QMS, INCORPORATED One Magnum Pass Mobile, AL 36618,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. INC. 98-165
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed QMS, Inc. ("Taxpayer") for corporate income tax for the fiscal years ending September 1990 and September 1991. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. Bryan Thames, Gregory Jones, and Louis Braswell represented the Taxpayer. Assistant Counsel Dan Schmaeling and Duncan Crow represented the Department.

ISSUES

This case involves three primary issues:

(1) Does Alabama's corporate income tax scheme discriminate against corporations engaged in interstate commerce, and thus violate the Commerce Clause of the U.S. Constitution, Article 1, §8, Cl. 3? Specifically, does Alabama's dividends received deduction at Code of Ala. 1975, §40-18-35(14) unconstitutionally discriminate against foreign corporations that do not conduct business in Alabama?

(2) The Taxpayer was required to recognize "gross up" income and "deemed dividends" as income for federal tax purposes pursuant to 26 U.S.C. §§78 and 951, respectively. Should the Taxpayer also be required to include those items in gross income for Alabama purposes pursuant to Code of Ala. 1975, §40-18-34?

(3) If the gross up and deemed dividends constitute gross income for Alabama purposes, should such income be treated as "business income" or "non-business income" pursuant to the Multistate Tax Compact ("MTC"), Code of Ala. 1975, §40-27-1, et seq., an related regulations?

FACTS

The Taxpayer is a Delaware corporation commercially domiciled in Alabama. The Taxpayer designs, manufactures, and markets advanced printing systems and related supplies and accessories. The Taxpayer conducts business throughout the United States and foreign countries.

The Taxpayer owned 100 percent of the stock of two non-U.S. subsidiaries during the subject years, QMS Europe BV and QMS Canada, Inc. Neither subsidiary conducted business in Alabama during the subject years, and thus did not pay Alabama income tax in those years. The subsidiaries were "integrally related to the operation of QMS. They were basically an extension of QMS in the foreign markets." Transcript at 43.

The Taxpayer pledged the stock of the two subsidiaries as collateral for an obligation. As a result, the Taxpayer was treated for federal income tax purposes under 26 U.S.C. §§951 and 956 as having received a "deemed dividend" equal to the value of the pledge. 26 U.S.C. §902 also allowed the Taxpayer to claim a foreign tax credit because the Taxpayer was deemed to have paid foreign income tax on the income resulting from the deemed dividends. To claim the credit, however, the Taxpayer was required by 26 U.S.C. §78 to recognize "gross up" income for federal purposes equal to the foreign taxes deemed paid.

The Taxpayer reported the §951 deemed dividends and the §78 gross up income on its federal returns during the subject years. The Taxpayer failed to report those items as income on its Alabama returns. The Department included the amounts as Alabama income. The Department also allocated 100

percent of the income to Alabama as non-business income pursuant to the MTC and related Reg. 810-3-31-.02. The Taxpayer appealed.

ANALYSIS

ISSUE (1) - The Constitutionality of Alabama's Corporate Income Tax Scheme.

The Taxpayer argues that Alabama's corporate income tax scheme, and specifically the dividends received deduction at §40-18-35(a)(14), is unconstitutional because it discriminates against foreign corporations that do not conduct business in Alabama, citing Kraft General Foods, Inc. v. Iowa Dept. of Rev. and Finance, 112 S.Ct. 2365 (1992).

The Administrative Law Division cannot address that issue because, as part of an executive branch agency, it does not have the judicial authority to declare a statute or a statutory scheme unconstitutional. See generally, Dial Bank v. State of Alabama, Inc. 95-289 (Admin. Law Div. 08/10/98).

The Taxpayer argues that the Uniform Revenue Procedures Act ("URPA"), at Code of Ala. 1975, §40-2A-7, et seq., gives the Administrative Law Division the authority to declare a statute unconstitutional. Specifically, the Taxpayer cites §40-2A-9(a), which provides that URPA shall be construed "to provide for the fair, efficient, and complete resolution of all matters in dispute," and §40-2A-9(e), which provides that a final order of the Administrative Law Judge "shall have the same force and effect as a final order issued by a circuit judge sitting in Alabama."

