C&D CHEMICAL PRODUCTS, INC. § STATE OF ALABAMA
469 N. Harrison Road DEPARTMENT OF REVENUE
Princeton, NJ 08540-3510, § ADMINISTRATIVE LAW DIVISION

Taxpayer, § DOCKET NO. CORP. 00-288

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed 1993, 1994, and 1995 corporate income tax against C&D Chemical Products, Inc. ("Taxpayer"). 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 August 17, 2000. Chris Grissom and Bruce Ely represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

ISSUES

The issues in this case are:

(1) Should the Taxpayer be allowed to deduct for corporate income tax purposes the Alabama foreign franchise tax it paid in the subject years;

(2) Did the Department correctly eliminate the payroll factors from the Taxpayer's Alabama returns for the subject years; and if so, should the Taxpayer be allowed to employ an alternative factor;

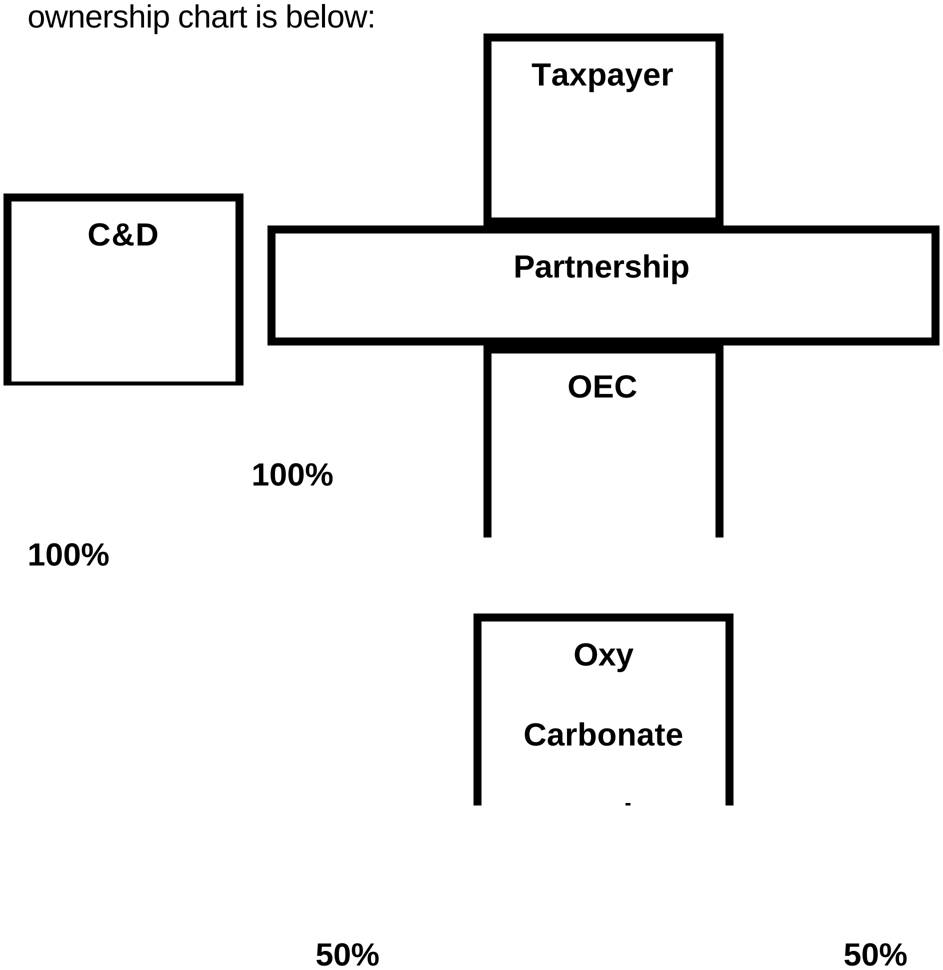
(3) Should the Taxpayer be allowed to reduce the numerator of its Alabama sales factors in the subject years by deleting sales reported in four states in which the Taxpayer filed combined returns with its parent corporation; and,

(4) Should part of the interest that accrued during the audit period be abated because of undue delay by Department personnel?

FACTS

Church and Dwight Company, Inc. ("C&D") and Occidental Electrochemicals Corporation ("OEC") entered into a Partnership Agreement on October 1, 1986. The Agreement provided that subsidiaries of C&D and OEC would each own a 50 percent interest in a general partnership, Armand Products Company ("Partnership"). The Partnership would manufacture potassium carbonate at OEC's manufacturing facility in Muscle Shoals, Alabama, and then sell the product worldwide.

