

MACOL CORPORATION	§	STATE OF ALABAMA
Post Office Box 23500		DEPARTMENT OF REVENUE
Montgomery, Alabama 36123-5000,		ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. F. 96-266
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

FINAL ORDER

The Revenue Department assessed franchise tax against Macol Corporation ("Macol") for 1993 through 1995. Macol appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on July 31, 1996. Will Sellers and Jo Mitchum represented Macol. Assistant Counsel Jeff Patterson represented the Department.

During the years in question, Macol owned 78 percent of a partnership operating in Alabama. The sole issue in this case is whether the long-term debt of the partnership must be included in Macol's capital base for Alabama franchise tax purposes. The debt was secured solely by partnership property and was nonrecourse against Macol.

The facts are undisputed.

During the years in issue, Macol was a 78 percent general partner in East Montgomery Investment Company, a partnership doing business in Alabama. The partnership incurred long-term debt secured by partnership property. The debt was nonrecourse against Macol. It is undisputed that the debt constituted "capital" as defined for franchise tax purposes at Code of Ala.1975, §40-14-

41(b)(3).

Macol failed to report the debt as capital on its Alabama franchise tax returns for the subject years. The Department reviewed the returns, included the debt as capital, and entered the final assessment in issue. Macol appealed to the Administrative Law Division.

Macol argues that the debt should not be included in its capital base because (1) it is not liable for the debt, and (2) it is not required by generally accepted accounting principles ("GAAP") to record the debt on its financial statements. I agree that Macol is not directly liable for the debt, and also that Macol may not be required by GAAP to record the debt on its financial statements. I disagree, however, that the debt should not be included in Macol's capital base.

This same issue was decided in Flournoy Development Company & Flournoy Construction Company v. State, F. 95-481 & F. 95-482 (Admin. Law Div. 1/21/97). Flournoy held that a portion of the long-term debt of a partnership doing business in Alabama must be included in the capital base of a corporate general partner equal to the general partner's percentage ownership of the partnership.

A foreign corporation that is a general partner in a partnership operating in Alabama is "doing business" in Alabama through the partnership, and thus is subject to Alabama franchise tax. See, American Television & Communications Corporation v. State, F. 95-258 (Admin. Law Div. 8/29/95). Consequently, Flournoy Development, as a general partner in various limited partnerships operating in Alabama, is subject to Alabama franchise

tax. As stated, the primary issue is whether the nonrecourse partnership debt should be included in Flournoy Development's capital base.

Alabama franchise tax is based on "capital employed" in Alabama. Code of Ala. 1975, §40-14-41(a).

"Capital" is defined at §40-14-41(b)(3) to include "long-term" indebtedness maturing in more than one year. If a foreign corporation is operating in Alabama as a general partner in a partnership, and the partnership has long-term debt, i.e., capital employed in Alabama, that capital employed is generally attributable to the foreign corporation/general partner. See, American Television.

Flournoy Development argues, however, that the partnership debt should not be included in its capital base because it is not liable for the nonrecourse debt. I disagree.

Capital employed in Alabama is the taxable event. The capital represented by the partnership long-term debt is being employed in Alabama. That capital employed (or a portion thereof) is attributable to Flournoy Development through its interest in the partnership. The fact that Flournoy Development cannot be held liable for the debt is irrelevant.

Flournoy Development, F. 95-481 & F. 95-482 at 2, 3.

The same rationale applies in this case. The long-term debt, i.e. capital employed, by Macol in Alabama through the partnership must be included in Macol's Alabama capital base equal to Macol's 78 percent interest in the partnership. "The Department properly treated the Taxpayer's percentage share of the partnership's long-term debt as Taxpayer capital." American Television & Communications Corp. v. State, F. 95-258 (Admin. Law Div. 8/29/95) at 2.

Macol also argues that the long-term debt should not be

included in its capital base under GAAP. Macol's rationale is that it "is not required to disclose the debt on its financial statements because the likelihood of Macol paying the debt is remote." Macol brief at 2, citing FASB Statement #5. Again, I disagree.

Macol may not be required by GAAP to record the debt on its financial statements, but the debt still constitutes capital employed by Macol in Alabama. "The substance of the underlying transaction must control, not how it is recorded on a corporation's books." Pechiney Corp. v. State, F. 96-106 (Admin. Law Div. 1/16/97), citing Magnolia Methane v. State, 676 So.2d 341 (Ala.Civ.App. 1996).

The above substance over form principle was applied by the Administrative Law Division in at least three franchise cases in 1996, each time to the benefit of the taxpayer/corporation. Pechiney, Weavexx Corp. v. State, F. 94-300 (Admin. Law Div. 1/16/96), and Speedring, Inc. v. State, F. 95-337 & F. 95-288 (Admin. Law Div. 4/16/96). In each case, the corporation's financial statements included an entry which as recorded constituted "capital" as defined at §40-14-41(b). The Department relied on the corporation's books in each case and included the entry as capital. In each case, the substance over form principle was applied, and the book entry was determined not to be capital, and thus excluded from, or not included in, the corporation's

capital base.<sup>1</sup>

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<sup>1</sup>In Weavexx, the corporation's books included a "loans to shareholders" account. The corporation conceded that on its face, the account was includable in capital. The Administrative Law Division determined, however, that in substance the accounts

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represented intracompany transactions within the same corporation, and thus should not be included in capital.

In Speedring, the corporation recorded an intercompany payable on its books using "push down" accounting. Applying the substance over form principle, the Administrative Law Division determined that the account was not capital because "in substance, there was no underlying indebtedness owed by" the corporation. Speedring, F. 95-237 at 5.

Finally, in Pechiney, a corporation advanced \$1.7 billion to two subsidiaries that used the funds to repurchase junk bonds. The advances were recorded as intercompany loans on the corporation's books. The Department thus included the loans as capital. Again applying substance over how the item was recorded on the corporation's books, the advance was determined to be an investment in the subsidiaries, and thus excludable from capital under §40-14-41(d)(2), as amended by Act 95-564.

It is undisputed that the long-term debt in question constituted "capital" pursuant to §40-14-41(b)(3). A portion of that capital was being employed by Macol in Alabama through the partnership. Whether Macol elected under GAAP not to record the debt on its financial statements had no effect on the substance of the transaction. Capital was still being employed by Macol in Alabama.

The Department properly included the pro-rata share of the partnership's long-term debt in Macol's Alabama capital base during the subject years. The final assessment in issue is affirmed. Judgment is entered against Macol for 1993 through 1995 Alabama franchise tax of \$42,450.61, plus applicable interest.

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

Entered January 29, 1997.

BILL THOMPSON  
Chief Administrative Law Judge