The Alabama Legislature is authorized to give an administrative agency such judicial power as necessary to accomplish the purpose for which the agency was created. Alabama Constitution 1901, Amend. 328, §6.01(b). This includes the authority to declare a statute unconstitutional. But those general URPA provisions cited by the Taxpayer do not give the Administrative Law Division that authority. Before

the Administrative Law Division can declare a statute unconstitutional, the Legislature must specifically invest the Administrative Law Division with that judicial power.

The Administrative Law Division can, however, apply broad constitutional principles to determine if a corporation, or the income of a corporation, is subject to Alabama income tax. Consequently, assuming that the §78 gross up income and the §951 deemed dividends in issue constitute income for Alabama purposes, the issue is whether the Department can constitutionally tax such income derived from a foreign subsidiary corporation that did not do business in Alabama.

In F.W. Woolworth Company v. Taxation and Revenue Department, 102 S.Ct. 3128 (1982), New Mexico attempted to tax a non-domiciliary corporation doing business in New Mexico on its gross up income received from foreign subsidiaries. The U.S. Supreme Court held that New Mexico could not tax the income because the foreign subsidiaries were discreet business enterprises, and not part of Woolworth's unitary business conducted in New Mexico.

The Taxpayer in this case concedes that the foreign subsidiaries from which it received the gross up and deemed dividends are integrally related to and are an extension of its business in foreign markets. Because the subsidiaries are part of the Taxpayer's unitary business, Alabama is not prohibited from taxing the dividends received from those subsidiaries.

Justice O'Connor, in her dissent in ASARCO, Inc. v. Idaho State Tax Commission, 102 S.Ct. 3103 (1982), decided in tandem with Woolworth, also pointed out that the unitary business principle is limited to only non-domiciliary taxpayers. ASARCO, 102 S.Ct. at 3123, n. 12. See also, Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 100 S.Ct. 1223 (1980). Because the Taxpayer is commercially domiciled in Alabama, and again assuming that the items in issue constitute income for Alabama purposes,

Alabama is not constitutionally barred from taxing the income.

ISSUE (2) - Did the §78 "gross up" income and the §951 "deemed dividends" constitute gross income for Alabama corporate income tax purposes?

During the period in issue, Alabama imposed an income tax on foreign corporations based on the "net income . . . from business done and transacted within this state." Code of Ala. 1975, §40-18-31.[1]

Code of Ala. 1975, §40-18-33 defined "net income" for corporate income tax purposes as "gross income as defined in §40-18-34, less the deductions allowed by §40-18-35 . . ."

Section 40-18-34 defined "gross income" for corporate income tax purposes as gross income as defined for individual taxpayers at Code of Ala. 1975, §40-18-14. Section 40-18-34 also provided that concerning foreign corporations, "gross income includes only the gross income from sources within this state, . . ."

The threshold issue is whether §78 gross up income and §951 deemed dividends constitute gross income pursuant to §40-18-14. That section broadly defines "gross income" to include "gains, profits, . . . and income derived from any source whatever, including any income not exempt under this chapter and

[1]Section 40-18-31 was substantially amended in 1998, as was the definition of "net income" in §40-18-33 and "gross income" in §40-18-34. This Order addresses the pre-amendment version of those statutes in effect during the years in issue.

against which income there is no provision for a tax."

Arguably, gross up income and deemed dividends are not gross income under §40-18-14 because they are fictitious items recognized for federal income tax purposes only. Sections 78 and 951 of the Internal Revenue Code that required the Taxpayer to recognize the items as income for federal purposes have not been adopted by Alabama. Alabama law alone controls the computation of a taxpayer's Alabama income tax liability. Reliance on federal law is inappropriate. State v. Chesebrough-Pond's, Inc., 441 So.2d 598, 601-02 (Ala. 1983). But for the specific federal statutes, a corporation would not be required to recognize gross up income and deemed dividends as income even for federal purposes.

