrelated party in 1999. It still owns and manages the Nova Scotia timberland, and also the Utah and California manufacturing facilities.

As part of its long-term strategy, KC also planned to reduce its exposure in the pulp business. KC's goal in the mid-1990's was to reduce its dependency on internal pulp production from 80 percent to 30 percent. KC consequently sold its Coosa mill and the adjacent KCW Coosa timberland to an unrelated party in March 1997 for $600 million.[1] KCW received $350 million for the Coosa timberland. KC received the balance of $250 million for the Coosa mill. KC used the sale receipts to either acquire other businesses or repurchase its own stock.

KC also acquired and disposed of various other businesses or business segments during the 1990's as part of its corporate strategy discussed above. It has ten to fifteen employees at its Texas headquarters that plan and oversee acquisitions and dispositions. KC sold two pulp/paper mills in the early 1990's, and one paper mill other than the Coosa

[1]Another factor considered by KC in deciding to sell the Coosa mill was that it would have been required to spend millions of dollars to comply with the EPA=s Cluster Rules if it kept the mill.

mill during the 1996-1998 audit period. It owned and operated seven pulp/paper mills during the audit period, and acquired five mills after that period. Additionally, KC acquired five non-pulp/paper-related businesses and sold nine such businesses during the audit years.

KC and KCW reported the gross receipts from the sale of the Coosa mill and the Coosa timberland, respectively, as apportionable business income on their 1997 Alabama corporate income tax returns. They also excluded the sale receipts from their apportionment sales factors pursuant to the Department's Special Rule. That rule requires that if "substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor." Reg. 810-27-1-4-.18(3)(a).

The Department initially accepted the Taxpayers' classification of the income as apportionable business income. However, it disallowed the exclusion of the gross receipts from the sales factors. It also made other adjustments that are not contested. The Department notified KC that KC was due a reduced refund of $147,649 for the subject years. It also billed KCW for additional tax and interest of $3,372,129.

The Taxpayers filed petitions for review with the Department, arguing that the Coosa sale receipts should be excluded from their sales factors pursuant to the Special Rule. They also argued in the alternative that the sale receipts constituted nonbusiness income, and thus should be allocated 100 percent to Texas, their state of commercial domicile.

The Department accepted the Taxpayers' alternative argument that the income was nonbusiness income. However, instead of allocating the income to the Taxpayers' state of commercial domicile, the Department allocated it 100 percent to Alabama pursuant to Code of Ala. 1975, §40-27-1, Art. IV, ¶6(a). The Department consequently assessed KC and

KCW for $7,382,559 and $13,593,834, respectively. The Taxpayers appealed.

The Taxpayers argue that their earlier alternative argument that the sale receipts were nonbusiness income was based on incomplete information, and was incorrect. They now contend that the receipts were business income because the sales were made in the regular course of business. In support of their position, the Taxpayers emphasize that (1) the sale receipts were reinvested in business-related activities; (2) they reported the income as business income in most of the states in which they filed returns during the subject years; and (3) the sales did not liquidate either company. KCW also claims that it actively managed the Coosa timberland.

The Taxpayers also still assert that the sales receipts must be excluded from their apportionment sales factors pursuant to the Special Rule.

The Department claims that the Coosa sales resulted in nonbusiness income because they involved a non-core division of KC, were extraordinary in nature, and were not made in the regular course of business. The Department points out that KC reported the sale as an "extraordinary item" for financial accounting purposes. It also argues that if the income is deemed to be apportionable business income, the sales receipts must be included in the Taxpayers' sales factors so as to fairly reflect the Taxpayers' business activities in Alabama.

ANALYSIS

Issue (1). Are the sale receipts business income or nonbusiness income?

