RHEEM MANUFACTURING COMPANY 405 LEXINGTON AVE. – 22ND FLOOR NEW YORK, NY 10174-0307,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. B.P. 03-1086
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE	§	

FINAL ORDER

The Revenue Department denied a refund of business privilege and shares tax requested by Rheem Manufacturing Company ("Rheem") for the 2000 tax year. Rheem appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. A hearing was conducted on January 20, 2005. Roy Crawford represented Rheem. Assistant Counsel Jeff Patterson represented the Department.

FACTS

Rheem manufactures and sells air conditioning and heating equipment and water heaters. Rheem operated a water heater manufacturing facility in Montgomery, Alabama in 2000.

In 1988, Paloma Industries, Ltd. acquired 100 percent of the stock of PACE Industries, Inc. ("PACE"), Rheem's corporate great grandparent. Rheem was the operating company of the PACE Group, which consisted of PACE Group Holdings, Inc., a first tier subsidiary of PACE, and PACE Group, Inc., a second tier subsidiary of PACE. Paloma acquired PACE by a merger of Paloma Acquisition Corporation, a subsidiary of Paloma, into PACE, with PACE being the surviving corporation.

The consideration for the PACE/Paloma merger was $900 million in cash, none of which was paid to Rheem. However, the merger resulted in approximately $593 million in

goodwill, which was pushed down to Rheem's balance sheet.

The Department audited Rheem's 2000 business privilege tax and shares tax return and billed Rheem for additional tax due. Rheem subsequently filed an amended 2000 business privilege and shares tax return on which it claimed a refund of $250,000.[1]

In calculating its business privilege liability on the amended return, Rheem excluded over $480 million in goodwill from its taxable net worth pursuant to Code of Ala. 1975, §40-14A-23(g)(3). That statute allows a subtraction from net worth for the "unamortized portion of goodwill and core deposit intangibles appearing on the taxpayer's balance sheet by reason of a direct purchase of another corporation . . ."

In calculating its shares tax liability on the amended return, Rheem deducted over $106 million pursuant to Code of Ala. 1975, §40-14A-33(b)(4). In 2000, that statute allowed a deduction from the taxable shares base for the "unamortized balance of any amount that the taxpayer properly elected pursuant to pronouncements of the Financial Accounting Standards Board or any successor authority, to amortize over a period of years rather than immediately charging that amount to earnings."[2]

The Department reviewed the amended return and notified Rheem that it did not owe additional business privilege or shares tax for the subject year. However, the Department also disallowed all of the business privilege tax refund and a portion of the shares tax refund claimed by Rheem. Rheem appealed.

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[1] Rheem paid estimated tax of $250,000 when it requested an extension to file its 2000 return in March 2000.

[2] Section 40-14A-33(b)(4) was amended by Act 2000-705 in 2000. The amendment substituted "Pronouncement 106" for "pronouncements." However, the statute as originally enacted applies in this case.

ISSUES

(1) Concerning the business privilege tax refund, the issue is whether the goodwill on Rheem's balance sheet as a result of Paloma's acquisition of PACE was "by reason of a direct purchase of another corporation" within the purview of §40-14A-23(g)(3).

(2) Concerning the shares tax refund, the issue is whether Rheem can deduct the unamortized balance of the reserves created on its books as a result of Paloma's acquisition of PACE. That issue turns on whether the reserves were on Rheem's books pursuant to "pronouncements of the Financial Accounting Standards Board or any successor authority" within the purview of §40-14A-33(b)(4).

(3) Regardless of the outcome of Issues (1) and (2), should the goodwill pushed down to Rheem's books be included in Rheem's net worth and taxable shares base for business privilege and shares tax purposes, respectively?

Issue (1). The business privilege tax issue.

Alabama's business privilege tax is levied on a taxpayer's net worth in Alabama. Code of Ala. 1975, §40-14A-22(a). "Net worth" is defined generally at §40-14A-23. As indicated, §40-14A-23(g)(3) provides for a subtraction from net worth for the "unamortized portion of goodwill and core deposit intangibles appearing on the taxpayer's balance sheet by reason of a direct purchase of another corporation . . ."

Rheem argues that §40-14A-23(g)(3) does not require that the "direct purchase" must be by the taxpayer on whose balance sheet the goodwill appears. Rather, according to Rheem, "all the statute requires is that the goodwill must 'appear . . . on the taxpayer's balance sheet by reason of a direct purchase of another corporation.' Here, the goodwill appeared on taxpayer's balance sheet by reason of the direct purchase of PACE by

Paloma, and taxpayer is entitled to the deduction." Rheem's Brief at 11.