The rationale behind the federal statutes also does not support inclusion of the items in Alabama gross income. A corporation is required to recognize §78 and §951 income for federal purposes as a quid pro quo to offset certain tax advantages allowed the corporation for federal purposes. But the corporation is not allowed those tax advantages for Alabama purposes. For example, a corporation is required to recognize §78 gross up income for federal purposes to offset the foreign tax paid credit allowed the corporation for federal purposes pursuant to 26 U.S.C. §902. For Alabama purposes, however, the corporation is not allowed a foreign tax paid credit that makes recognition of §78 income necessary for federal purposes.

For the above reasons, the gross up income and deemed dividends in issue arguable should not be included in gross income for Alabama purposes. As explained below, however, the Alabama Supreme Court has determined that the items must be included as gross income pursuant to §40-18-14.

In White v. Kimberly-Clark Corporation, 503 So.2d 296 (Ala. 1987), one of the issues was whether §78 gross up income and §951 deemed dividends should be included in net income from business done

outside of Alabama for purposes of the federal income tax paid deduction ratio at Code of Ala. 1975, §40-18-35(3). The circuit court had ruled that the items were "fictitious income" that did not constitute net income for Alabama purposes. Kimberly-Clark, 503 So.2d at 302.

The Alabama Court of Civil Appeals reversed, holding that the gross up income and the deemed dividends constituted gross income under §40-18-14:

> "For a number of reasons, we cannot escape the conclusion that this 'gross up income' must also be treated as 'gross income' under §40-18-14, Code 1975. Therefore, this 'gross up income' must be included in the denominator of the formula at issue.
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> First, we note that §40-18-14 expressly includes as gross income those 'gains, profits and income derived from . . . dividends.' While 'dividends' is not expressly defined by this section, the section was copied in large part from the federal statute, I.R.C. §61. As such, the fact that 'gross up income' is a 'dividend' under federal statute may be given some weight by this court. *See State v. Gulf Oil*., 47 Ala. App. 434, 256 So.2d 172 (1971); Alabama Department of Revenue Regulation 810-3-14-.01(8).
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> Second, even if this 'gross up' income were not a 'dividend' under §40-18-14(1), it would be included as 'gross income' under the catch-all phrase 'income derived from any source whatever.' *See* §40-18-14(1). *See also* Regulation 810-3-14-.10(1) (defining gross income as 'all wealth flowing to the taxpayer from whatever source'). There can be no argument that the domestic corporation required to compute 'gross up income' has received some economic benefit from its election to take the §902 credit. As we have already discussed, it was this very economic preference for foreign subsidiaries that prompted Congress to pass §78.
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> Third, at least one other state appellate court has addressed a similar issue concerning I.R.C. §78. In a splendidly explained opinion, that court held similarly that §78 'gross up income' may constitute gross income under that state's tax laws. *See Dow Chemical Co. v. Commissioner of Revenue*, Mass. 254, 391 N.E. 2d 253 (1979).
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> For the same analytical reasons given in our discussion of §78 'gross up income' as 'gross income' under §40-18-14(1), we must conclude that §951 'Subpart F income' is also 'gross income' as encompassed by the definition given in §40-18-14(a). Such income is due to be included in the denominator of the federal tax deduction ratio.

> 'Subpart F income' is considered as 'gross income' under I.R.C. §61. If this increase in the wealth of the taxpayer were not included in the determination of its gross income in the same taxable year as it is considered so under the I.R.C., it might not ever find inclusion into the state tax system. When this income is finally 'paid out' to the domestic corporation, it is not included as gross income under I.R.C. §61. *See* I.R.C. §959; Bittker & Eustice para. 17.31. It seems logical to us, that this increase in wealth must at some point be included in the taxpayer's gross income. The best and fairest way to ensure this is to have both the state and federal systems recognize this increase of wealth in the same taxable year."