Alabama adopted the Multistate Tax Compact ("MTC") in 1967.[2] The MTC was

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[2]The Department did not formally acknowledge the applicability of the MTC in Alabama until after the 1993 decision in *State, Dept. of Revenue v. MGH Management, Inc.*, 627 So.2d 408 (Ala.Civ.App. 1993). It

intended as a uniform system by which the states could accurately identify and thus fairly tax that part of a multistate corporation's income attributable to each state. The MTC does not rely on the geographical sourcing of income. Rather, it is based on the allocation and apportionment rules established in 1957 by the Uniform Division of Income for Tax Purposes Act ("UDITPA"). *Ex parte Uniroyal Tire Co.*, 779 So.2d 227, 230 (Ala. 2000). A multistate corporation's business-related income is apportioned among the states in which the corporation operates, generally in accordance with an equal weighted three-factor formula of sales (gross receipts), payroll, and property. Code of Ala. 1975, §40-27-1, Art. IV, ¶9. The corporation's nonbusiness income is allocated 100 percent to one state, usually the corporation's state of commercial domicile, but concerning income from the sale of real property, as in this case, to the state in which the property was located. Code of Ala. 1975, §40-27-1, Art. IV, ¶¶5-8; see generally, R. Pomp & O. Oldman, *State and Local Taxation* (4th ed. 2001) at 10-7 et seq.

The MTC also provides that if the usual allocation and apportionment provisions do not fairly reflect a taxpayer's business activity in the state, the tax administrator may require or the taxpayer may request an alternative method "to effectuate an equitable allocation and apportionment of the taxpayer's income" to the state. Code of Ala. 1975, §40-27-1,

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had, however, promulgated and applied a version of the MTC allocation and apportionment rules as early as 1971. See generally, *QMS, Inc. v. State of Alabama*, Inc. 98-165 (Admin. Law Div. OPO 9/23/99) at 13-16.

Art. IV, ¶18.

During the years in issue, “business income” was defined in Alabama at §40-27-1, Art. IV, ¶1(a), as follows:[3]

> “Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.

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[3]The Alabama Legislature enacted a new definition of Abusiness income@ in 2001, effective for tax years beginning after December 31, 2001. See, Act 2001-1113, 4th Special Sess. p. 1178, '1. The new definition broadly defines the term, and is codified at Code of Ala. 1975, '40-27-1.1. The income in issue would clearly qualify as business income under the current definition. As indicated, however, the original MTC definition at '40-27-1, Art. IV, &1(a) was in effect during the years in issue, and thus controls in this case.

The Alabama Supreme Court addressed the "business income" issue in *Ex parte Uniroyal Tire Co.*, 779 So.2d 227 (Ala. 2000). The Court first recognized that courts in other states have disagreed concerning the definition, some holding that it includes only a "transactional test," with others finding an alternative "functional test." Id. at 230. The Court rejected the existence of an alternative functional test, and held that the definition included only a transactional test.[4] The Court held that Uniroyal's 100 percent liquidation of its interest in a partnership was not in its regular course of business, and thus constituted allocable nonbusiness income under the transactional test .

The transactional test focuses on the first clause of the definition – "income arising. . . from transactions and activities in the regular course of the taxpayer's trade or business. . . ." Under the transactional test, the "controlling factor. . .is the nature of the particular transaction giving rise to the income. . .the frequency and regularity of similar transactions and the former practices of the business are pertinent considerations." Id. at 230, citing

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[4]A respected commentator has harshly criticized the *Uniroyal* decision as contrary to the original intent of the UDITPA drafters. See, J. Peters, AAlabama Supreme Court Undermines the Multistate Tax Compact and its Commission,@ *State Tax Notes*, March 26, 2001, p. 1105. However, Alabama case law requires that the language of a statute must control, not what the drafters of the statute may later claim they intended. *Pilgrim v. Gregory*, 594 So.2d 114 (Ala.Civ.App. 1991).

In their treatise, Professors Jerome and Walter Hellerstein note that as a matter of policy, business income should include the functional test, i.e. should encompass income from the sale of property that was used in the taxpayer=s business. They conclude, however, that the UDITPA definition of Abusiness income@ includes only a transactional test.

> In short, despite the compelling policy reasons for adoption of the functional test, we do not believe that the language of UDITPA authorizes it. Nor do we believe that the language of the statute can be altered by administrative regulation (such as the MTC=s regulation) or by the drafter=s comments.