In support of its case, Rheem points out that the Alabama Legislature attempted to amend §40-14A-23(g)(3) pursuant to Act 2003-102 in 2003 by adding the phrase "by the taxpayer" after "direct purchase."[3] Rheem argues that by adding the phrase "by the taxpayer," the Legislature intended to change the law because if it had only intended to clarify existing law, the Legislature could and would have so stated. Consequently, because the phrase "by the taxpayer" would have been a change in the law, Rheem argues that the phrase "direct purchase," as originally enacted, must be construed to mean a direct purchase of another corporation by any corporation, not just the taxpayer corporation.

The Department counters that §40-14A-23(g)(3) requires that the direct purchase must be by the taxpayer corporation on whose books the goodwill appears. "Also, the use of the word 'direct' in §23(g)(3) shows that the goodwill must be attributable to a purchase *by the taxpayer*. If, as contended by Rheem, the purchase could be by an entity other than the taxpayer, then the legislature would not have needed to use the word 'direct.' That is so, because every purchase (under Rheem's interpretation) would qualify as a 'direct purchase.'" Department's Brief at 8.

I agree that the Legislature must have included the word "direct" for a purpose. Every word in a statute must be given a meaning, if possible. *Custer v. Homeside Lending, Inc.*, 858 So.2d 233 (Ala. 2003). If Rheem's position is correct, then the word "direct" in the

[3] The provisions of Act 2003-102 were dependent on the passage of Amendment 1 on September 9, 2003. That constitutional amendment failed to pass by a vote of the people. Consequently, Act 2003-102 never took effect.

statute would have no meaning. Consequently, the phrase "direct purchase of another corporation" must be interpreted as a purchase of another corporation by the taxpayer corporation on whose books the goodwill appears. The goodwill that was pushed down to Rheem's books was created by the purchase of PACE by Paloma, not by a purchase, direct or otherwise, by Rheem of another corporation. Rheem thus is not entitled to the deduction provided in §40-14A-23(g)(3). The above conclusion is supported by the rule of construction that a deduction from tax must be strictly construed against the deduction and for the Department. *Ex parte Kimberly-Clark Corp.*, 503 So.2d 304 (Ala. 1987).[4]

Issue (2). The shares tax issue.

Alabama's shares tax is levied on a taxpayer's "taxable shares base," which is defined generally at Code of Ala. 1975, §40-14A-33(a). As discussed, for the 2000 tax year, §40-14A-33(b)(4) allowed a deduction from the taxable shares base for "the unamortized balance of any amount that the taxpayer properly elected pursuant to pronouncements of the Financial Accounting Standards Board or any successor authority to amortize over a period of years rather than immediately charging that amount to earnings."

Rheem subtracted $106,158,556 pursuant to §40-14A-33(b)(4) in calculating its 2000 shares tax liability. Of that amount, the Department allowed $21,035,656, which was recorded on Rheem's books pursuant to Pronouncement 106 of the Financial Accounting

[4] The Legislature's attempt in 2003 to add the phrase "by the taxpayer" could be construed as supporting Rheem's position. But the language the Legislature actually used in the statute must control, not what the Legislature may have intended with a proposed, but failed, amendment. Also, the Legislature may still have intended that the phrase "by the taxpayer" was for clarification only, even if it did not so specify in Act 2003-102.

Standard Board ("FASB"). The Department disallowed the balance of $85,122,900 because that amount was not recorded pursuant to a FASB pronouncement, but rather pursuant to Opinion 16 of the Accounting Principles Board ("APB"), and specifically paragraphs 88(h) and (i) of Opinion 16.

This issue turns on whether Opinion 16 issued by the APB constituted a pronouncement of FASB. If not, the Department correctly refused to allow Rheem to subtract the $85,122,900 from its shares tax base.

The APB issued Opinion 16 in the late 1960's. At the time, the APB was the recognized governing authority concerning generally accepted accounting principles ("GAAP"). FASB was established in 1973 and succeeded the APB as the governing authority on accounting standards. FASB subsequently issued several pronouncements that amended or related to APB Opinion 16. FASB issued Pronouncement 141 in 2001, which superseded APB Opinion 16.

Dr. Wayne Aldeman, a distinguished professor of Accounting at Auburn University, testified that in his opinion, APB Opinion 16 was a pronouncement of FASB. With due respect to the Professor, I must disagree.

