VULCAN MATERIALS COMPANY P.O. Box 530187 Birmingham, AL 35253-0187,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. CORP. 98-157
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

FINAL ORDER
ON TAXPAYER=S APPLICATION FOR REHEARING

This appeal concerns the Taxpayer=s Alabama income tax liabilities for 1990, 1991, and 1992. An Opinion and Preliminary Order was entered on December 13, 1999 addressing the various issues raised by the parties. One of the issues was whether dividends received by the Taxpayer from two corporations, ACE and Tradeco, constituted business or nonbusiness income for apportionment (or allocation) purposes. The Taxpayer argued that the dividends were business income, and thus should be apportioned among the various states in which it conducted business. The Department argued that the income was nonbusiness, and thus should be allocated 100 percent to Alabama, the Taxpayer=s state of commercial domicile.

A related issue involved the foreign corporation interest expense deduction at Code of Ala. 1975, '40-18-35(a)(2). Department Reg. 810-3-31-.02(a)(5)(l) specified during the subject years that a foreign corporation=s Ainterest expense shall be prorated to nonbusiness assets by multiplying that interest expense by the ratio of average costs of the nonbusiness assets to the average cost of the total assets.@[1]

[1]The substantive provisions of Reg. 810-3-31-.02 (including the interest deduction ratio at 810-3-31-.02(a)(5)(l)) were repealed by the Department by amendment in 1996. Amended Reg. 810-3-31-.02 contains no substantive provisions, and only directs the

reader to Alabama=s MTC statute, Code of Ala. 1975, '40-27-1 et seq., and related regulations. The Department promulgated its MTC regulations in 1994. Those regulations, as last amended effective November 22, 1996, are set out in Reg. 810-27-1-4-.01. MTC Reg. 810-27-1-4-.01(d)(1) governs the proration of the interest expense, and contains the same allocation ratio as did repealed Reg. 810-3-31-.02(a)(5)(l). For a discussion of Alabama=s interest expense allocation, see, M. Wethekam & C. Fields, *Hunt-Wesson and Excessive Disallowance Issues*, State Tax Notes, July 24, 2000, at 252.

The Taxpayer initially included the ACE and Tradeco stock as a nonbusiness asset in the numerator of the interest deduction ratio. The parties agreed, however, that if the ACE and Tradeco dividends were determined to be business income for apportionment purposes, the ACE and Tradeco stock should be treated as a business asset, and thus excluded from the numerator of the ratio.

The Administrative Law Division ruled that although ACE and Tradeco were not part of the Taxpayer=s unitary business, the dividends from those corporations still constituted apportionable business income because the stock served an operational function in the Taxpayer=s business. See, Vulcan Materials Company v. State of Alabama, Corp. 98-157 (Opinion and Preliminary Order 12/13/99), at 8-10. Consequently, as agreed by the parties, when the Department recomputed the Taxpayer=s liabilities for the subject years, it treated the ACE and Tradeco stock as a business asset, and thus removed it from the numerator of the ratio.

However, the Department also excluded from the numerator the Taxpayer=s stock in eight subsidiary corporations that the Taxpayer had initially included as a nonbusiness asset in the numerator.[2] The eight subsidiaries are Reed Crushed Stone, Central States Materials, RECO Transportation, Vulcan Lands, Inc., BRT Terminal, Vulcan Gulf Coast

[2]This issue concerning the eight subsidiaries was not addressed at the initial hearing. The Department subsequently removed the eight subsidiaries from the numerator based on its position that the subsidiaries were identical in substance to ACE and Tradeco. That is, because the ACE and Tradeco stock was a business asset, the stock in the eight subsidiaries should also be treated as a business asset. The Administrative Law Division determined that a decision on the issue was necessary for a full and fair resolution of the case. See, Vulcan, *supra*, (Third Preliminary Order on Taxpayer=s Application for Rehearing 3/9/00), at 2.

Materials, Statewide Transport, and Vulcan Materials Deutschland.

The Administrative Law Division also ruled that the Department had improperly assessed the 25 percent failure to timely pay penalty levied at Code of Ala. 1975, '40-2A-11(b). The Administrative Law Division instead directed the Department to assess the 5 percent negligence penalty levied at Code of Ala. 1975, '40-2A-11(c). See, Vulcan, *supra*, (Opinion and Preliminary Order 12/13/99), at 14-15.

The Department recomputed the Taxpayer=s liabilities as indicated above. The Administrative Law Division entered a Final Order on January 4, 2000. The Taxpayer applied for a rehearing. A rehearing was conducted on May 25, 2000. Robert Walthall and Assistant Counsel Jeff Patterson again represented the Taxpayer and the Department, respectively.

The Taxpayer raises two issues on rehearing:

(1) The Taxpayer argues that the Department incorrectly classified the Taxpayer=s stock in the eight subsidiaries as a business asset, and thus incorrectly removed the stock from the numerator of the interest deduction ratio; and,

(2) The Taxpayer contends that the 5 percent negligence penalty was improperly imposed.

Issue (1) Did the Taxpayer=s stock in the eight subsidiaries constitute a business or nonbusiness asset?

The threshold question is what constitutes a Abusiness asset@ versus a Anonbusiness asset@ for purposes of the interest deduction ratio.

The parties agreed that if the ACE and Tradeco dividends constituted business

income, the ACE and Tradeco stock should be treated as a business asset for purposes of the interest expense ratio. I agree that if an asset produces apportionable business income, the asset should be treated as a business asset, and vice versa.[3] That is, if dividends paid by a subsidiary to a parent constitute business income, either because the subsidiary is unitary with the parent or the subsidiary serves an operational function in the parent=s business, the underlying stock is a business asset of the parent.[4] Consequently, the stock of the eight subsidiaries was a business asset if the subsidiaries (1) constituted part of the Taxpayer=s unitary business, or (2) served an operational function in the Taxpayer=s business.

