SOUTHTRUST MORTGAGE CORP. 100 Brookwood Place, Suite 300 Birmingham, Alabama 35209,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. F. 95-369
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed franchise tax against SouthTrust Mortgage Corporation ("Taxpayer") for the years 1989 through 1994. The Taxpayer appealed to the Administrative Law Division, and a hearing was conducted on December 13, 1995. Robert C. Walthall represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

This case involves the franchise tax deduction set out at Code of Ala. 1975, §40-14-41(d)(3)a.[1] That section allows a foreign corporation to deduct from capital employed any loans in Alabama that are secured by mortgages on real estate in Alabama, provided the recording privilege tax has been paid on the mortgage. The specific issue is whether the otherwise deductible mortgage loans claimed by the Taxpayer during the subject years should be disallowed because the money or financing used to make the loans was not or may not have been initially included in the Taxpayer's capital base.

[1]The statute in issue was previously codified as §40-14-41(d)(2)a., but was changed to §40-14-41(d)(3)a. by Act 95-564, effective July 31, 1995.

The facts are undisputed.

The Taxpayer is a foreign corporation for Alabama franchise tax purposes, and has its principal place of business in Birmingham, Alabama. The Taxpayer is a full-service mortgage banker, and in that capacity makes loans that are secured by mortgages on real estate in Alabama. The funds used to make the loans are obtained from the Taxpayer's retained earnings and through borrowings.

The Taxpayer has consistently claimed the mortgage loan deduction in issue since at least 1974. The deduction has previously never been disputed by the Department.

The Department audited the Taxpayer for the years in issue, and disallowed the Alabama mortgage loans deducted on each year's return. The Taxpayer paid the additional tax assessed by the Department, and then applied for a refund. The Department denied the refund, and the Taxpayer appealed to the Administrative Law Division.

The Department's position is that the loans cannot be deducted because the amounts used to make or finance the loans were not initially included in the Taxpayer's capital base. The Department cites Reg. 810-2-3-.05, which reads that "The purpose of the exclusions and the deductions is to remove from total capital those items set out in subsection D, §40-14-41, Code of Ala. 1975, therefore, if the items are not included in total capital there is

no basis for an exclusion or a deduction."

The Taxpayer counters that the statute clearly allows for the deduction, and that the plain language of the statute must control, not the Department's regulation.

Both sides cite the usual rules of statutory construction. However, the rule of construction most applicable is that the intent of the Legislature must be discerned from the specific language used in a statute. If the language is reasonably clear and not ambiguous, then no other rules of construction need be applied. Heater v. Tri-State Motor Transit Co., 644 So.2d 25 (Ala.Civ.App. 1994); Kimberly-Clark Corp. v. Eagerton, 445 So.2d 566 (Ala.Civ.App. 1983).

Section 40-14-41(d) provides for both exclusions and deductions.

The nature of an exclusion from capital is that the amount must first be included in capital before it can be excluded. Consequently, subparagraphs (d)(1) and (d)(2), as amended by Act 95-564, provide for exclusions "from the amount of capital as determined in subparagraph (b)" for investments in certain other corporations. Note the exclusions are from capital only, not capital employed. If the corporation's capital base as determined under subparagraph (b) does not include any such investments, then obviously those amounts cannot be excluded and subparagraphs (d)(1) and (d)(2) would not apply. Reg. 810-2-3-.05 is thus correct concerning exclusions. If the item is not first included as

capital, it cannot be excluded.

On the other hand, the deductions provided for in subparagraph (d)(3), as amended by Act 95-564, are "below the line" deductions. The subparagraph provides that "There shall be deducted from the amount of capital employed in this state as determined in accordance with subsections (b) and (c) . . ." That is, total capital is first computed under subparagraph (b), and is then apportioned under subparagraph (c) to arrive at net capital employed in Alabama.[2] The items specified as deductions under subparagraph (d)(3) are then deducted from that net capital employed figure. Unlike an exclusion, an amount allowed as a deduction under subparagraph (d)(3) must not first be included as capital under subparagraph (b). Reg. 810-2-3-.05 is thus rejected concerning the mortgage loan deduction and all other deductions specified in subparagraph (d)(3).

By analogy, for income tax purposes, §40-18-19 exempts certain income that would otherwise be included as taxable income, the same as §§40-14-41(d)(1) and (d)(2) exclude certain amounts otherwise included as capital under §40-14-41(b). Section 40-18-15 also provides for certain deductions from gross income. For example, §40-18-15(a)(1) provides a deduction for all ordinary and necessary

[2]Prior to Act 95-564, subparagraph (c) did not specify that capital employed in Alabama would be determined by apportionment, although that was the accepted method used by the Department. However, Act 95-564 specifically provided for apportionment.

business expenses. It is not necessary that the money used to pay the deductible business expense must first be included in the taxpayer's gross income for the deduction to be allowed. The expense obviously can be paid from a non-taxable source such as cash on hand or a loan.

The weakness of the Department's argument is illustrated by the fact that sometimes it is impossible, or almost impossible, to determine the source of the funds that are the basis for the subparagraph (d)(3) deductions. My understanding is that if the Department can establish that the item was not included as capital, then the deduction will be disallowed. If the item was included as capital or if the source cannot be determined, the Department will allow the deduction. There is some dispute in this case as to whether the money used to make the mortgage loans was included in the Taxpayer's capital base. But as discussed, that question is not relevant. The deduction must be allowed, regardless of the source of the funds.

In summary, subparagraph (d)(3)a. clearly allows a deduction from net capital employed for all loans in Alabama secured by mortgages on Alabama real estate. The source of the funds used to make the loans is irrelevant. Consequently, the mortgage loans deducted by the Taxpayer should be allowed. The refunds in issue should accordingly be granted.

This Final Order may be appealed to circuit court within 30

days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered March 5, 1996.

BILL THOMPSON
Chief Administrative Law Judge