THE COLONIAL BANCGROUP § STATE OF ALABAMA
One Commerce Street DEPARTMENT OF REVENUE
Montgomery, AL 36104, § ADMINISTRATIVE LAW DIVISION

Taxpayer, § DOCKET NO. CORP. 99-515

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed 1997 financial institution excise tax ("FIET") against The Colonial BancGroup ("BancGroup"). BancGroup appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on August 8, 2000. David Wooldridge and Joe Sullivan represented BancGroup. Assistant Counsel Jeff Patterson represented the Department.

ISSUE

BancGroup is a financial institution subject to Alabama's FIET, Code of Ala. 1975, §40-16-1, et seq. BancGroup and several of its subsidiary financial institutions filed a consolidated 1997 Alabama FIET return. One of the subsidiaries claimed a net operating loss ("NOL") on the return. The NOL was incurred in 1984 through 1994 by two nonfinancial corporations ("C corporations") that merged with the subsidiary in 1997. The issue is whether the income tax NOL incurred by the two C corporations can be carried over and claimed by the subsidiary to offset BancGroup's consolidated FIET liability.

FACTS

The Colonial Company, a C corporation, was subject to Alabama corporate income tax from 1984 through 1994. It incurred substantial operating

losses in those years, which it carried forward for income tax purposes pursuant to Code of Ala. 1975, §40-18-35.1.

Before February 1995, The Colonial Company owned several operating subsidiaries, including Colonial Properties, a C corporation. Colonial Properties was subject to Alabama income tax from 1984 through 1994, and also incurred substantial operating losses in those years, which it carried forward for income tax purposes pursuant to §40-18-35.1.

On February 17, 1995, Colonial Properties merged into The Colonial Company. The Colonial Company changed its name to CMC Services, Inc. On the same day, Colonial Bank, a financial institution, acquired CMC Services in a tax-free reorganization under 26 U.S.C. §368(a)(1)(B).

BancGroup owns Colonial Bank. Colonial Bank and CMC Services filed as part of BancGroup's consolidated Alabama FIET returns for 1995 and 1996 pursuant to Code of Ala. 1975, §40-16-3(b).

On December 31, 1997, CMC Services merged into Colonial Bank. Colonial Bank claimed the combined $26.5M NOL incurred by the C corporations from 1984 through 1994 on BancGroup's 1997 Alabama consolidated FIET return. The Department disallowed the NOL. BancGroup appealed.

As indicated, the primary issue is whether the NOL carryover should be allowed. As a sub-issue, the parties also dispute the amount of the NOL. The Department audited The Colonial Company and Colonial Properties for corporate income tax purposes for the years before 1995, and reduced the income tax NOL in issue to approximately $9.5M. The corporations contested that adjustment, which is still pending. The parties agree that even if the NOL is allowed for FIET purposes, some of the losses are time-barred because they were incurred more than eight years before the NOL was claimed in 1997. See,

Code of Ala. 1975, §40-16-1(2)k. The parties agree that, depending on how the primary issue is decided, they will attempt to agree on the amount of the NOL, if any, available in 1997.

ARGUMENTS OF THE PARTIES

The Department argues that the FIET NOL deduction at §40-16-1(2)k. can only be claimed for losses incurred by a financial institution. The Department thus contends that the losses incurred by the two C corporations in 1984 through 1994 cannot be transferred to and claimed by BancGroup for FIET purposes.[1] The Department cites the rule of statutory construction that a deduction must be strictly construed for the Department and against the deduction. *Ex parte Kimberly-Clark Corporation*, 503 So.2d 304 (Ala. 1987).

The Department recognizes that "a successor financial institution shall be allowed to carry over and deduct from succeeding years' income, in the manner prescribed herein, the net operating loss of its predecessor." Section 40-16-1(2)k. The Department asserts, however, that because the NOL referred to in §40-16-1(2)k. relates only to losses incurred by financial institutions, the "net operating loss of its predecessor" can only refer to a loss incurred by a predecessor financial institution subject to the FIET.

Finally, the Department points out that the income tax NOL carryover period is 15 years, §40-18-35.1(5), whereas the FIET NOL carryover period is only 8 years, §40-16-1(2)k. The 5 percent corporate income tax rate, Code of Ala. 1975, §40-18-31(a), is also lower than the 6 percent FIET rate, Code of Ala. 1975, §40-16-4(a).

