VULCAN MATERIALS COMPANY ' STATE OF ALABAMA
Post Office Box 530187 DEPARTMENT OF REVENUE
Birmingham, AL 35253-0187, ' ADMINISTRATIVE LAW DIVISION

Taxpayer, ' DOCKET NO. CORP. 98-157

v. '

STATE OF ALABAMA '
DEPARTMENT OF REVENUE.

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed corporate income tax against Vulcan Materials Company (ATaxpayer@) for 1990, 1991, and 1992. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, ' 40-2A-7(b)(5)a. A hearing was conducted on February 2, 1999.[1] Robert Walthall and Wood Herren represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

The issues in this case are as follows:

(1) The Taxpayer received dividends from Vulcan International, Ltd. (AVIL@), a foreign sales corporation (AFSC@), in 1990 and 1992. Should those dividends be classified as apportionable Abusiness income@ or allocable Anon-business income@?

(2) The Taxpayer owned stock in two corporations during the subject years, A.C.E. Insurance Company (Bermuda), Ltd. (AACE@) and Tradeco/Vulcan, Ltd. (ATradeco@). Did the stock constitute business assets, and should the dividends received by the Taxpayer from the stock be classified as business or non-business income?

(3) The Taxpayer paid taxes to various state and local jurisdictions during the subject years. Code of Ala. 1975, ' 40-18-35(a)(3) allows a deduction for taxes paid to any state or local taxing authority,

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[1]The Administrative Law Division initially held this case in abeyance pending a final decision in Uniroyal v. State of Alabama, [Ms. 2971007, May 28, 1999], ____ So.2d ____ (Ala. 1999), cert. granted November 10, 1999. Uniroyal involves the issue of whether proceeds from the sale of a business constitute business or non-business income for apportionment purposes. On further review, however, this case need not be held pending Uniroyal because the business/non-business issues in this case can be distinguished and will not be affected by the holding in Uniroyal.

excluding income taxes. Did the taxes paid by the Taxpayer constitute non-deductible income taxes for purposes of the taxes paid deduction?

(4) A foreign corporation is allowed a pro rata interest deduction in Alabama computed Aby the ratio of average costs of the non-business assets to the average cost of the total assets.@ Department Reg. 810-3-31-.02(a)(5)(I). This issue involves three sub-issues:

(a) Should the Taxpayer=s stock in VIL be included in the numerator of the ratio as non-business assets? The parties agree that if the VIL dividends are treated as non-business for purposes of Issue (1), the same treatment should be applied to this sub-issue, and vice versa.

(b) Should the term Acosts@ as used in the regulation be the Taxpayer=s actual cost of the assets, as argued by the Department, or net costs (actual costs less depreciation and depletion), as argued by the Taxpayer?

(c) In computing Aaverage costs,@ should the beginning year and year ending figures be averaged, as argued by the Department, or should only the net cost at year end be used, as argued by the Taxpayer?

(5) Did the Department properly assess the failure to timely pay penalty levied at Code of Ala. 1975, ' 40-2A-11(b)? If so, should it be waived for reasonable cause pursuant to Code of Ala. 1975, ' 40-2A-11(h)?

The Taxpayer is a New Jersey corporation commercially domiciled in Alabama. The Taxpayer produces and sells construction aggregates and industrial chemicals in the United States and throughout the world.

The Department audited the Taxpayer=s 1990, 1991, and 1992 Alabama corporate income tax returns

and adjusted the returns as discussed below. The Department made other adjustments that are not disputed by the Taxpayer.

<u>ISSUE (1) - The FSC</u>.

The Taxpayer formed VIL, a FSC, in 1989. VIL paid the Taxpayer dividends in 1990 and 1992. The Taxpayer treated the dividends as apportionable business income on its Alabama returns for the subject years. The Department recharacterized the dividends as non-business income pursuant to Reg. 810-3-31-.02(1)(a)4(iv), Example (III), and allocated them 100 percent to Alabama. The issue is whether the dividends were business or non-business income. An understanding of FSCs will help in understanding the issue.