Whether a subsidiary is part of a parent=s unitary business, as opposed to a discrete business enterprise, generally requires a fact-based analysis of the relationship

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[3]This conclusion is supported by the language of the interest deduction statute, Code of Ala. 1975, '40-18-35(a)(2), as amended by Act 98-502, effective December 31, 1997. That section provides that the interest expense of a corporation not domiciled in Alabama shall be reduced Aby the amount that bears the same ratio to the total interest expense as the average value of the corporation=s assets producing nonbusiness income bears to the average value of the corporation=s total assets, . . .@ ANonbusiness assets@ and Aassets producing nonbusiness income@ are thus interchangeable terms.

[4]It does not necessarily follow, however, that if an asset produces business income, then the income from the subsequent sale of the asset also constitutes business income. Rather, that issue turns on whether the income constitutes Abusiness income@ as defined and interpreted in the various states. Many states have adopted the MTC=s definition of Abusiness income,@ or a variation thereof. The courts in those states have interpreted the definition in different ways. See generally, Uniroyal v. State of Alabama, 1999 WL 339304 (May 28, 1999), cert. granted, November 10, 1999, and cases cited therein. For more recent cases on point, see Hoechst Celanese Corp. v. Franchise Tax Board, 90 Cal.Rptr.2d 768 (Cal.Ct.App. 2000); Union Carbide Corp. v. Offerman, 526 S.E.2d 167 (NC 2000); Department of Revenue v. ABC, Inc, Dept. of Rev. No. IT99-4 (1999); Robert Half International, Inc. v. Franchise Tax Bd., 28 Cal.Rptr.2d 453 (Cal.Ct.App. 1998); Hercules, Inc. v. Commissioner of Revenue, 575 N.W.2d 111 (MN 1998); Hercules, Inc. v. Maryland Comptroller of Treasury, 716 A.2d 276 (MD 1998).

between the two corporations. That is, was there Afunctional integration, centralization of management, and economies of scale.@ Allied-Signal, Inc. v. Director, Div. of Taxation, 112 S.Ct. 2251 (1992); ASARCO, Inc. v. Idaho State Tax Comm., 102 S.Ct. 3103 (1982); F.W. Woolworth Co. v. Taxation and Revenue Dept., 102 S.Ct. 3128 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 100 S.Ct. 1223, 1232 (1980). Unfortunately, neither party presented evidence at the rehearing from which those questions could be decided.

The Taxpayer argued at the rehearing that the subsidiaries were independent entities because they had their own officers and performed some of their own administrative functions. But the Taxpayer failed to present evidence supporting that claim. In any case, those facts alone would be insufficient to establish that the subsidiaries were not unitary with the Taxpayer.

The Department submitted the Taxpayer=s income tax returns filed for the subject years in California, Indiana, Illinois, Kansas, Nebraska, and Oregon. The Taxpayer reported the eight subsidiaries as part of its unitary business operations on those returns. The Department contends that the above is proof that the subsidiaries were unitary with the Taxpayer, and thus that the subsidiaries= stock should be treated as a business asset. I agree.

Tax statutes vary from state to state. Consequently, it is generally irrelevant for Alabama purposes how a corporation reports in another state. See, Uniroyal Tire Company v. State, Corp. 96-183 (Admin. Law Div. Final Order 3/27/97), at 9. However,

the unitary business concept does not vary from state to state. A subsidiary cannot be unitary with its parent in one state, and not unitary in another state. Consequently, having reported as a fact under penalty of perjury in at least six states that the eight subsidiaries were part of its unitary business, the Taxpayer cannot now argue that the subsidiaries were not unitary for the sole purpose of reducing its Alabama liability. The Department correctly removed the subsidiaries= stock from the numerator of the ratio.

The above finding that the eight subsidiaries were business-related assets is supported by Department Exhibits 1-17 introduced at the rehearing. Those documents confirm that the eight subsidiaries, and particularly the Reed Companies, were operationally related to the Taxpayer=s construction aggregates business during the subject years. The Taxpayer failed to submit evidence to the contrary.

Issue (2) - The 5 percent negligence penalty.

The Department assessed the Taxpayer for the 25 percent failure to timely pay penalty levied at Code of Ala. 1975, '40-2A-11(b). The Administrative Law Division voided that penalty, and instead directed the Department to assess the 5 percent negligence penalty at Code of Ala. 1975, '40-2A-11(c), but only concerning the additional tax resulting from the interest expense deduction issue. See, Vulcan, *supra*, (Opinion and Preliminary Order 12/13/99), at 14-15.

The negligence penalty applies if any underpayment is due to negligence or disregard for regulations. ANegligence@ includes Afailure to make a reasonable attempt to

comply with (the Alabama Revenue Code), . . .@

The Taxpayer=s position concerning the interest expense ratio, and specifically sub-issues (b) and (c) on pages 12-14 of the Opinion and Preliminary Order, was not reasonable. That is, there was no basis for the Taxpayer=s position that, as used in the regulation, Acosts@ should be defined as Acosts less accumulated depreciation and depletion,@ or that Aaverage costs@ should be construed as net costs at the end of the year. Under the circumstances, the negligence penalty was properly applied to the additional tax due relating to those issues.

The Final Order entered on January 2, 2000 reduced the final assessment from $849,441 to $382,355. Judgment against the Taxpayer in that amount is affirmed. The Taxpayer=s application for rehearing is denied.

This Final Order on Taxpayer=s Application for Rehearing may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, '40-2A-9(g).

Entered August 3, 2000.

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BILL THOMPSON
Chief Administrative Law Judge