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[1]Although technically the NOL was claimed by Colonial Bank on BancGroup's consolidated return, for ease of reference, BancGroup will be deemed as having claimed the NOL.

BancGroup argues that Colonial Bank is a "successor financial institution" of CMC Services (and thus also of The Colonial Company and Colonial Properties), and should be allowed to deduct the NOL carryover. BancGroup contends that §40-16-1(2)k. does not require the "predecessor" to be a financial institution.

BancGroup also argues that the FIET NOL provision is similar to the federal income tax law dealing with NOLs, and that federal rules and decisions should be considered, citing Dept. Reg. 810-9-1-.01(4)(j). BancGroup claims that under federal income tax law, a bank may deduct the losses of a non-bank entity acquired in a tax-free reorganization.

ANALYSIS

This case involves an issue of first impression in Alabama. Can a financial institution acquire a C corporation by merger and then deduct the C corporation's accrued income tax NOLs to offset its FIET liability in later years?

As a preliminary matter, BancGroup contends that CMC Services became a financial institution for FIET purposes when it was formed in February 1995. The Department disagrees.

CMC Services was formed by the merger of two C corporations. Consequently, unless CMC Services operated after the merger as a "financial institution," as defined at Code of Ala. 1975, §40-16-1(1), it remained a C corporation in 1995 and 1996. BancGroup argues that CMC Services performed various functions of a financial institution in 1995 and 1996. There is no evidence to support that claim. The fact that CMC Services was acquired by a financial institution in February 1995 also does not establish that it thereafter qualified as a financial institution.

In any case, the above issue is irrelevant. The NOL in issue was incurred by The Colonial Company and Colonial Properties, as C corporations, from 1984 through 1994. Thus, even if CMC Services qualified as a financial institution in

1995 and 1996, the issue still is whether the income tax NOL incurred by the C corporations can be carried over and claimed by a financial institution, either CMC Services or Colonial Bank, for FIET purposes.

This case ultimately turns on how the following sentence in §40-16-1(2)k. should be interpreted - "A successor financial institution shall be allowed to carryover and deduct from succeeding years' income, in the manner prescribed herein, the net operating loss of its predecessor." The sentence is vague because reading it in the context of the FIET statutes, Title 40, Chapter 16, Code 1975, it is unclear whether the "predecessor" must be a financial institution, as argued by the Department, or any corporation, including a C corporation, as argued by BancGroup. Because the statute is vague, other factors should be considered in discerning the legislative intent. *John Deere Co. v. Gamble*, 523 So.2d 95 (Ala. 1988).

BancGroup argues that federal income tax law allows a bank to inherit the NOL of a non-bank entity acquired in a tax-free reorganization. BancGroup is correct, with certain limitations discussed below. However, BancGroup failed to prove, or even assert, that it (or Colonial Bank) was allowed to claim the NOL in issue for federal income tax purposes. But the point is irrelevant because for federal purposes, banks and C corporations are both subject to federal income tax, whereas for Alabama purposes, banks and C corporations are subject to different taxes, the FIET and the income tax, respectively.

Alabama has also adopted specific federal statutes (26 U.S.C. §§381, 382, and 384) that govern the carryover of NOLs for income tax purposes. Code of Ala. 1975, §40-18-35.1(6). Those federal statutes were enacted in 1954, and are exceptionally mystifying, even by IRC standards. Generally speaking, §381

allows a transfer of NOLs and other tax attributes to a successor corporation. Section 382 (and other sections) provides complex limitations on such transfers.[2]

The above federal statutes have not, however, been adopted for Alabama FIET purposes. Consequently, how NOL carryovers are allowed under those federal income tax statutes is irrelevant. Rather, how the courts treated NOL carryovers before the federal statutes were enacted in 1954 controls the issue for FIET purposes.

Initially, federal courts allowed an NOL carryover to be claimed only by the same taxpayer that incurred the loss. *New Colonial Ice Co. v. Helvering*, 54 S.Ct. 788 (1934). The U.S. Supreme Court subsequently enunciated the "continuity of business enterprise" doctrine in *Libson Shops, Inc. v. Koehler*, 77 S.Ct. 990 (1957).[3] That is, a surviving corporation was "not entitled to a carryover since the income against which the offset was claimed was not produced by substantially the same businesses which incurred the losses." *Libson Shops*, 77 S.Ct. at 998. "In combination, *New Colonial Ice* and *Libson Shops* restricted the benefit of net operating loss carryovers to the taxable entity that generated the loss and allowed carryovers only if that entity continued the particular corporate business that produced the loss." D. Simmons, *supra,* note 1, at 6.