J. Hellerstein & W. Hellerstein, *State Taxation* (3d ed. 2001) at &9.05[2][c].

General Care Corp. v. Olsen, 705 S.W.2d 642, 644 (Tenn. 1986).[5]

Some state courts have found that a corporation's sale of a business segment resulted in nonbusiness income under the transactional test. See, *Western Natural Gas Co. v. McDonald*, 446 P.2d 781 (1968) (a gas company's sale of its oil and gas leases in a complete liquidation gave rise to nonbusiness income); *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 486 (N.M. Ct. App.), *cert. denied* 546 P.2d 71 (1975) (the taxpayer's liquidation of a large pipe division resulted in nonbusiness income because "the transaction in question was a partial liquidation of taxpayer's business and a total liquidation of taxpayer's big inch (pipe) business." Id. at 492); *Laurel Pipeline Co. v. Comm. Board of Finance & Revenue*, 642 A.2d 472 (Pa. 1994) (a pipeline company's sale of an idle pipeline produced nonbusiness income because "[a]lthough Laurel continued to operate a second, independent pipeline, the sale (of the idle pipeline) constituted a liquidation of a separate and distinct aspect of its business." Id. at 475).

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[5]Under the functional test, Abusiness income@ includes income from the sale of property that served an integral function in the taxpayer=s business operations, even if the sale itself was not in the regular course of the taxpayer=s trade or business, See generally, J. Hellerstein & W. Hellerstein, *supra* note 4, at &9.05(2)(b).

Other state courts have found that a sale of substantial business assets resulted in business income under the transactional test. See, *PPG Industries, Inc. v. Dept. of Revenue*, 765 N.E.2d 34 (Ill. App. Ct. 2002) (PPG's sale of a subsidiary resulted in business income because PPG "was engaged in the acquisition and divestiture of other companies in the regular course of its business and the sale of (the assets in issue) was attributable to a type of business transaction in which (PPG) regularly engaged." Id. at 45); *Welded Tube Co. of America v. Commonwealth of Pennsylvania*, 515 A.2d 988 (Pa. Commw. Ct. 1986) (sale of manufacturing facility gave rise to business income, even though the taxpayer made only two such sales in its 30 year history); *Atlantic Richfield Co. v. State of Colorado*, 601 P.2d 628 (Colo. 1979) (an oil company's sale of substantial assets resulted in business income under the transactional test "because it resulted from a transaction in the regular course of Richfield's business." Id. at 632).[6]

The Taxpayers argue that the Coosa sales produced business income because they subsequently used the income in their ongoing business operations. That factor has been considered by some state courts in deciding the issue. See, *Welded Tube*, 515 A.2d at 993; *General Care Corp.*, 705 S.W.2d at 644. The Alabama Supreme Court also supported its finding in *Uniroyal* that the subject income was nonbusiness by noting that the sale proceeds were distributed to the shareholders, and not reinvested in the business. *Uniroyal*,

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[6]For an analysis of numerous other state court decisions on the business income issue, see, J. Hellerstein & W. Hellerstein, *supra* note 4, at &9.05, et seq.; see also, W. Hellerstein, AThe Business-Nonbusiness Income Distinction and the Case for its Abolition,@ *State Tax Notes*, September 3, 2001, p. 725.

779 So.2d at 238.

There is some question as to how much of the Coosa sale receipts were reinvested in KC's ongoing business operations because some was used to repurchase KC stock. In any case, I respectfully disagree that how income is later used is relevant in determining whether it is business or nonbusiness income under the transactional test. Rather, the issue turns on the nature of the transaction, i.e. was the transaction in the regular course of the taxpayer's business. How the income is later used cannot change the nature of the transaction that gave rise to the income. For example, a multistate retailer derives business income from the sale of its merchandise. It is irrelevant that the retailer later uses the income to buy more merchandise, or to buy undeveloped property as a speculative investment, or distributes it as a dividend to its shareholders. In all cases, the income would still be business income from the retailer's regular course of business.

I also find it irrelevant that the Taxpayers reported the sale receipts as business income in most of the states in which they filed returns. They also reported it as nonbusiness income in some states. While the MTC was intended as a uniform system of taxation, it is anything but uniform as amended and interpreted in the various states. This is illustrated by the variety of apportionment formulas now used by the states, see generally, J. Hellerstein & W. Hellerstein, *supra* note 4, at ¶8.14, and the conflicting interpretations of "business income." Consequently, how other states required (or allowed) the Taxpayers to report the income is not binding on the Department.