Kimberly-Clark, 503 So.2d. at 303-04.

The Alabama Supreme Court affirmed the Court of Civil Appeals' decision. Ex parte Kimberly-Clark, 503 So.2d 304 (Ala. 1987). As indicated, the issue in Kimberly-Clark was whether gross up income and deemed dividends should be included in the denominator of the federal tax paid deduction ratio. But the language of the Court, as quoted above, is sufficiently broad to require that the items must be included in §40-18-14 gross income for all purposes.

A second reason the gross up income and deemed dividends must be included in gross income is Code of Ala. 1975, §40-18-35(a)(15), effective May 20, 1996. That statute allows corporations commercially domiciled outside of Alabama to deduct dividends received from a subsidiary corporation, "including amounts included in gross income under 26 U.S.C. §§78 and 951 . . ." While §40-18-35(a)(15) was not in effect during the years in issue, it illustrates that §78 gross up and §951 deemed dividends constitute gross income for Alabama purposes. Otherwise, a non-domiciliary corporation could exclude the items from Alabama gross income, and yet still deduct the items pursuant to §40-18-35(a)(15). Certainly, the Legislature did not intend such a windfall.[2]

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[2]Perhaps the drafters of Act 96-550, which added §40-18-35(a)(15), included the phrase "including

The issue in Chesebrough-Ponds was whether dividends received by Chesebrough-Ponds from a subsidiary not domiciled in Alabama should be included in the denominator of the §40-18-35(3) federal tax paid deduction ratio. The Alabama Supreme Court held that although the dividends were from non-Alabama sources, they constituted gross income under §40-18-14, and thus must be included in the denominator.

The Taxpayer argues that Chesebrough-Ponds "stands for the proposition that, while they may be considered in calculating a foreign corporation's deduction in Alabama for federal taxes paid, deemed or inter-company dividends are not taxable in Alabama." (underline in original). Taxpayer's Memorandum of Law at 22. That statement is wrong.

Assuming that the payor subsidiary and the parent are unitary, intercompany dividends paid by the subsidiary to the parent must be included in gross income for Alabama purposes, either as allocable non-business income, or apportionable business income, depending on the nature of the dividend and whether the parent is commercially domiciled in Alabama. See, Department Reg. 810-27-1-4-.01. The Alabama

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amounts included in gross income under 26 U.S.C. §§78 and 951" as a precaution that if §78 and §951 dividends are includable in gross income, then such items could be deducted. But the plain language of the statute must be read as written, without speculation as to what the drafters may have intended but did not express in the statute.

Supreme Court did not hold otherwise in Chesebrough-Ponds.

Chesebrough-Ponds involved the 1978 tax year. At that time, Reg. 31.2 provided that "dividend income is business income when dealing in securities is a principal business activity of the taxpayer. Most other dividends are non-business income."[3] Given that limited definition of what dividend income constituted business income, the parties in Chesebrough-Ponds conceded that the intercompany dividends in issue were non-business income, and thus allocated 100 percent to Chesebrough-Ponds' state of commercial domicile, New York. Chesebrough-Ponds, 441 So.2d at 603. Consequently, the dividends were not taxable in Alabama only because they were allocated 100 percent to another state as non-business income. The Court recognized the "[i]f Chesebrough had been domiciled in Alabama instead of New York, then all intercompany dividends would have been allocated directly to Alabama for purposes of determining net income taxable within Alabama." Chesebrough-Ponds, 441 So.2d at 603. The Taxpayer in this case is commercially domiciled in Alabama. Consequently, the gross up income and deemed dividends can be taxed in Alabama, either as allocable non-business income, or as apportionable business income. See Issue (3), below.

The Taxpayer also argues that while deemed dividends and gross up income may be considered in computing the denominator of the federal tax paid deduction ratio, Kimberly-Clark holds that such items received "from non-Alabama corporations are **not** taxable in Alabama." (emphasis in original). Taxpayer's November 12, 1998 letter brief at 5. That is an incorrect reading of the case.

