SOUTHERN COMPANY SERVICES, INC. BIN 10139 241 Ralph McGill Blvd., NE Atlanta, GA 30308-3328,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. CORP. 03-355
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Southern Company Services, Inc. ("Taxpayer") for corporate income tax for 1990, 1991, 1992, 1993, and 1998. 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 March 4, 2004. Will Sellers represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

ISSUES

The primary issue is whether the Taxpayer was required to use the same accounting method for Alabama income tax reporting purposes during the subject years that it used for federal income tax purposes. If so, a second issue is whether the Department is barred by the doctrine of laches from assessing the Taxpayer for the subject years. If the Taxpayer is required to change accounting methods, a third issue is whether it should be allowed adjustments in the year of change to prevent the double counting and/or omission of items of income and expense. Finally, if the final assessments are affirmed, a fourth issue is whether all or a part of the accrued interest should be abated because of undue delay by the Department.

FACTS

The Taxpayer was incorporated in 1949 as a mutual service company regulated by the Public Utilities Holding Company Act. The Taxpayer provides various tax accounting, engineering, information, and other incidental services to the various subsidiaries of its parent corporation, The Southern Company. The Taxpayer is required to provide the services at cost, and cannot make a profit from the services provided to its affiliated group.

From 1949 through 1998, the Taxpayer filed its Alabama corporate income tax returns using the book method of accounting. The Taxpayer explained its reporting method in an attachment to its notice of appeal, as follows:

> SCS was incorporated under the laws of the state of Alabama and has filed state of Alabama domestic returns since its inception. The company has determined and reported its Alabama taxable income consistent with the method used to determine book income. Using this method, the company had no taxable income for the years 1949 – 1977.
>
> Effective 1978, the state of Alabama corporate income tax form was changed so that federal taxable income became the starting point for determining Alabama taxable income. To comply with this requirement, while at the same time continuing to use the overall method of accounting it had used for almost 30 years, SCS reflected its taxable income for Alabama purposes as federal taxable income and included adjustments to reverse federal Schedule M-1 items. Permanent items – those which will never be deductible from or included in taxable income – are identified and included in or excluded from Alabama taxable income as appropriate. This methodology results in Alabama taxable income being equal to book income ($0) plus or minus these permanent items. A statement explaining the company's method of determining its Alabama taxable income was included in each return filed.

The Department accepted the Taxpayer's method of reporting before 1990. The Department audited the Taxpayer's 1990 through 1993 returns and recomputed the Taxpayer's liabilities for those years using the same tax accounting method employed by the Taxpayer for federal income tax purposes. The Department entered a preliminary

assessment for 1990 through 1993 on September 15, 1995. The Taxpayer timely petitioned for a review of the preliminary assessment on October 12, 1995.

The Department took no action on the petition until it conducted a conference on February 9, 2001. The Department took no action after the conference until it entered the 1990 through 1993 final assessment in issue on April 25, 2003. The Taxpayer timely appealed.[1]

While the audit for 1990 through 1993 was pending, the Department also audited the Taxpayer's 1994 through 1996 returns. The Department auditors discussed the Taxpayer's book method of accounting used on the returns with the Taxpayer during that audit. The Department subsequently notified the Taxpayer in November 1998 that its 1994 through 1996 returns were accepted as filed.

The Department did not assess the Taxpayer for 1997 tax. However, it entered a final assessment of 1998 tax against the Taxpayer on October 7, 2003. That assessment is based on the same accounting adjustments made by the Department to the Taxpayer's 1990 through 1993 returns. The Taxpayer also timely appealed the 1998 final assessment, which was consolidated with the pending appeal concerning 1990 through 1993.

Issue (1). The correct accounting method.

