PECHINEY CORPORATION 475 Steamboat Road Greenwich, Connecticut 06830-7144,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. F. 96-106
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed franchise tax against Pechiney Corporation ("Taxpayer") for 1992, 1993, and 1994. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. Hearings were conducted on February 27, 1996 and October 28, 1996. Peter Stathopoulos, John Allan, and Timothy Trankina represented the Taxpayer. Assistant Counsel Dan Schmaeling represented the Department.

This case involves two issues:

(1) Should $1.7 billion advanced by the Taxpayer to repurchase outstanding debt of two subsidiary corporations be treated as an investment in the subsidiaries, and thus excluded from capital pursuant to Code of Ala. 1975, §40-14-41(d)(2), as amended by Act 95-564, or as loans to the subsidiaries, and thus not excluded from capital; and

(2) Did the Department properly apportion the Taxpayer's capital to Alabama.

The Taxpayer is a Delaware corporation and is commercially domiciled in Connecticut. The Taxpayer's sole business activity is that it manages the investments of its parent corporation, Pechiney

International.

The Taxpayer purchased two corporations in 1988.

Both subsidiaries had large outstanding debt, or "junk bonds," when purchased by the Taxpayer. The Taxpayer decided to retire the high interest bonds. Accordingly, the Taxpayer advanced $1.7 billion to the subsidiaries in October 1992 to be used to repurchase the junk bonds. The Taxpayer deposited the funds directly with Manufacturers Hanover Trust Company, which acted as repurchasing agent for the two subsidiaries.

A shareholder agreement indicated that the Taxpayer provided the funds to the two subsidiaries in return for senior indebtedness. However, no notes or other evidences of indebtedness were ever executed. No formal terms concerning the rate of interest, repayment terms, security, or a maturity date were ever agreed on. Neither subsidiary has ever paid the Taxpayer interest or principle on the advances. The Taxpayer's representatives testified that the advances were intended as an investment in the subsidiaries, not loans.

The Taxpayer initially classified the advances as intercompany loans on its financial statements, but reclassified the advances in the years 1989 through 1992 as investments in the subsidiaries. The Taxpayer claims that the advances were initially designated as intercompany loans because "if the bond holders were to suddenly find themselves in a position of very high yield investors in a

corporation made increasingly sound and stable by cash contributions from shareholders, then they would be less likely to tender their bonds." (Taxpayer's brief, at pages 2, 3). The Taxpayer stopped reclassifying the advances as investments after 1992 because most of the junk bonds had been repurchased, and they were being eliminated through consolidation at year end in any case. Consequently, the amounts remained as intercompany loans on the Taxpayer's books in 1993 and 1994.

The Taxpayer acquired a 99 percent interest in a partnership, Intsel, in 1992. Intsel is a carbon and steel product company that operates throughout the United States. One of Intsel's distribution centers is in Bessemer, Alabama. The Taxpayer conducts no other business in Alabama except through its investment in Intsel. Intsel's business is unrelated to the Taxpayer's other activities and investments outside of Alabama.

Intsel had total capital everywhere of approximately $35.5 million in 1993 and $39.7 million in 1994. Its average Alabama apportionment factors were 10.3413 in 1993 and 9.8043 in 1994.[1]

The Taxpayer filed Alabama franchise tax returns in 1992,

[1]The Taxpayer used the sales, payroll, and property factors in 1992 and 1993, and the income, payroll, and property factors in 1994. Those factors are not contested by the Department.

1993, and 1994 because of its interest in Intsel. The Taxpayer reported and paid $12,500 in franchise tax in 1992. That year is not contested.

The Taxpayer included its total capital everywhere in its apportionable Alabama capital base in 1993 and 1994, but then excluded from capital the amounts advanced to repurchase the junk bonds as an investment in the two subsidiaries pursuant to Code of Ala. 1975, §40-14-41(d)(2), as retroactively amended by Act 95-564. That section allows an exclusion from capital for "an investment by the taxpayer in the capital" of any subsidiary corporation that is more than 50 percent owned by the taxpayer and which itself does not pay an Alabama franchise tax. The exclusion resulted in negative capital in 1993 and 1994. Consequently, the Taxpayer paid only the minimum $25 franchise tax in those years.