C&D incorporated the Taxpayer for the sole purpose of holding its 50 percent interest in the Partnership. Oxy Carbonate, Inc., a wholly owned subsidiary of OEC, owns the remaining 50 percent of the Partnership. The Partnership's ownership chart is below:



C&D and OEC entered into service agreements with the Partnership on October 1, 1986. Pursuant to its service agreement, OEC provides approximately 25 OEC employees that operate the Partnership's manufacturing facility in Alabama. Those employees reside and work full-time for the Partnership in Alabama. Other OEC employees also provide the Partnership with various legal, data processing, and marketing services outside of Alabama.

Pursuant to its service agreement, C&D provides approximately 25 employees that perform various marketing, accounting, sales, and other services for the Partnership. Those C&D employees are located in New Jersey. Most are "shared" employees that perform services for both the Partnership and C&D.

The Partnership is managed by a management committee comprised of two C&D employees and two OEC employees. A general manager appointed by C&D manages the Partnership's activities, including the C&D and OEC employees when they perform services for the Partnership.

The Partnership is required to pay C&D and OEC an administrative fee based on their fully allocated costs incurred in providing services to the Partnership, including employee compensation. C&D and OEC budget an annual amount in advance for their expected costs in providing services to the Partnership. The Partnership pays one-twelfth of that amount monthly to C&D and OEC via wire transfer.

As indicated, the Taxpayer's sole function is to hold C&D's ownership interest in the Partnership. The Taxpayer has no employees, owns no property, and does not conduct business other than through the Partnership.

The Taxpayer filed Alabama corporate income tax returns for the subject years and apportioned its income to Alabama using the property, payroll, and sales factors in the Multistate Tax Compact ("MTC"), Code of Ala. 1975, §40-27-1, et seq. The Taxpayer used the Partnership's factor data on the returns. It computed the payroll factors based on the annual amounts the Partnership paid for the services provided by the C&D and OEC employees. The numerator (Alabama payroll) was the compensation paid for the OEC employees in Alabama. The denominator (everywhere payroll) was the total employee compensation paid to both C&D and OEC.[1]

The Taxpayer also deducted franchise tax on the 1994 and 1995 returns.

The Department audited the Taxpayer, eliminated the payroll factor from the returns, and also disallowed the franchise tax deductions. The Department entered a preliminary assessment for the additional tax due on December 8, 1997. The Taxpayer filed a petition for review on February 28, 1998. The petition included a request for the use of an alternative apportionment factor. The Department reviewed the petition, and notified the Taxpayer on February 7, 2000 that it had not

[1]C&D estimated that 25 percent of its administrative fee received from the Partnership was attributable to the cost of its shared employees that performed services for the Partnership. The Department did not dispute that amount, and otherwise did not challenge the payroll factor numbers reported on the Taxpayer's returns.

changed its position. The Department entered the final assessment in issue on April 3, 2000. The Taxpayer appealed.

ANALYSIS

Issue (1). The franchise tax deduction.

This issue is no longer disputed. The parties agree that the Alabama franchise tax paid by the Taxpayer in 1994 and 1995 should be allowed. The Taxpayer paid 1994 franchise tax of $30,065, and 1995 franchise tax of $1,830. Department's Brief, at 2. The Taxpayer has not contested those amounts.

Issue (2). The payroll factor.

The Taxpayer's only business activity is its 50 percent interest in the Partnership. Dept. Reg. 810-27-1-4-.09 provides that if a corporation has a business interest in a partnership, the corporation's apportionment formula shall include its pro rata share of the partnership's factor data. The Department agrees that the Taxpayer properly included the Partnership's property and sales data in its apportionment formulas. The Department argues, however, that the Taxpayer should not be allowed a payroll factor because the Partnership did not have employees, and thus did not have a payroll within the scope of Reg. 810-27-1-4-.13.

Relating to the payroll factor, Reg. 810-27-1-4-.13(a)(3) provides that the "term 'compensation' means wages, salaries, (etc.) paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded. Only amounts paid directly to employees are included in the payroll factor." Reg. 810-27-1-4-.13(a)(4) defines "employee" in part as "any individual who, under the usual common law rules applicable in determining the employer/employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if he is included by the taxpayer as an employee for purposes of the payroll taxes . . ."

I agree that the C&D and OEC employees that performed services for the Partnership were not employees of the Partnership within the scope of the Department's regulation. But a regulation must comply with the statute to which it relates, and cannot enlarge or add to the language of the statute. *Ex parte Uniroyal Tire Co.*, 2000 WL 1074041 (Ala. 2000). The ultimate question thus is whether the Department's regulation is consistent with the language and purpose of the statute it interprets.