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[3]Reg. 31.2 was readopted as Reg. 810-3-31-.02 in September 1982. Reg. 810-3-31-.02 was substantially amended in June 1988. That amended regulation was in effect during the years in issue in this case, and is discussed below concerning Issue (3).

The Department, for whatever reason, did not attempt to tax the gross up income and deemed dividends in issue in Kimberly-Clark. Consequently, the taxability of those items in Alabama was not in issue. The Court of Civil Appeals apparently assumed, without analyzing the issue, that the income was not taxable in Alabama. On close review, however, it is clear that the Court did not hold that §78 gross up income and §951 deemed dividends could never be taxed by Alabama.

In Woolworth, the New Mexico Supreme Court held that §78 gross up dividends received by Woolworth from a foreign subsidiary constituted business income apportionable to New Mexico. The United States Supreme Court reversed, not because the §78 gross up income was not income, but because the foreign subsidiary had no unitary relationship with Woolworth's business activities in New Mexico. Woolworth, 102 S.Ct. at 3139.

The Alabama Court of Civil Appeals, in Kimberly-Clark, correctly read Woolworth as not holding that gross up income could never be taxed by a state:

> "In F.W. Woolworth Co., it was the Supreme Court of New Mexico that characterized the 'gross up income' as 'fictitious,' not the United States Supreme Court. The Supreme Court did not hold that such income could never be taxed, but only that a state could not tax it if the domestic corporation's 'foreign subsidiaries . . . had no unitary business relationship with' that state. F.W. Woolworth Co., 458 U.S. 372-373, 102 S.Ct. at 3139.

Kimberly-Clark, 503 So.2d at 303.

The New Mexico Supreme Court in Woolworth described the gross up income as "fictitious," and that it did not fit the ordinary definition of income. The Court nonetheless held that the gross up dividend constituted income for New Mexico purposes. Woolworth, 102 S.Ct. at 3133-34. That finding supports the conclusion that the gross up and deemed dividends in issue constitute gross income pursuant to §40-18-14.

If the gross up income and deemed dividends constitute gross income under §40-18-14, what is the

effect of the statement in §40-18-34 that a foreign corporation's gross income "includes only the gross income from sources within this state . . ." As in Chesebrough-Ponds, that phrase "complicates our analysis." Chesebrough-Ponds, 441 So.2d at 604.

The 1935 Act that established Alabama's corporate income tax included the phrase in issue that concerning foreign corporations, "gross income includes only the gross income from sources within this state." Acts 1935, No. 194. That phrase was intended to ensure that Alabama taxed only that portion of a foreign corporation's income attributable to sources in Alabama.

As state corporate income taxation developed, however, states, including Alabama, moved away from taxing only the income of a foreign corporation sourced in the state, and instead began relying on allocation and factor apportionment to better determine a corporation's income attributable to the state. This development is explained in State Taxation, (2nd Ed. 1992) Para. 8.10(2), J. Hellerstein and W. Hellerstein, as follows:

> "Historically, the States do appear to have regarded their jurisdiction to tax income as depending on the source of the income in the State, but as State corporate income taxation developed, there was a growing recognition that the benefits and protection afforded a multistate or multinational business and the public costs incurred in furnishing public service facilities and resources to the business ought also be given weight in the apportionment, both for purposes of determining the State's taxing jurisdiction under the U.S. Constitution and as a matter of fiscal policy.
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> Source of income is a factor to be considered in determining a State's power to impose income taxes and, indeed, it is taken into account in determining apportionment under the standard three-factor property, payroll, and sales formula used by most States. But source is by no means the only factor by which the income attributable to a State may or should be measured. Consequently, apportionment of the income of multistate or multinational businesses is not vulnerable, either as a constitutional matter or from the vantage point of fiscal policy, on the ground that the apportionment does not correspond to the source of the income."