Uniroyal involved a complete liquidation. But I disagree with the Taxpayers that only complete liquidations give rise to nonbusiness income under the transactional test. The sale of an operating division or other substantial business component by a corporation that does not make such sales in the regular course of business will give rise to nonbusiness income under the transactional test, even if the corporation continues to operate. See, *McVean & Barlow* and *Laurel Pipeline, supra*.

Finally, KCW claims that it managed the Coosa timberland. The Department correctly argues, however, that KC employees managed the Coosa property, not KCW employees. The point is moot in any case because who managed the property before its sale is irrelevant under the transactional test.

Although I disagree with some of the Taxpayers' arguments as indicated above, I agree that the Coosa mill sale receipts constituted apportionable business income. KC bought and sold major businesses and business components in the regular course of business during the 1990's pursuant to its long-term corporate strategy.

> In 1992, Kimberly-Clark was widely diversified. We were a consumer products company, to be sure, but we also owned paper and forest products operations and an airline. All these businesses were profitable, but in mapping our strategy for long-term sustainable growth, we concluded it lay in building on basic strengths: our core technologies, our well-known trademarks and our consumer product franchises. Businesses that did not--or could not--build on those strengths would be candidates for divestiture. Those that fit into our strategy would merit further investment and support. Outside businesses that fit into our strategy became acquisition candidates.

KC 1996 Annual Report at 3.

KC bought five non-pulp/paper-related businesses and sold nine such businesses or business components during the audit years. It sold two pulp/paper mills before the audit years and one paper mill other than the Coosa mill during the audit years. It also purchased five paper mills after the audit years.

KC's business practice of regularly buying and selling businesses was similar to that of the taxpayer in *Atlantic Richfield*, supra. The Colorado Supreme Court applied the transactional test in that case, and held that the sale of various petroleum-related properties resulted in business income because Richfield "regularly engaged in major acquisitions and dispositions of the same type involved here. From 1956 to 1977, it was involved in fifteen purchases or mergers and eleven sales of companies or blocks of assets aside from the sales at issue here. Such acquisitions and dispositions of assets constitute a systematic and recurrent business practice." Id. at 632. Likewise, KC's sale of the Coosa mill was consistent with its corporate strategy and regular practice of buying and selling businesses and business components.

The sale of the Coosa mill also did not end KC's active involvement in the pulp/paper business. It owned and operated seven pulp/paper mills during the audit period, and currently owns and operates twelve such mills. KC's goal in the mid-1990's was to reduce its dependence on internally produced pulp, not get out of the pulp and paper business entirely. While KC's sale of the Coosa mill was a substantial transaction, it did not result in a liquidation or cessation of a distinct aspect of KC's business, as was the case in *Western Natural Gas, McVean & Barlow*, and *Laurel Pipeline*.[7]

KC was required by Accounting Principles Board Opinion 16 (APB 16) to report the Coosa income as an extraordinary item for financial accounting purposes. APB16 requires that in some instances, a gain or loss from the sale of an asset within two years of a business combination must be classified as an "extraordinary item." See APB16, ¶60. The U.S. Supreme Court has stated, however, that "a company's internal accounting techniques

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[7]The parties spend considerable energy in their briefs arguing whether the Coosa properties were a Anon-core division@ of KC. But that designation, whether accurate or not, is irrelevant to the issue. Likewise, it is also irrelevant that one factor considered by KC in deciding to sell the Coosa mill was that it would have been required to spend millions of dollars to comply with the EPA=s Cluster Rules.

are not binding on a state for tax purposes." *Exxon Corp. v. Wisconsin Dept. of Revenue*, 100 S.Ct. 2109, 2119 (1980). Consequently, how KC characterized the transaction for financial accounting purposes does not change the above finding.

KCW's sale of the Coosa timberland also gave rise to business income. KCW was formed in November 1996 for the primary business purpose of acquiring, managing, and selling timberland. It exchanged or sold 30 small tracts of timberland in the regular course of business from 1996 through 1998. In addition to acquiring and selling the Coosa timberland, it also acquired 520,000 acres of Mobile timberland in 1998 and sold that land in 1999. It still owns and manages the 995,000 acres of timberland in Nova Scotia.