The Taxpayer formed VIL to take advantage of the federal tax benefits allowed FSCs under ''921 through 927 of the Internal Revenue Code (AIRC@) of 1986. Specifically, the IRC exempts from federal income tax part of the combined taxable income of a domestic corporation and its FSC attributable to export sales by the domestic corporation.

Congress created FSCs in 1984 as a replacement for domestic international sales corporations (ADISC@). DISCs were created in the 1970's to stimulate export sales by U.S. corporations. Toward that end, Congress allowed a tax advantage for domestic corporations by making a part of the DISC income tax-deferred.

The international community objected to DISCs as an unfair trade practice. In response, Congress repealed the DISC legislation and replaced it with the FSC legislation. The purpose for the FSC legislation, as was the purpose for the DISC legislation, was to encourage foreign sales by domestic corporations by giving a tax advantage to domestic corporations. A FSC is the functional equivalent of a DISC, except that where a DISC provided a tax-deferral, a FSC provides a tax exemption for part of the revenue derived from the U.S. parent=s export sales.

The FSC exemption works as follows: A domestic U.S. corporation makes export sales to various overseas trading partners. The corporation pays a Asales commission@ to its FSC of generally 23 percent of the foreign sales receipts. The domestic corporation is allowed to deduct the sales commission for federal income tax purposes. The FSC is taxed on only 8/23rds of the sales commission. The remaining 15/23rds is tax-exempt. The sales commission, less federal income tax and minimal operating expenses, is returned to the domestic parent as a non-taxable (for federal purposes) dividend.

FSCs have no functional purpose other than the federal tax advantages explained above. The FSC in issue, VIL, has no assets or employees. The officers of VIL are employees of the Taxpayer, and perform only ministerial duties such as keeping VIL=s books and records. The foreign export sales are solicited and made by the Taxpayer. The goods are shipped by the Taxpayer, or at the Taxpayer=s direction, to the overseas purchasers. The sales proceeds are paid directly to the Taxpayer. VIL is not involved in the sale.

A foreign corporation doing business in Alabama is required to compute its Alabama income tax liability pursuant to the Multistate Tax Compact (AMTC@), Code of Ala. 1975, ' 40-27-1, et seq., and related regulations. The MTC includes the allocation and apportionment rules established in the late 1950's by the Uniform Division of Income for Tax Purposes (AUDITPA@). Those rules require that a foreign corporation=s business income must be apportioned among the various states in which the corporation does business, generally pursuant to a three factor formula involving payroll, property, and sales.[2] All other non-business

[2]While Alabama still uses the equally weighted three factor formula, a number of states have tinkered with the formula, usually by giving greater weight to the sales factor. For example, Arkansas, Florida, and Georgia use a 66.7 percent sales, 16.6 percent each payroll and property formula. Kentucky, Michigan, and Louisiana use a 90 percent sales, 5 percent each payroll and property formula, and so forth. Giving extra weight to the sales factor relieves the tax burden on corporations that have large property holdings and workforces in the state. Unfortunately, it also contravenes the intent of UDITPA to create a uniform tax system among the fifty states.

income is allocated to one location, generally the corporation=s state of commercial domicile.

ABusiness income@ is defined by the MTC, Code of Ala. 1975, ' 40-27-1, Art. IV, &1(a), as:

> A. . . 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.@

The same definition is provided by Department Reg. 810-3-31-.02(1)(a).[3]

[3]Reg. 810-3-31-.02(1)(a) was in effect during the years in issue, 1990 through 1992. The Department substantially repealed Reg. 810-3-31-.02 in 1994, and replaced it with MTC Regs. 810-27-1-4-.01 through 810-27-1-4-.18. The current regulation defining Abusiness income@ is Reg. 810-27-1-4-.01(a).