Alabama law defines the "payroll factor" as "a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the tax period." Section 40-27-1, Art. IV, ¶13. That statute does not require that the compensation must be paid to an employee. Further, "compensation" is defined as "something given or received as payment or reparation, as for a service . . ." *American Heritage Dictionary*, 2nd College Edition, at 301. That definition also does not require that compensation must be something paid to an employee. Consequently, the amounts paid by the Partnership for the services provided by the C&D and OEC employees constituted "compensation paid" within the scope of the statute, and should be included in the payroll factor. The regulations are rejected to the extent they conflict with that finding.[2]

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[2]Alabama's apportionment regulations are modeled after the MTC regulations. The Administrative Law Division conducted extensive research, including a review of

UDITPA, *Report of Special Subcommittee on State Taxation*, H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964) (the Willis Committee Report), and the MTC website, but was unable to find a stated reason why the payroll factor should be limited to only compensation paid to an employee.

The above result was also reached in *Cincinnati, New Orleans and Texas Pacific Railway Co. v. Kentucky Dept. of Revenue*, 684 S.W.2d 303 (Ky. App. 1984). In that case, a parent corporation's employees performed services for a subsidiary. The subsidiary reimbursed the parent for the cost of the employees' services. The Kentucky Court of Appeals held that the subsidiary should include the indirect compensation in its payroll factor.

> The purpose of (Kentucky's apportionment statute) is to adopt a formula to determine the business income attributable to activity in Kentucky. To include the compensation of the employees in the formula of the (subsidiary) for whom service was performed would promote this purpose.

Cincinnati, New Orleans, 684 S.W.2d at 305.

A statute must also be construed to satisfy its intent and purpose. *Gulf Coast Media, Inc. v. The Mobile Press Register, Inc.*, 470 So.2d 1211 (1985). The purpose of factor apportionment is to fairly divide the income of a multistate corporation between the various states in which it does business. "Formula apportionment is a device for dividing the income of a corporation among States through determining the proportionate location of certain income-producing activities." *Report of Special Subcommittee on State Taxation*, infra, Vol. 1 at 194. A fair apportionment formula insures that a state taxes only that part of "a corporation's income that is 'reasonably related to the (corporation's) activities conducted in the taxing state.'" *Exxon Corp. v. Wisconsin Dept. of Revenue*, 100 S.Ct. 2109, 2120 (1980), citing *Moorman Mfg. Co. v. Bair*, 98 S.Ct. 2340, 2341

(1978). Payroll is included in the formula because the activities of a corporation's employees directly contribute to the production of apportionable business income.

Substance over form must govern in tax matters.[3] *EZY Rental, Inc. v. Dept. of Revenue*, F. 96-401 (Admin. Law Div. 5/8/97); *Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala.Civ.App. 1994); *Boswell v. Paramount Television Sales, Inc.*, 282 So.2d 892 (Ala. 1973). For apportionment purposes, there is no substantive difference between an employee of a corporation and a non-employee that performs the same services as an employee. Both contribute to the production of income. Consequently, including the C&D and OEC employees in the Partnership's payroll data is necessary to accurately determine what part of the Partnership's income was attributable to Alabama.[4]

Limiting the payroll factor to only compensation paid directly to employees also allows a corporation to manipulate the factor. For example, the Partnership

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[3]The Department argues that the Alabama Supreme Court negated the substance over form doctrine in Alabama by its holding in *Ex parte Sonat*, 752 So.2d 1211 (Ala. 1999). I disagree. In *Sonat*, the substance of the transaction was that a Sonat subsidiary conducted business in Alabama and paid Alabama income tax of $87 in 1988. The subsidiary also paid Sonat a dividend of $185,000,000 in 1988. The Supreme Court ruled that Sonat was entitled to deduct the $185,000,000 pursuant to Alabama's dividends received deduction because the statute had been technically complied with. The Court did not reject the substance over form doctrine. What it did do was disregard the fact that there was no business purpose for the transaction other than tax avoidance.

[4]The Department's property factor regulation requires that rented property must be included in the factor. See, Reg. 810-27-1-4-.10(d). Independent contractors and shared employees that perform services for a corporation are in substance rented employees of the corporation, and by analogy should be included in the payroll factor.

could hire several employees outside of Alabama in lieu of using several C&D shared employees. The Partnership would then have a payroll, and unquestionably the Taxpayer would be allowed an Alabama payroll factor. But because the OEC employees that operate the Partnership's Alabama facility would not be recognized, the Taxpayer would have a zero Alabama payroll numerator, and thereby reduce its Alabama liability. Such manipulation would be prevented if states required corporations to include in the payroll factor all compensation paid to employees, independent contractors, shared employees, etc. that contribute to the production of business income.