Alabama followed the trend of requiring foreign corporations to apportion and allocate income when it adopted the MTC, Code of Ala. 1975, §40-27-1, et seq., in 1967.[4] The MTC was an attempt by various states to establish a fair and uniform system of taxing multistate corporations. Chesebrough-Ponds, 441 So.2d at 603. At the heart of the MTC are the allocation and apportionment rules first established by the Uniform Division of Income for Tax Purposes Act ("UDITPA") in 1957. Those rules do not rely on the geographic source of income in computing a foreign corporation's liability in a state. Rather, business income from all sources is apportioned among the states in which the corporation does business, normally in Alabama in accordance with a three factor formula of sales, payroll, and property. Non-business or investment income from all sources is usually allocated 100 percent to the corporation's state of commercial domicile.[5]

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[4]Alabama apparently allowed foreign corporations the option of apportionment even before the MTC was adopted in 1967, see, State Dept. of Revenue v. Fuqua Industries, Inc., 261 So.2d 410 (1972), which involved the 1996 tax year. That case does not specifically explain what method of apportionment was allowed.

[5]The traditional or Massachusetts formula originally used by most states required the balanced use of the sales, payroll, and property factors. Many states have tinkered with the formula to require, for example, a double weighted sales factor, or, in some cases, a single sales factor formula. The growing trend of non-uniformity among the states obviously results in a less uniform system of state taxation.

The Revenue Department refused to formally recognize the MTC until the Alabama Court of Civil Appeals affirmed the Administrative Law Division's decision in State, Dept. of Revenue v. MGH Mgt., Inc., 627 So.2d 408 (Ala.Civ.App. 1993), holding that the MTC had been in effect in Alabama since 1977. But although the Department did not formally recognize the MTC until 1993, it did adopt the UDITPA-based MTC allocation and apportionment rules as early as 1971.

The Department revised its corporate income tax regulations in 1971, including Reg. 398.2, entitled "Determination of income from multistate operations." That regulation adopted a version of the MTC allocation and apportionment rules. Reg. 398.2 was revised in 1975, re-adopted in 1979 as Reg. 31.2, and re-adopted again in 1982 as Reg. 810-3-31-.02. Reg. 810-3-31-.02 was substantially amended in 1988. Finally, after MGH Mgt., Inc., the Department in substance revoked Reg. 810-3-31-.02, and promulgated the current regulation, Reg. 810-27-1-4-.01, entitled "Multistate Tax Compact Regulation Definitions." All of the above regulations required or require foreign corporations to allocate and apportion income to Alabama.

The above history illustrates that since at least 1971, the Department has not followed the §40-18-34 limitation that a foreign corporation's gross income includes only income from Alabama sources. Rather, the Department has consistently required foreign corporations to allocate and apportion its income from all sources to Alabama using the MTC and related regulations.

The rationale behind apportionment, and why a foreign corporation's income attributable to a given

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Alabama still generally uses the equal weighted sales, property, and payroll formula.

State is not tied to the source of the income, was explained by the U.S. Supreme Court in Mobil Oil:

> "The argument that the source of the income precludes its taxability runs contrary to precedent. In the past, apportionability often has been challenged by the contention that income earned in one State may not be taxed in another if the source of the income may be ascertained by separate geographical accounting. The Court has rejected that contention so long as the intrastate and extrastate activities formed part of a single unitary business. (cites omitted). In these circumstances, the Court has noted that separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Butler Bros. v. McColgan, 315 U.S., at 508-509, 62 S.Ct., at 704-705. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required."

Mobil Oil, 100 S.Ct. at 1232.

As illustrated, the §40-18-34 limitation that gross income includes only income from sources in Alabama clearly conflicts with the MTC and related regulations. If the §40-18-34 definition of gross income is strictly applied, the MTC and related regulations would be emasculated, and, in effect, made meaningless. Allocation and apportionment would be inappropriate and unnecessary. As in Chesebrough-Ponds, certainly the Legislature did not intend such a "nonsensical result." Chesebrough-Ponds, 441 So.2d at 604. Consequently, the gross up income and deemed dividends in issue, although not technically from an Alabama source, must be included in Alabama income, either as allocable non-business income or apportionable business income.