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[2]For a detailed analysis of the federal law on the subject, see, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶12.01, et seq. (6th Ed. 1998); D. Simmons, *Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers*, 63 Tln. L. Rev. 1045 (1989); P. Faber, *Net Operating Loss Carryovers in Corporate Acquisitions After the Tax Reform Act of 1986*, ¶201 U.S.C. Law Center Tax Institute (1987).

[3]*Libson Shops* was decided in 1957, after the 1954 IRC statutes were enacted. However, *Libson Shops* involved tax years before 1954. Thus, pre-1954 law was in issue.

The Colonial Company and Colonial Properties, as C corporations, were engaged in various construction, real estate, and other nonfinancial businesses when they incurred the NOLs from 1984 through 1994. By definition, C corporations and financial institutions cannot be engaged in the same business activities, see §40-16-1(1) ("financial institution" defined). The successor financial institution into which the C corporations merged, whether it was CMC Services or later Colonial Bank, thus could not have continued in the same business enterprise engaged in by the C corporations. Consequently, the carryover cannot be allowed under the *Libson Shops* doctrine.[4]

There is also no evidence that the December 1997 merger of CMC Services into Colonial Bank served a valid business purpose other than tax avoidance.

The U.S. Supreme Court established the "business purpose doctrine" in *Gregory v. Helvering*, 55 S.Ct. 266 (1935). Simply stated, the doctrine provides that if a transaction (a reorganization in *Gregory*) served no business purpose other than tax avoidance, it will not be recognized for tax purposes. That was the

[4]Even under current federal income tax law, a successor corporation must in certain situations continue the business enterprise of the acquired corporation for at least two years. See, 26 CFR §1.368-1. As indicated, Colonial Bank acquired CMC Services in a §368 transaction. Numerous other states also apply the *Libson Shops* doctrine in determining if an NOL carryover to a successor corporation should be allowed. See, *Cunningham Group, Inc. v. Comm. of Revenue Service*, 709 A.2d 61 (Conn. 1997); *Bell South Telecommunications, Inc. v. North Carolina Dept. of Revenue*, 485 S.E.2d 333 (N.C. App. 1997); *Grade A Market, Inc. v. Comm.*, 688 A.2d 1364 (Conn. 1996). See also, *Caterpillar, Inc. v. Wisconsin Dept. of Revenue*, Docket No. 97-1-191 (Wis. Tax App. Comm'n March 25, 1991) (Surviving corporation in an "F" reorganization not allowed to use predecessor's losses because Wisconsin has adopted strict "identical corporation" rule); *Little Six Corporation v. Johnson*, No. 01-A-9806-CH-0028T (Tenn. Ct. App. May 28, 1999) (Surviving corporation in merger could not use losses of predecessor because each corporation is treated as a separate entity).

holding in *Realprom Holding Corporation*, 1999 WL 150026 (Cal.St.Bd.Eq.), in which a parent corporation was not allowed to carryover the NOL of a subsidiary acquired in a merger because there was no business purpose for the merger other than the capture of the stranded NOLs.

For other state cases applying the business purpose doctrine, see *Syms Corp. v. Comm. of Revenue*, Docket Nos. F. 215484 and F. 228324 (Mass. App. Tax Bd., September 14, 2000); *Sherwin-Williams Co. v. Comm. of Revenue*, Docket No. F233560 (Mass. App. Tax Bd., July 19, 2000)*; Easco, Inc. v. Cardwell*, 840 S.W.2d 913 (Tenn. 1992); *Bunge Corp. v. Comm. of Revenue*, 305 N.W.2d 779 (Minn. 1981); see also, F. Ferguson & D. Silverman, *State Tax Hide and Seek: The 'Business Purpose Doctrine' Is Not 'It'*, State Tax Notes, June 5, 2000, and cases cited therein.

CMC Services merged with Colonial Bank on the last day of 1997. Was the merger for any purpose other than to obtain the NOL for tax purposes? The above question was not raised at the hearing before the Administrative Law Division, and thus no evidence was submitted on the issue. But the timing of the merger suggests that tax planning was a primary if not sole consideration. Consequently, without evidence to the contrary, it could be argued that under the business purpose doctrine, the merger, and thus the NOL carryover, should not be recognized for tax purposes.