Various states have struggled with the MTC definition of business income, or variations thereof.[4] The dispute generally involves whether the definition includes both a transactional test, which is set out in the first part of the definition (Aincome arising from transactions and activity in the regular course of the taxpayer=s trade or business@), and also a functional test, which is set out (or not) in the remainder of the definition. A detailed analysis of whether the definition includes both a transactional and a functional test is not necessary, however, because the VIL dividends clearly constitute business income under the transactional test.

VIL was formed and operated as part of the Taxpayer=s regular course of business to take advantage of the federal tax benefits afforded FSCs. The dividends paid by VIL to the Taxpayer were activities and transactions conducted in the regular course of the Taxpayer=s business of making export sales. As such, the dividends constituted apportionable business income.

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[4]See generally, Hellerstein & Hellerstein, State Taxation (3rd Ed.) &9.05, et seq. For a general discussion of the issue, see the Administrative Law Division=s Final Order in Uniroyal. For more recent cases on point, see L.M. Berry & Co. v. Commissioner of Revenue, State of Tennessee, Appeal No. 01A01-9809-CH-00487 (10/28/99); A.L. Laboratories, Inc. v. Ill, Dept. of Rev., Ill.Cir.Ct., No. 96L50934, December 23, 1998; Robert Half International, Inc. v. Franchise Tax Board, 66 Cal.App. 4th 1020, 78 Cal. Rptr. 2d 453 (1998); Polaroid Corp. v. Offerman, 507 S.E.2d 284, 12/4/98, U.S. No. 98-1395, cert. denied, 5/3/99.

The Department=s reliance on Reg. 810-3-31-.02(1)(a)4.(iv) is misplaced. That regulation read during the years in issue as follows:

> ADividend income is business income when dealing in securities is a principal business activity of the taxpayer, or when the dividends represent the business earnings of the taxpayer (such as dividends from a Domestic International Sales Corporation - ADISC@) or when the dividends are the result of investment of business funds. Dividends which qualify for the 85% dividends received deduction under I.R.C. ' 243 will be presumed to be business income, unless clearly established otherwise. Most other dividends are presumed to be nonbusiness income, unless clearly established otherwise.@[5]

The Department cites Example (III) under the regulation, which reads as follows:

> AThe taxpayer owns all the stock of a subsidiary corporation which is engaged in a business similar to that of the taxpayer. Any dividends received from the subsidiary would be non-business.@

Example (III) is incorrect, or at best misleading. The subsidiary corporation in the example presumably was involved in a unitary business with the taxpayer. Dividends received from a unitary subsidiary constitute business income. Mobil Oil Corp. v. Comm. of Taxes, 100 S.Ct. 1223 (1980); see also, Hellerstein & Hellerstein, State Taxation, (3rd Ed.) &9.10(1)(d). Even if the subsidiary is not unitary with the taxpayer, dividends constitute apportionable business income if ownership of the stock serves an operational rather than an investment function. Allied-Signal, Inc. v. Director, Division of Taxation, 112 S.Ct. 2251 (1992). AWe agree

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[5]As discussed in footnote 3, supra, Reg. 810-3-31-.02 was substantively repealed in 1994 and replaced with MTC Regs. 810-27-1-4-.01 through 810-27-1-4-.18. The current provision relating to dividends is Reg. 810-27-1-4-.01(c)(4).

that the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment. Container Corp. says as much. What is required instead is that the capital transaction serve an operational rather than an investment function.@ Allied Signal, 112 S.Ct. at 2251, citing Container Corporation of America v. Franchise Tax Board, 103 S.Ct. 2933, 2948 (1983). See also, Hellerstein & Hellerstein, State Taxation, (3rd Ed.) &807(2)(a)v. - AOperationally connected assets (and the income they produce) are apportionable; assets that serve merely an investment function (and the income they produce) are not apportionable.@ Consequently, the dividends in the example would also constitute business income if ownership of the subsidiary served an operational function in the taxpayer=s business.