The Department argues that the Taxpayer was required by Code of Ala. 1975, §40-18-13(a) to file its Alabama returns for the subject years using the same accounting

[1] The Department concedes that the 1990 liability should be voided because it was not timely assessed as required by Code of Ala. 1975, §40-2A-7(b)(2).

method it used for federal income tax purposes. Section 40-18-13(a) provides in pertinent part as follows:

> Income shall be computed . . . in accordance with the same method of accounting that the taxpayer properly employs for federal income tax purposes. If no such method of accounting has been employed or if the method so employed does not clearly reflect income, computation shall be made upon such basis and in such manner as in the opinion of the Department of Revenue, and consistent with federal income tax treatment, does clearly reflect income.

The Taxpayer contends that the book method of accounting it used during the subject years accurately reflected its income because it is prohibited by federal law from making a profit. "In an effort to clearly reflect its income, the Taxpayer included additions and deductions on its state return to adjust federal taxable income to its actual (book) income of zero ($0) (R. 48-49)." Taxpayer's Brief at 2.

The Taxpayer was required by §40-18-13(a) to compute and report its Alabama income during the subject years using the same tax accounting method it used for federal tax purposes.[2] While the Taxpayer may have been prohibited from making a net profit, it could still realize and recognize taxable income in a given year for federal and Alabama income tax purposes. The Taxpayer's tax manager acknowledged that book accounting and tax accounting are applied for different purposes. (T. at 64.) There is also no

[2] Before 1990, §40-18-13 only required that "net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer, . . ." Section 40-18-13 was amended by Act 90-583 in 1990 to require that income shall be computed for Alabama purposes by the same accounting method used for federal income tax purposes. Consequently, the Taxpayer was not required to use its federal tax accounting method for Alabama reporting purposes until 1990, which perhaps explains why the Department had accepted the Taxpayer's book method returns without question before 1990.

evidence that requiring the Taxpayer to report its Alabama income using its federal tax accounting method does not clearly reflect the Taxpayer's Alabama taxable income during the subject years for income tax purposes.

Issue (2). Laches.

The Taxpayer argues that the Department should be estopped from assessing it for the subject years based on the doctrine of laches. The Taxpayer asserts that the Department's seven year delay in assessing it for 1990 through 1993 was inexcusable, and that requiring it to change its accounting method in those years would cause it undue prejudice.

The Department failed to adequately explain or justify the seven year delay in assessing the Taxpayer for 1990 through 1993. The delay also complicates the matter because the Department subsequently accepted the Taxpayer's book method of accounting for 1994 through 1996, and those years are now closed. Consequently, the Taxpayer will be required to use its federal tax accounting method for 1990 through 1993, change back to the book method for 1994 through 1996, and then back to federal tax accounting for 1998 (and presumably subsequent years).

It is unclear, however, whether the Taxpayer or the State would be prejudiced by the change in methods, as explained in the following exchange between the Department's attorney and the Taxpayer's tax manager at the March 4 hearing:

> Q. So just because tax accounting creates, if you want to call it that, income for tax purposes, whereas book accounting may not create that same income or may zero it out, does not automatically make the tax accounting incorrect, does it, for tax purposes.
>
> A. Not as long as you pick up all of the timing differences. You can't in these years say we're going to follow federal and pick up these timing

> differences between book and tax that result in income without taking into account amounts that were expenses in prior years. You can't just chop off the old method and apply the new method, without penalizing the taxpayer or, you know, you could penalize the state.
>
> You don't know what you're lopping off by not going through and doing a very detailed calculation to determine what the adjustment needs to be in order to implement the change in accounting method for state reporting purposes.
>
> Q. Well, that's a good point. Now, that, as you said, shows that this issue for other years, these timing differences, as I believe you call them, could cut both ways, couldn't they?
>
> A. They could, yes.
>
> Q. So the State could be penalized in some other years by Judge Thompson upholding the Department's position in this case; isn't that right?
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> A. It's doubtful that that would be the case.
>
> Q. But it is possible, though?
>
> A. Oh, it's – without having looked at every one of the returns for the prior years, I would not be able to answer that question. It's possible that that could be the case for one or more years.