The above is supported by the rule of statutory construction that where an administrative agency has consistently construed and applied a statute for a number of years, that interpretation is entitled to considerable weight. State v. Tri-State Pharmaceutical, Inc., 371 So.2d 910 (Ala.Civ.App. 1979). That rule is reinforced where the Legislature has declined to disapprove of the agency's interpretation. Pilgram v.

Gregory, 594 So.2d 114 (Ala.Civ.App. 1991). The Legislature has done nothing to show its disapproval of the Department's long-time application of the MTC and related regulations.

In Ex parte Sonat, Inc, ____ So.2d ____, (S.Ct. 1961585, August 27, 1999), the Alabama Supreme Court held that "the interpretation of 'net income' in Chesebrough-Ponds, Inc., is necessarily limited to the particular language and purpose of" the federal tax paid deduction ratio. The Court held that the Chesebrough-Ponds interpretation of "net income" did not apply to the dividend received deduction under §40-18-35(a)(14) because "there is no conflict between the (dividend received deduction) requirement that the subsidiary be taxable upon its next income and the (§40-18-34) limitation" that gross income includes only gross income from Alabama sources. Sonat, ____ So.2d ____ at ____.

As illustrated, however, just as there was a conflict between statutes in Chesebrough-Ponds, there is an inherent conflict between the last sentence in §40-18-34 and the MTC and related regulations. That conflict must be resolved in favor of the MTC. In any case, allocation and apportionment of income in substance serves the purpose of the disputed phrase in §40-18-34 because by that method Alabama computes that portion of a foreign corporation's income attributable to Alabama.[6]

The dividends in issue in Sonat were paid to Sonat by a wholly-owned subsidiary, SODI, a Delaware corporation headquartered in Texas. The income that generated the dividends was derived from liquidating distributions SODI received from two of its non-U.S. subsidiaries. SODI did not report those distributions as

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[6]As indicated in footnote 1, supra, §40-18-34 was amended in 1998 by Act 98-502. That statute now defines "gross income" for corporate tax purposes as "gross income as defined in Section 40-18-14 and classified as either business or nonbusiness income under Chapter 27 . . ." The Act also deleted the phrase "gross income includes only the gross income from sources within this state." While the amendment was enacted after the years in issue, it ratifies the Department's long-standing practice that a foreign corporation must allocate and apportion income from all sources to Alabama under the MTC and related regulations.

income on its 1988 Alabama return. The Supreme Court stated:

> "Under §40-18-34, the income that generated the dividend was not includable in SODI's 1988 gross income because it came from sources outside of Alabama, two of SODI's non-U.S. subsidiaries."

Sonat, ____ So.2d ____ at ____.

With due respect, the above statement is technically incorrect. SODI did not exclude the distributions from Alabama income because they were from sources outside of Alabama. Rather, the dividends were excluded because, as argued by Sonat, they were exempt as a liquidating dividend pursuant to Code of Ala. 1975, §40-18-8(i) (currently §40-18-8(h)). In addition, SODI was not required to report the liquidating dividends to Alabama because the payor subsidiaries were not unitary with SODI's leasing activity in Alabama. If the dividends had not been exempt under §40-18-8(i), and if the payor subsidiaries had been unitary with SODI's leasing activity in Alabama, SODI would have been required to report the income on its Alabama return.

Importantly, Sonat reported the $185 million intercompany dividend from SODI as income on its 1988 Alabama return, even though the income was not from an Alabama source. This confirms that foreign source intercompany dividends must be included in income for Alabama purposes, again assuming that the payor subsidiary is unitary with the parent. The issue in Sonat was only whether the dividends should be deducted out of Alabama income.[7]

ISSUE (3) - Should the §78 and §951 income be classified as allocable non-business income or apportionable business income?