In any case, the language of Reg. 810-3-31-.02(1)(a)4.(iv) clearly supports the Taxpayer=s position. The regulation defines business income to include dividends that Arepresent the business earnings of the taxpayer (such as dividends from a Domestic International Sales Corporation - DISC) . . .@ That statement correctly recognizes that dividends paid by a DISC to its domestic parent were, in substance, the business earnings of the parent. A FSC is the functional equivalent of a DISC. Consequently, dividends paid by a FSC to its domestic parent represent the earnings of the parent, and as such are business income.

ISSUE (2) - Were the Dividends from ACE and Tradeco Business or Non-business?

The Taxpayer owned less than one percent of the stock of ACE during the years in issue. Steve Allums, the Taxpayer=s Tax Compliance Manager, testified that the Taxpayer was required to purchase the ACE stock in order to obtain general liability insurance from ACE for its chemical business. ACE subsequently dropped its requirement that the Taxpayer must own some ACE stock before it could be insured by ACE. The Taxpayer consequently sold the ACE stock in the early 1990's.

Tradeco is a Saudi Arabian company. Allums testified that the Taxpayer was required to purchase 48 percent of the stock of Tradeco to be allowed to operate its chemical business in Saudi Arabia. The

Taxpayer=s Saudi Arabian venture was unsuccessful. The Taxpayer consequently stopped doing business in Saudi Arabia and sold its Tradeco stock in the early 1990's.

The Taxpayer initially reported the dividends received from ACE and Tradeco as non-business income. It now argues that the dividends were apportionable business income because it purchased the stock of the two companies to further its business activities. I agree.

ACE and Tradeco were not unitary with the Taxpayer. As discussed, however, dividends received from a non-unitary corporation constitute apportionable business income if the taxpayer=s ownership of the stock served an operational rather than an investment function. The operational-investment distinction originated in Corn Products Ref. Co. v. Commissioner, 76 S.Ct. 20 (1955). The Corn Products doctrine is explained in Hellerstein & Hellerstein, State Taxation, (3rd Ed.), **&**9.10(1)(c), as follows:

> **A**The *Corn Products* case spawned the *Corn Products* doctrine under which gain or loss from the sale of intangible assets - frequently stock in other corporations - was held to be ordinary gain or loss because the asset was >bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer=s business.= Under the *Corn Products* doctrine, courts have found that ordinary income or loss rather than capital gain or loss resulted from (1) a geological exploration company=s sale of stock and securities of corporations acquired to gain access to their personnel and expertise; (2) an oil products wholesaler=s sale of a noncontrolling interest in stock of an oil refinery purchased to secure a source of supply of petroleum products; (3) a restaurant operator=s sale of stock of a corporation acquired to gain access to a restaurant business; (4) a newspaper=s sale of a noncontrolling interest in the stock of a paper manufacturer to secure a source of supply of newsprint; (5) a newspaper=s sale of contract rights to purchase newsprint at favorable prices; (6) and a manufacturers=s sale of the stock of a supplier acquired to secure the taxpayer=s flow of a vital source of inventory.
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> **A**By analogy, dividends received on stocks falling within the *Corn Products* doctrine may be regarded as business income that is apportionable under UDITPA. Indeed, as already observed here, the MTC regulations support this view by characterizing dividends from stock acquired to secure a source of supply as business income. Moreover, the U.S. Supreme Court referred to *Corn Products* in drawing a distinction between capital transactions that serve an >operational function= and thus give rise to constitutionally apportionable income, and transactions that serve an >investment function= and thus give rise to income that is not constitutionally apportionable. The cases also support this view.**@** (cites omitted)

In this case, the Taxpayer owned the ACE and Tradeco stock for valid business purposes. The Taxpayer was required to purchase the ACE stock so it could obtain insurance from ACE necessary to operate its chemical business. The Tradeco stock was required for the Taxpayer to operate its chemical business in Saudi Arabia. Ownership of the stocks thus served an operational function in the Taxpayer=s business. The stocks constituted business assets, and the dividends from the stocks constituted apportionable business income.[6]

ISSUE (3) - The Taxes Paid Deduction.