The Department recharacterized the advances as "intercompany loans," and thus disallowed the exclusions from capital. The Department treated the advances as loans solely because the Taxpayer listed the amounts as intercompany receivables on its books in 1993 and 1994. After returning the excluded amounts to apportionable capital, the Department applied the average apportionment factors and determined the Taxpayer's capital employed in Alabama was approximately $106 million in 1993 and $136 million in 1994. That adjustment resulted in the final assessment in issue, which totals $1,042,052, including penalties and

interest.

Issue 1 - Debt Versus Equity.

The Department must necessarily rely on a foreign corporation's financial statements in determining the corporation's capital base for franchise tax purposes. However, substance over form must govern in tax matters, Dept. of Revenue v. Acker, 636 So.2d 470 (Ala.Civ.App. 1994), and "if the true nature of an account or other item on a financial statement is established as something other than capital, as that term is defined at §40-14-41(b), then the true nature of the account must govern." Weavexx Corporation v. State, F. 94-300 (Admin. Law Div. 1/16/96). The same principle applies concerning exclusions or deductions from capital. The substance of the underlying transaction must control, not how it may be recorded on a corporation's books. Magnolia Methane v. State, 676 So.2d 341 (Ala.Civ.App. 1996).

In Stinnett's Pontiac Service, Inc. v. CIR, 730 F.2d 634 (1984), the Eleventh Circuit Court of Appeals, citing Estate of Mixon v. U.S., 464 F.2d 392 (5th Cir. 1992), cited 13 objective factors to be considered in deciding if an advance constitutes debt or an investment. Those factors include whether there is a fixed maturity date or rate of interest, whether there is a chance of repayment, and whether the parties intended for the amount to be repaid, among other factors. None of the factors indicating an

arm's-length loan are present in this case. Consequently, the $1.7 billion advance was an investment in the subsidiaries, not an arm's-length loan.

However the debt versus equity issue is not controlling. Rather, the case turns on how much of the Taxpayer's total capital is apportionable to Alabama.

Issue 2 - The Apportionment Issue.

The Alabama franchise tax is levied on "the actual amount of (a foreign corporation's) capital employed in this state." Code of Ala. 1975, §40-14-41(a). The Department first determines a foreign corporation's apportionable capital base. A portion of the capital is then apportioned to Alabama using any one of several combinations of factors (sales, payroll, etc.) from Schedule C of the Alabama return. The formulas used by the Taxpayer in this case are undisputed. Rather, the issue is what part of the Taxpayer's total capital everywhere is apportionable to Alabama.

The Department argues that the Taxpayer's capital everywhere is apportionable to Alabama. The Taxpayer initially reported its entire capital on its 1993 and 1994 returns, and then excluded the advances. It now argues, however, that only the capital employed by Intsel is apportionable to Alabama because its out-of-state business activities are totally unrelated to Intsel's business in Alabama. I agree with the Taxpayer.

The United States Supreme Court has repeatedly stated that the "linchpin of apportionability" for state tax purposes is the unitary-business principle. Mobil Oil Corp. v. Comm'r of Taxes of

Vermont, 100 S.Ct. 1223, 1232 (1980); Container Corp. of America v. Franchise Tax Board, 103 S.Ct. 2933 (1983). For a concise history of the unitary-business principle, see Allied-Signal, Inc. v. Director, Div. of Taxation, 112 S.Ct. 2251, at 2258-2262 (1992). The above Supreme Court cases involved the apportionment of income for income tax purposes. However, the same underlying constitutional principles also apply to the apportionment of capital for Alabama franchise tax purposes.

To be included in a state's tax base, the unitary-business principle requires that the activity to be taxed, either income earned or capital employed, must be related to or a part of the taxpayer's unitary-business activity carried on in the taxing state. This is rooted in the due process requirement that there must be some "minimum connection" or "nexus" between the interstate activities sought to be taxed and the taxpayer's activities in the taxing state. In other words, a state cannot lasso into its apportionable tax base either income earned or capital employed by a foreign corporation in an unrelated business activity outside of the state.

> The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities - even on a proportional basis - unless there is a "'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" *Exxon Corp. v. Wisconsin Dept. of Revenue, supra*, 447 U.S., at 219-220, 100 S.Ct., at 2118, quoting *Mobil Oil Corp. v. Commissioner of Taxes, supra,* 445

> U.S., at 436, 437, 100 S.Ct., at 1231. At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported "unitary business" unless at least some part of it is conducted in the State. (cites omitted).
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> In addition, the principles we have quoted require that the out-of-state activities of the purported "unitary business" be related in some concrete way to the in-state activities. The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or measurement - beyond the mere flow of funds arising out of a passive investment or a distinct business operation - which renders formula apportionment a reasonable method of taxation. (cites omitted).