The Department argues that the Coosa timberland sale was not in KCW's regular course of business because it was one of only two substantial sales of timberland ever made by KCW. But there is no minimum number of transactions needed before a transaction can give rise to business income. While "the frequency and regularity of similar transactions . . . are pertinent considerations", *Uniroyal*, 779 So.2d at 230, those factors are not conclusive. Rather, as discussed, the issue turns on whether the sale was in the regular course of business. The sale of the Coosa timberland was a transaction in KCW's regular course of business because KCW was in the business of buying and selling timberland. And like the sale of the Coosa mill by KC, the sale of the Coosa timberland did not result in a liquidation or cessation of a distinct aspect of KCW's business. It continued to actively buy, manage, and sell timberland after the Coosa sale.

In *Welded Tube*, *supra*, the court held that a pipe manufacturer's sale of a manufacturing facility resulted in business income, even though the manufacturer had bought and sold real property only twice in 30 years.

> The Board argues that the taxpayer was not regularly engaged in the buying and selling of manufacturing plants and the disposition of real property only twice over the course of a thirty year corporate history cannot constitute a "systematic and recurrent" business practice so as to satisfy the (transactional) test formulated in Atlantic Richfield indicative of business income.
>
> In our view, the narrow interpretation proposed by the Board is not supported by the wording of the statute. The statute makes no reference to transactions and activity in the regular course of the taxpayer's principal business. As we read the statute, . . . it makes no difference whether the income derives from the main business, the occasional business or the subordinate business so long as the income arises in the regular course of business.

Id. at 994.

Because KC and KCW sold the Coosa mill and the Coosa timberland, respectively, in the regular course of their ongoing businesses, the gains from the sales constituted apportionable business income under the transactional test as enunciated by the Alabama Supreme Court in *Uniroyal*.

Issue (2). Should the Coosa sale receipts be excluded from the Taxpayers' sales factors pursuant to the Special Rule?

The "factor or factors used in the apportionment formula must accurately reflect a reasonable sense of how income is generated." *Container Corp. of America v. Franchise Tax Bd.*, 103 S.Ct. 2933, 2942 (1983). Specifically, "there should be a correspondence between the particular sources of income that are included in the apportionable tax base and the factors that are used to apportion such income." W. Hellerstein & J. Hellerstein, *supra* note 4, at ¶9.15(1). Consequently, if receipts from the sale of real property are included as business income in the apportionable tax base, as in this case, the receipts must also be included in the sales factor. See, §40-27-1, Art. IV, ¶15; Dept. Reg. 810-27-1-4.15(a) (a sales factor must include "all gross receipts derived by the taxpayer from transactions and activity in the course of its regular trade or business operations which produce business income . . .").

The Taxpayers argue, however, that the Coosa receipts must be excluded from their sales factors pursuant to the Special Rule, Reg. 810-27-1-4-.18(3)(a). That regulation is identical to MTC Reg. IV.18(c)(1), and was promulgated in 1994 when the Department adopted the MTC regulations en masse following the 1993 decision in *MGH Management, supra* note 2. The Special Rule reads as follows:

> Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

The Special Rule relates to the MTC "equitable apportionment" provision at §40-27-1, Art. IV, ¶18. MTC ¶18 allows for a departure from the normal MTC allocation and apportionment provisions if those provisions do not fairly reflect the taxpayer's activities in the state. The Special Rule was promulgated pursuant to ¶18(d), which allows for the use of any other method "to effectuate an equitable allocation and apportionment of the taxpayer's income." Section 40-27-1, Art. IV, ¶18(d).

As discussed, it is axiomatic that if sale receipts are included in the apportionable tax base, the receipts must also be represented in the sales factor. Otherwise, there would not be a reasonable correspondence between the tax base and the factors used to apportion it. The Special Rule deviates from the norm and requires that certain business income included in the apportionable tax base must nonetheless be excluded from the sales factor.

The rationale for the Special Rule must be that receipts from incidental or occasional sales not in the taxpayer's regular course of business should be excluded from the sales factor because including such extraordinary receipts would not fairly reflect the taxpayer's normal business activities in the state. The Special Rule thus presumes the existence of the functional test for determining business income because only under the functional test will such extraordinary receipts be included as apportionable business income and in the sales factor in the first place. That is, receipts from "an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's business" must be receipts from an extraordinary sale that produces business income under only the functional test, but not under the transactional test. The Special Rule was not intended to apply to receipts from a sale in the normal course of a taxpayer's business. Those receipts necessarily reflect the taxpayer's normal business activities, and must be represented in the sales factor to achieve fair apportionment.[8]

The Alabama Supreme Court rejected the existence of the functional test in *Uniroyal*.