The Taxpayer paid taxes during the subject years to various state and local governments. The taxes were designated as either franchise, excise, or business taxes, but were measured by income. The Taxpayer deducted the taxes pursuant to ' 40-18-35(a)(3). That section allows a deduction for taxes paid to state and local governments, not including an income tax. The Department disallowed the deductions because it determined that the taxes were non-deductible income taxes.

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[6]The principle that stock purchased as an incident to a taxpayer=s business produces apportionable business income is tacitly recognized in current MTC Reg. 810-27-1-4-.01(c)(4), and specifically Example (III). That example reads in part - AThe taxpayer acquired the stock (of an unrelated corporation) in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.@

The term **A**income tax@ is not defined in Chapter 18 of Title 40, Code of Alabama 1975, which levies an income tax in Alabama. The term is defined, however, in the MTC. Specifically, Article II(4) of the MTC defines **A**income tax@ as **A**a tax imposed on or measured by net income . . .@

The only Alabama case involving this issue is Burton Manufacturing Company, Inc. v. State of Alabama, 469 So.2d 620 (1985). At issue in Burton was whether the company was entitled to a credit pursuant to Code of Ala. 1975, ' 40-18-21 for income taxes paid to Florida. The Court of Civil Appeals, applying the MTC definition of **A**income tax,@ held that the Florida tax measured by income was an income tax.

> **A**Given the scarcity of other definitions of the term >income tax= within this state, we consider that the language and definitions used in '' 40-27-1 to 6, Code 1975 (the Multistate Tax Compact) are relevant in this case. Statutes dealing with the same subject being construed (statutes in pari materia) are a form of extrinsic aid deemed relevant as to how a statute should be interpreted and applied. Sutherland Stat. Const., 51.01 (4th Ed.) (1973).@

Burton Manufacturing, 469 So.2d at 623.

I recognize that the Burton Manufacturing Court also looked to other factors in deciding the case. But given that the MTC definition of **A**income tax@ is the only definition of that term in the Alabama Tax Code, that definition must also be applied in this case. The taxes in issue thus constituted non-deductible income taxes because they were measured by income.

The above is supported by the rule of statutory construction that a tax deduction must be construed for the Department and against the deduction. Community Action Agency, Inc. v. State, 406 So.2d 890 (Ala. 1981). Further, the Taxpayer had the burden of proving it is entitled to the deduction. S.H.J. v. State Department of Revenue, 682 So.2d 1354 (Ala.Civ.App. 1995). The Taxpayer failed to prove that the taxes were considered as something other than income taxes by the states or local jurisdictions that levied the taxes.

ISSUE (4) - The Interest Deduction Allocation Ratio.

Code of Ala. 1975, ' 40-18-35(a) read as follows during the years in issue:

> AIn the case of foreign corporations doing business partly within and partly without Alabama where income is apportioned and allocated to Alabama, the expense incurred by such corporation in connection with earning such income shall be apportioned to Alabama in such amount as shall fairly reflect the net income of the corporation attributable to its operations in Alabama;@

Department Reg. 810-3-31-.02(a)(5)(I) related to the proration of interest expense, and provided in part:

> A(I) Interest expense shall be prorated to non-business assets by multiplying that interest expense by the ratio of average costs of the non-business assets to the average costs of the total assets.@

(a) The first sub-issue is whether the Taxpayer=s VIL stock constituted a non-business asset, in which case it should be included in the numerator of the ratio. The parties agree that the Issue (1) holding as to whether the VIL dividends constituted business or non-business income should be applied consistently to this sub-issue. As indicated, the VIL dividends were business income. Consequently, the VIL stock should also be treated as a business asset for purposes of the interest deduction ratio.

(b) The second sub-issue is how should Acosts@ be defined for purposes of the ratio. The Taxpayer argues that costs should be construed as Anet asset costs.@ The Taxpayer defines net asset costs as Acosts less accumulated depreciation and depletion with respect to such assets.@ Taxpayer=s brief at page 13. I disagree.