[7]This discussion of Sonat does not necessarily indicate that I disagree with the Supreme Court's ultimate holding. It is only an attempt to clarify the holding to allow the reader to better understand this case.

The Department classified the §78 and §951 dividends as non-business income, and thus allocated them 100 percent to Alabama. The Taxpayer argues that if the income is taxable at all, it should be apportioned to Alabama as business income. I agree with the Taxpayer.

"Business income" is defined by §40-27-1, Art. IV, para. 1.(a), as follows:

> "Business income means 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 relevant regulation in effect during the years in issue was Reg. 810-3-31-.02, as amended on June 17, 1988. That Regulation repeated the MTC definition of "business income" at §40-27-1. See, Reg. 810-3-31-.02(1)(a). Concerning dividends, Reg. 810-3-31.02(1)(a)(4)(iv) stated as follows:

> "Dividends. Dividend 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 - "DISC") or when the dividends are the result of investment of business funds. Dividends which qualify for the 85 percent dividends received deduction under IRC §243 will be presumed to be business income, unless clearly established otherwise. Most other dividends are presumed to be non-business income, unless clearly established otherwise."

The Department relied on Example III to characterize the §78 and §951 dividends in issue as non-business income. Example III provided - "The 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 income."

First, Reg. 810-3-31-.02(1)(a)(4)(iv), as it read during the subject years, incorrectly characterized dividends as business income "when the dividends are the result of investment of business funds." All funds

invested or otherwise spent by a corporation are business funds. But a corporation's investment of those business funds in stock does not always result in the receipt of business income. Clearly, if a corporation invests in the stock of an unrelated corporation that is not connected to the corporation's business activity, dividends received from that investment would constitute non-business income.[8]

Concerning Example III, the wholly-owned subsidiary that paid the dividends was presumably involved in a unitary business with the taxpayer. Consequently, contrary to the Department's classification of the dividends as non-business income, the dividends clearly constitute business income derived from an activity in the taxpayer's regular trade or business. In State Taxation (2nd Ed. 1992), para. 9.13(1)(c), the author explained that dividend income received from a subsidiary corporation that is unitary with its parent constitutes apportionable business income.

> "Dividends received from other corporations that are part of the taxpayer's unitary business carried on in the State and that are paid out of earnings derived from the regular business operations of the enterprise represent a flow of income from normal business operations. The fiscally sound tax treatment of such an enterprise is to combine the income of the parent and subsidiary companies for purposes of unitary apportionment. In that event, the dividend issue would disappear, since the intercompany dividends would be eliminated

[8]The current version of the regulation relating to dividends, Reg. 810-27-1-4-.01(c)(4), provides as follows: "Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose of acquiring and holding the stock is related to or incidental to such trade or business operations." That regulation much better conforms to the statutory definition of "business income" adopted by Alabama.

in the combination or consolidation.

> "If, however, neither the State nor the taxpayer exercises an election or power granted by the statute to utilize the combined apportionment approach, or there is no statutory or administrative provision therefor, or if the taxpayer does not qualify for combination, the character of the dividend income on a separate parent company basis of reporting, now *qua* dividend instead of operating income, nevertheless remains unchanged. It is still operating income, which ought to be apportioned in taxing the recipient."

Alabama currently requires foreign corporations to file on a separate return basis. Consequently, applying the above principle, the dividends in issue received by the Taxpayer from its unitary non-U.S. subsidiaries clearly constitute apportionable business income.[9]

The Department is directed to recompute the Taxpayer's liability for the subject years 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 within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered September 23, 1999.

BILL THOMPSON
Chief Administrative Law Judge

BT:ks

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[9]It is irrelevant that the Taxpayer's subsidiaries were non-U.S. corporations. In Mobil Oil, the U.S. Supreme Court afforded no special protection to the dividends received by Mobil from its foreign subsidiaries. See also, State Taxation (2nd Ed. 1992), para. 9.12(2), n. 233.

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