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[8]I agree that the Coosa mill and timberland sales fit the dictionary definition of Aoccasional@ (AOccurring from time to time.@ *American Heritage Dictionary*, Sec. Col. Ed. at 859). But in the context of the Special Rule, the word can only refer to an extraordinary sale not in the taxpayer=s normal course of business. A sale cannot be an occasional or incidental sale for purposes of the Special Rule, and also a sale in the regular course of business for purposes of determining if the sale receipts are business or nonbusiness income under the transactional test.

The Court also rejected the Department regulation that applied the functional test because it was inconsistent with the statute. *Uniroyal*, 779 So.2d at 238. Likewise, the Special Rule must also be rejected as inapplicable in Alabama because it is premised on the functional test.[9]

Applying the Special Rule in this case also would not fairly reflect the Taxpayers' business activities in Alabama. The Taxpayers adamantly argue that the Coosa sales were in the regular course of their business activities in Alabama. Consequently, only if the Coosa receipts are included in the Taxpayers' sales factors would their apportionment formulas fairly reflect their business-related activities in Alabama. The purpose of §40-27-1, Art. IV, ¶18 is to insure that a corporation's income is fairly apportioned to and taxed by a

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[9]This holding applies only for tax periods in which the MTC definition of Abusiness income@ is applicable. As discussed, *supra* note 2, the Alabama Legislature enacted a new definition of Abusiness income,@ effective for tax years beginning after December 31, 2001. The new definition clearly encompasses a functional test for business income. Consequently, the Special Rule would apply if the conditions of the Rule are satisfied. The Special Rule presumes distortion if the normal MTC rules are applied. The burden would thus be on the party opposing application of the Special Rule to show that applying it would cause distortion. See, *Appeal of Fluor Corp.*, Cal. State Bd. of Equal. (Dec. 12, 1995), Docket No. 95-SBE016.

state. The Special Rule, if applied in this case, would cause a result contrary to that purpose. A regulation must be rejected if unreasonable and contrary to the intent of the statute to which it relates. *Uniroyal*, 779 So.2d at 232. The California State Board of Equalization has also rejected the rule as contrary to the plain language of the UDITPA provision that requires the sales factor to include all receipts. *Appeal of Triangle Publications, Inc.*, Cal. State Bd. of Equal., June 27, 1984.

The Taxpayers argue that the Special Rule must be followed because it is a Department regulation of long-standing, and is consistent with the intent of the statute to which it relates. They also contend that they relied on the Special Rule in structuring their business affairs, i.e. deciding to sell the Coosa properties. I disagree.

Alabama adopted the Special Rule when it adopted the MTC regulations en masse in 1994. There is no evidence the Special Rule has ever been applied by the Department, much less consistently followed by the Department. And as discussed, applying the Special Rule in this case would be contrary to the intent and purpose of §40-27-1, Art. IV, ¶18. There also is no evidence, nor do I suspect, that the Taxpayers even considered much less relied on the Special Rule in deciding to sell the Coosa properties.

In summary, because the Special Rule is premised on the existence of the functional test for business income, it is inconsistent with the Alabama Supreme Court's holding in *Uniroyal*, and is rejected. Further, applying the Special Rule and excluding the $600 million in issue from the Taxpayers' sales factors would be contrary to §40-27-1, Art. IV, ¶18 because their apportionment formulas would not fairly reflect their business activities in Alabama.

The Department's initial audit adjustments that accepted the Coosa sale receipts as business income and included the receipts in the Taxpayers' sales factors were correct. Pursuant to those adjustments, the Department is directed to issue KC a refund of $147,649 for the subject years, plus applicable interest. The final assessment against KCW is reduced to the amount of the March 15, 2001 preliminary assessment, or $3,372,129. Additional interest is also due as required by Code of Ala. 1975, §40-1-44. Judgment is entered accordingly.

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

Entered March 11, 2003.

BILL THOMPSON
Chief Administrative Law Judge