Costs means costs, which is defined as the Aamount paid or required in payment for a purchase; price.@ American Heritage Dictionary, Second College Edition, at page 329. Cost is thus the amount the Taxpayer paid for its non-business assets. It is not cost less (or plus) anything. If a word in a statute is unambiguous, as is the word Acosts@ in the regulation, its plain, commonly understood meaning should be applied. IMED Corp. v. Systems Engineering Associates Corp., 602 So.2d 344 (Ala. 1992). I see no reason why the same rule of construction should not apply to a Department regulation.

The Alabama Supreme Court has also ruled that a duly promulgated Department regulation must be upheld if reasonable. Ex parte White, 477 So.2d 422 (1985). The Taxpayer has not established that the use of Acosts@ instead of Anet costs@ in the regulation is unreasonable.

(c) The third sub-issue is how should Aaverage costs@ of non-business assets be computed for purposes of the ratio. The Department argues that average costs should be computed by averaging the Taxpayer=s costs of its non-business assets at the beginning of a tax year by the costs of such assets at the end of the year. The Taxpayer contends that the net costs of the Taxpayer=s non-business assets at the end of the year should be used. I agree with the Department.

As with sub-issue (b), the plain meaning of the term Aaverage costs@ should be applied. AAverage@ is defined by the American Heritage Dictionary, Second College Edition, at page 144, as Athe arithmetic mean.@ That same source, at page 775, defines Amean@ as Athe mid-point between two extremes.@ The Department thus reasonably interprets the term Aaverage costs@ as the sum of the beginning year and ending year costs divided by two. That is the average of the cost of the Taxpayer=s non-business assets held during the year. The same rationale should also be applied in determining the Taxpayer=s average cost of its total assets.

ISSUE (5) - The Failure To Timely Pay Penalty.

The Department assessed the Taxpayer for the one percent per month failure to timely pay penalty levied at ' 40-2A-11(b). The Department assessed the Taxpayer for the maximum 25 percent penalty, or $122,005, allowed by the statute. The Taxpayer contends the penalty should be waived for reasonable cause pursuant to ' 40-2A-11(h). However, that question need not be addressed because the failure to timely pay penalty does not apply in this case.

Section 40-2A-11(b) reads in pertinent part, as follows:

> A(b) Failure to timely pay tax. If a taxpayer fails to pay to the Department the amount of tax shown as due on a return required to be filed on or before the date prescribed for

payment of the tax . . . there should be added as a penalty one percent of the amount of the tax due if the failure to pay is not for more than one month, with an additional one percent of each additional month or fraction thereof during which failure to pay continues, not exceeding 25 percent in the aggregate.@

As indicated, the penalty applies only if a taxpayer fails to pay Athe amount of tax shown as due on a return.@ There is no evidence in this case that the Taxpayer failed to pay the tax due as reported on its returns for the subject years. Consequently, ' 40-2A-11(b) does not apply. See also, Dyncorp v. State of Alabama, Docket U. 95-375 (Admin. Law Div. 3/18/96); Dow-United Technologies Composite Prods., Inc. v. State of Alabama, Docket F. 95-175 (Admin. Law Div. 3/12/96). Rather, the five percent negligence penalty levied at Code of Ala. 1975, ' 40-2A-11(c) should be applied to the additional tax resulting from the reduced interest expense deductions. The negligence penalty should not be assessed concerning the taxes erroneously deducted by the Taxpayer. The Taxpayer had consistently deducted such taxes in the years before the subject years. Those deductions were not disallowed by the Department. The Taxpayer=s position that the taxes could be deducted, although wrong, was thus based on its good faith belief that the taxes were deductible.

The Department should recompute the Taxpayer=s liability as indicated above. A Final Order will then be entered for the adjusted amount due. This Opinion and Preliminary Order is not an appealable order. The Final Order, when entered, may be appealed to circuit court pursuant to Code of Ala. 1975, ' 40-2A-9(g).

Entered December 13, 1999.