T. at 65 – 67.

Even if the Department's delay prejudiced the Taxpayer, the Alabama Court of Civil Appeals has held that laches does not apply against the State in the performance of its official duties. "[B]y the decided weight of authority, the defense of laches is not available against the State in a suit by it to enforce [a] public right and interest." *State, Department of Revenue v. Clay J. Calhoun*, 2000 Ala. Civ. App. LEXIS 369, citing *Sisk v. State ex rel. Smith*, 31 So.2d 84, 85 (1947). Consequently, the Department is not barred by laches from requiring the Taxpayer to use its federal tax accounting method to compute its Alabama liabilities for the subject years.

Issue (3). Should there be a one-time adjustment, and if so, when.

As explained above, if the Taxpayer is required to change accounting methods, certain transitional adjustments would be required to properly implement the change. The Department apparently does not disagree. Dept. Reg. 810-3-13-.04 also provides that "any increase or decrease in income resulting from a change in accounting method must be taken into account in full in the year of change." The Taxpayer's tax manager explained the necessary changes at the March 4, hearing:

> Q. If they've been filing under the book method – and they have, obviously, for a number of years. Up until 1990, they continued to. But if the Department says, and which it has, in '91 – I'm sorry – because '90 is out of statute – that you should change your accounting method beginning this year, would there be any adjustments that had to be made in that first year? I think, Ms. Marsh, you said there probably should be.
>
> A. Yes.
>
> Q. And I don't know what those are. What would those be?
>
> A. Well, the determination of that amount would not be simple. To determine what the adjustments should be, I believe that you would actually have to go behind the big adjustment amounts to the individual income and/or expense accounts that made up those adjustments and recompute what the income or expense would have been for all prior years based on your new method rather than based on the old method.
>
> And the difference between your cumulative income and expense based on the new method that you want to use and what we actually used, that difference would be an adjustment, plus or minus.
>
> Q. In that first year of change?
>
> A. Yes. Yes.
>
> Q. You wouldn't have to do that for every subsequent year, would you?
>
> A. No, no. It would just be for the year of change.

Only the Taxpayer has the information needed to make the required adjustments for 1991, the first open year the Taxpayer's accounting method should be changed. The Taxpayer is directed to make the appropriate adjustments in that year. It should submit the adjustments and an explanation of the adjustments to the Administrative Law Division in due course. The Department will be allowed to respond. Appropriate action will then be taken.[3]

Issue (4). The abatement of interest.

The Department's Taxpayer Advocate is authorized to abate interest that has accrued because of undue delay by the Department. Code of Ala. 1975, §40-2A-4(b)(1)c. The Department unduly delayed for seven years before entering the 1990 through 1993 final assessment in issue.[4] The interest abatement provision in §40-2A-4(b)(1)c. clearly should be applied in this case. Consequently, the matter has been submitted to the Department's Taxpayer Advocate for review. The Taxpayer Advocate's findings will be

[3] Given the Department's unexplained seven year delay in entering the 1990 through 1993 final assessment in issue, and also the fact that the Department accepted the Taxpayer's book accounting method returns for 1994 through 1996, a reasonable and fair solution would have been to require the Taxpayer to change its accounting method prospectively only, or at least beginning with the 1998 tax year. However, the duty of the Administrative Law Division is only to determine if the Department has complied with Alabama law. The Department timely assessed the Taxpayer for 1991, 1992, 1993, and 1998. That is, a preliminary assessment was timely entered for those years, see Code of Ala. 1975, §40-2A-7(b)(2). The Department also correctly required the Taxpayer to use its federal tax accounting method in those years pursuant to §40-18-13(a). Consequently, the Department was within its authority in assessing the Taxpayer. The only question is what one-time adjustments are required because of the change in methods.

[4] While the Department is required by §40-2A-7(b)(2) to enter a preliminary assessment within a certain time, there is no statutory time limit within which a final assessment must thereafter be entered.

incorporated in the Final Order subsequently entered in the case.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered August 12, 2004.

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BILL THOMPSON
Chief Administrative Law Judge