But while the federal courts and courts in numerous other states have applied the business purpose doctrine, the Alabama Supreme Court has never done so. To the contrary, that Court recently held that because a corporation strictly complied with the requirements of a dividend received deduction statute, the deduction should be allowed, despite the obvious lack of any business purpose for the transaction other than tax reduction. *Ex parte Sonat, Inc.*, 752

So.2d 1211 (Ala. 1999). Consequently, even if the December 31, 1997 merger was for no purpose other than to obtain the NOL, there is no precedent that the Alabama Supreme Court would disallow the transaction solely for lack of a business purpose.

Finally, the Department argues that the income tax NOL should not be allowed for FIET purposes because the income tax and FIET statutes are different. Specifically, the carryover period is 15 years for income tax, but only 8 years for FIET purposes. The FIET tax rate of 6 percent is also higher than the income tax rate of 5 percent.

BancGroup concedes that if the carryover is allowed, it must be limited to the eight years allowed by the FIET statute. Concerning the discrepancy in the rates, BancGroup finesses the issue by pointing out that the income tax rate and the FIET rate are both now six and one-half percent; see, Code of Ala. 1975, §§40-18-31(a) and 40-16-4(a)(1), respectively. However, the change in the rates is effective only for years after December 31, 2000. If the income tax NOL in issue can be used for FIET purposes in the year in issue, 1997, it would provide BancGroup with a greater benefit (reduction of a 6 percent tax) than it would have for income tax purposes (reduction of a 5 percent tax). That point supports the Department's position. Another distinction between the income tax and the FIET is of greater significance. That is, FIET income and losses are computed differently than income tax income and losses. The different treatment of interest on federal obligations illustrates the point.

Interest on federal obligations can be deducted for Alabama income tax purposes. Code of Ala. 1975, §40-18-35(a)(3) (§40-18-38(a)(1) during the year in issue). However, interest on federal obligations is included in the FIET tax base. Consequently, a C corporation could incur a net tax loss in a year, whereas a financial institution with the same income and losses could have a net

tax gain for the year. For example, assume a C corporation suffered a net tax loss in a year that it received substantial interest income from federal obligations. But for the deductibility of the interest income, the C corporation would have had a gain. The C corporation is subsequently merged with a financial institution, which is allowed to carryover the C corporation's NOL to offset its FIET liability. In that case, the financial institution would be allowed to offset its FIET liability based solely on the deductibility of interest on federal obligations for income tax purposes, even though such interest is taxable for FIET purposes. The above example illustrates the primary flaw in BancGroup's position. If BancGroup's position is accepted, a financial institution would be allowed a deduction for FIET purposes that is not allowed under the FIET statutes. There is no indication the Legislature intended such a result.

Section 40-16-1(2)k. contains the following - "For purposes of this subdivision, the term net operating loss means the excess of allowable deductions over gross income." The "allowable deductions" referred to are those allowed for FIET purposes in Title 40, Chapter 16, Code 1975. As discussed, interest on federal obligations cannot be deducted for FIET purposes. Thus, by definition, the FIET NOL allowed by §40-16-1(2)k. cannot be computed by allowing a deduction for interest on federal obligations. But if an income tax NOL incurred by a C corporation is allowed for FIET purposes, the NOL may include a deduction for such interest.

Reading §40-16-1(2)k. in context, and applying the rule of statutory construction that a deduction must be strictly construed for the Department and against the deduction, the phrase "the net operating loss of its predecessor" can only refer to a net operating loss of a financial institution computed under the FIET statutes. Because the NOL in issue was incurred by C corporations, it cannot be allowed for FIET purposes.

In summary, the difference in how FIET and income tax NOLs are computed, as illustrated by the different treatment of interest on federal obligations, and the above analysis of the language of §40-16-1(2)k, are together sufficient to disallow the carryover. That finding is supported by the fact that the carryover would not be allowed under *Libson Shops*, and to a lesser degree that there is no evidence of a valid business purpose for the December 31, 1997 merger other than tax avoidance.

The final assessment is affirmed. Judgment is entered against BancGroup for 1997 financial institution excise tax of $1,747,791, plus additional interest from the date of entry of the final assessment, September 27, 1999.

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

Entered January 5, 2001.