Opinion 16 was issued by the APB before FASB was ever established. Consequently, APB Opinion 16 when originally issued was not a pronouncement of FASB. The APB Opinions remained in effect after FASB superseded the APB in 1973, with FASB taking editorial control over the Opinions. Dr. Alderman stated in his Report, Taxpayer Ex. 17, that "[t]he FASB, the AICPA, the accounting profession, and the Securities and Exchange Commission all view APBs and ARBs as in force and authoritative." Dr. Alderman further stated that "the FASB, the AICPA, and the SEC clearly have endorsed

and enforced (APBs). . .” The fact remains, however, that while APB Opinion 16 remained in force and effect as an accounting guideline under the auspices of FASB, it was never a pronouncement of FASB, as required for the §40-14A-33(b)(4) deduction to apply.

FASB pronouncements are issued by FASB’s seven member board. After due deliberations, the board votes on all proposed pronouncements. A majority of four votes is required to adopt a pronouncement. It is undisputed that FASB’s seven member board never voted to adopt or enact APB Opinion 16 as a formal pronouncement. The plain language of §40-14A-33(b)(4) required that a taxpayer must have made an election pursuant to a pronouncement of FASB or a successor authority. An Opinion of a predecessor authority, the APB, was not mentioned. Strictly construing the plain language of the deduction against Rheem, as required by Alabama law, Rheem is not entitled to the deduction in this case.

Issue (3). Should the goodwill pushed-down to Rheem’s books be included in Rheem’s tax base for business privilege tax and shares tax purposes?

Rheem argues that regardless of how Issues (1) and (2) are decided, its net worth and taxable shares base should not have increased as a result of the goodwill pushed-down to its books because, in substance, its business and its assets were exactly the same after the acquisition as before. Rheem cites as support the Administrative Law Division’s decision in a franchise tax case, *Rheem Manufacturing Co. v. State of Alabama*, F. 00-132A, F. 00-174A, and F. 00-175A (Admin. Law Div. Opinion and Preliminary Order 3/1/05).

In the *Rheem* franchise tax case, the Administrative Law Division held that the goodwill pushed down to Rheem as a result of the Paloma acquisition of PACE should not

be included in Rheem's capital base for franchise tax purposes because in substance Rheem did not receive additional capital from the transaction. That holding was based on the fact that for franchise tax purposes, Alabama law required a foreign corporation's capital to be determined in accordance with GAAP. GAAP did not require that the goodwill resulting from the Paloma/PACE transaction must be pushed down to Rheem. Further, "for accounting purposes, the substance of a transaction, rather than its form, should govern. AICPA Professional Standards §411.06." *Rheem Manufacturing*, at 9.

The holding in the *Rheem* franchise tax case does not apply in this case. As indicated, a foreign corporation's capital base for franchise tax purposes was governed by GAAP. For business privilege and shares tax purposes, however, Code of Ala. 1975, §40-14A-2(a) requires that a "taxpayer's net worth shall be determined for purposes of the (business privilege and shares) taxes levied by this chapter in accordance with the accounting principles used in preparing the taxpayer's financial statements . . ." The push-down accounting principle was employed to pushdown the goodwill in issue onto Rheem's financial statements. Consequently, because Rheem elected to push-down the goodwill to its books, §40-14A-2(a) requires that its tax base for business privilege and shares tax purposes must include that goodwill.

In the *Rheem* franchise tax case, the Department argued that Opinion 20 of the Accounting Principles Board required Rheem to use push-down accounting for franchise tax purposes because it had used push-down accounting in preparing its financial statements. The Administrative Law Division rejected that argument based on the difference between preparing financial statements and complying with the statutory requirements for determining capital for franchise tax purposes.

> The Department also argues that under Opinion No. 20 ("Accounting Changes") of the Accounting Principles Board ("APB 20"), Rheem must use push-down accounting in determining its §40-14-41(b) capital because Rheem uses push-down accounting in preparing its financial statements. The Department is correct that APB 20 does apply to the preparation of *financial statements* used for *financial reporting* purposes. APB 20, ¶3. However, application of APB 20 would be inappropriate in determining a taxpayer's §40-14-41(b) capital because (1) it ignores the distinction between preparing financial statements for financial reporting purposes and complying with the statutory requirements for determining capital,. . .

Rheem Manufacturing, at 11, 12.

As indicated, however, for business privilege and shares tax purposes there is no distinction between a taxpayer's financial statements and its tax base. Section 40-14A-2(a) specifies that the tax base shall be determined by the accounting principles used by a taxpayer in compiling its financial statements. A taxpayer's tax base for business privilege and shares tax purposes is thus controlled by how it reports items on its financial statements. Consequently, the goodwill pushed down to Rheem's financial statements must be included in its statutory tax base for business privilege and shares tax purposes.

The Department's partial disallowance of the business privilege and shares tax refund claimed by Rheem is affirmed.

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

Entered June 14, 2005.

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BILL THOMPSON
Chief Administrative Law Judge