Container Corp., 103 S.Ct. at 2940.

The Taxpayer clearly had nexus with Alabama through its investment in Intsel in Alabama. But nexus with the Taxpayer is by itself insufficient. There must be some "minimum connection" between the business activity in which capital was employed by the Taxpayer outside of Alabama and the Taxpayer's business activity in Alabama. "In the case of a tax on an activity (capital employed), 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.

To exclude capital from its apportionable Alabama franchise tax base, the burden is on the foreign corporation to prove that the capital is employed in "an 'unrelated business activity' (outside of Alabama) which constitutes a 'discrete business enterprise.'" ASARCO, Inc. v. Idaho State Tax Commission, 102 S.Ct. 3103, 3110 (1982). Factors to be considered in deciding if

a taxpayer's interstate activities are a part of a unitary business are (1) functional integration, (2) centralization of management, and (3) economies of scale. Allied Signal, 112 S.Ct. at 2260. The above factors need not be specifically applied in this case, however, because the Taxpayer's activities outside of Alabama are clearly unrelated to Intsel's activities in Alabama and elsewhere.

The Taxpayer's only capital employed in Alabama during the years in question was through its investment in Intsel. Intsel's business activities are unrelated to the Taxpayer's other investments and business activities outside of Alabama. "There is no sharing or exchange of values (between the Taxpayer and Intsel) . . . beyond the mere flow of funds arising out of a passive investment or a distinct business enterprise . . . ." Container Corp., 103 S.Ct. at 2940. Consequently, only the capital employed by the Taxpayer through its investment in Intsel is apportionable to Alabama.

Including the Taxpayer's capital everywhere in its apportionable Alabama tax base would not only violate the statutory requirement that only "the actual amount of its capital employed" in Alabama should be taxed, see §40-14-41(a), but also the external consistency requirement of the Due Process and Commerce Clauses. To be externally consistent, Alabama's apportionment method must reasonably reflect the actual amount of capital employed by a foreign corporation in Alabama. Exactness is not required, but an

apportionment method will be struck down if a taxpayer can prove "by 'clear and cogent evidence' that the (capital employed in) the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State' or has 'led to a grossly distorted result.'" Container Corp., 103 S.Ct. at 2942.

Intsel had total capital everywhere of approximately $36.5 million in 1993 and $39.7 million in 1994. Applying the undisputed Alabama apportionment factors of 10.3413 in 1993 and 9.8043 in 1994, the actual capital employed by the Taxpayer through Intsel in Alabama was approximately $3,770,000 in 1993 and $3,890,000 in 1994. However, if the Department's position is accepted, and the $1.7 billion advance is not excluded from capital, the Taxpayer would have capital employed in Alabama of approximately $108,500,000 in 1993 and $136,000,000 in 1994. Those amounts clearly do not reflect the actual capital that could have been employed by the Taxpayer through Intsel in Alabama. See generally, Hans Rees' Sons, Inc. v. North Carolina, 51 S.Ct. 385 (1931).

Ironically, if the Department's apportionment method is accepted, but the $1.7 billion advance is treated as an investment and thus excluded from capital, the Taxpayer would have negative capital in Alabama in 1993 and 1994, and thus owe the minimum $25 franchise tax in those years. But if only the capital employed by the Taxpayer in Alabama through Intsel is apportionable to Alabama, the Taxpayer will owe some additional Alabama tax.

The Taxpayer recomputed its Alabama liability for 1993 and

1994 apportioning only Intsel's capital to Alabama. See, Exhibit 1 to Taxpayer's November 6, 1996 letter brief. The Department should notify the Administrative Law Division if it accepts the Taxpayer's calculations, assuming that the only capital apportionable to Alabama is the capital employed by Intsel. If the Department disagrees with the Taxpayer's Exhibit 1, it should explain why. Otherwise, a Final Order will be entered reducing the assessments accordingly.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed within 30 days to circuit court pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered January 16, 1997.

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BILL THOMPSON
Chief Administrative Law Judge