The Department argues that C&D and OEC "very likely" included in their payroll factors in other states the full compensation paid to their employees that performed services for the Partnership. Department's Reply Brief, at 4, 5. The Department thus contends that allowing the Taxpayer to also include the employees in its Alabama payroll factor would result in a double counting of the data.

The Department is correct, assuming that C&D and OEC did not adjust their factors to account for the employee-related reimbursement they received from the Partnership.[5] But the accuracy of C&D's and OEC's apportionment factors in other states is not in issue. What is in issue is the accuracy of the Taxpayer's Alabama

[5]Alabama's payroll factor, and presumably the payroll factor in all other states that use such a factor, includes only compensation paid for the production of apportionable business income. Dept. Reg. 810-27-1-4-.13(a)(2). C&D and OEC thus should not have included in their payroll factors the compensation paid to their employees that worked full time for the Partnership. C&D also should have prorated the compensation paid to its shared employees to the extent they performed services for the Partnership. Whether they did so is not known.

apportionment formula, which requires that the compensation in issue be included in the payroll factor.

The U. S. Supreme Court has recognized that an overlapping of factor data is an inevitable result given the variety of apportionment formulas and other division of income rules followed by the various states. "For some risk of duplicative taxation exists whenever the States in which a corporation does business do not follow identical rules for the division of income." *Moorman Mfg.*, 98 S.Ct. at 2347. The Court thus held that a system used by a particular state (Iowa's single factor sales formula in *Moorman*) is not per se invalid because it differs from or overlaps with formulas used by other states. Consequently, including the C&D and OEC employees in the Taxpayer's Alabama payroll factor is not prohibited by the fact that C&D and OEC may also have included the employees in their payroll factors in other states.

Even if the payroll factor regulations are followed, and the Taxpayer's payroll factor is eliminated, the Taxpayer would be entitled to relief under §40-27-1, Art. IV, ¶18. That statute provides that if the MTC apportionment provisions "do not fairly represent the extent of the taxpayer's business activity" in Alabama, the taxpayer may use an alternative factor, or any other method that fairly apportions its income to Alabama. Section 40-27-1, Art. IV, ¶18(c) and (d).

Use of only the property and sales factors would not fairly reflect the Partnership's activities in Alabama because the income producing activities of the C&D and OEC employees would be ignored. Consequently, the Partnership should be allowed an alternative factor pursuant to ¶18 based on the compensation paid by the Partnership for those employees. The net effect would be an alternative factor that is identical to the payroll factor rejected by the Department. But only through use of an alternative "compensation" factor would the Partnership's income producing activities in Alabama be fairly reflected.

Finally, the Taxpayer argues that eliminating the payroll factor, and not allowing an alternative factor, would unconstitutionally distort its income apportioned to Alabama.

The U.S. Supreme Court has rejected as unconstitutional an apportionment formula that attributes income to the taxing state "out of all appropriate proportion to the business transacted" in the state. *Hans Rees' Sons v. State of North Carolina ex rel. Maxwell*, 51 S.Ct. 385, 389 (1931). The distortion in *Hans Rees'* was 250 percent.

The Court has, however, also recognized that apportionment formulas are inherently imperfect. *Container Corp. of America v. Franchise Tax Bd.*, 103 S.Ct. 2933, 2950 (1983). The Court thus affirmed a formula in *Container* that resulted in a 17 percent distortion, which was "within the substantial margin of error inherent in any method of attributing income . . . of a unitary business." *Container*, 103 S.Ct. at 2950.

The Taxpayer argues that if the payroll factor is eliminated, and no alternative factor is allowed, its Alabama liability will increase 40 percent in 1993, 42 percent in 1994, and 77 percent in 1995. Taxpayer's Brief, at 29. Whether that amount of "distortion" reaches an unconstitutional level is problematic, given the lack of any bright line test from the Supreme Court. But that issue need not be decided given the above finding that either a payroll factor should be allowed, or an alternative "compensation" factor should be allowed under ¶18.

Issue (3). The sales factor.

The Taxpayer reported 100 percent of the Partnership's sales in the numerator of its Alabama sales factors during the subject years. The Taxpayer now argues that the Partnership's sales in four states in which it filed combined returns with its parent should not have been included. I agree. The issue is moot, however, because although the reduced sales factors would result in overpayments in each year, any refunds are barred by the statute of limitations at Code of Ala. 1975, §40-2A-7(c)(2)a.

A taxpayer is required to request a refund within three years from when a return was filed, or two years from when the tax was paid, whichever is later. Section §40-2A-7(c)(2)a. The Department is also required to issue an automatic refund within the above statute of limitations. Code of Ala. 1975, §40-29-71.

The Taxpayer filed its 1993, 1994, and 1995 Alabama returns on September 20, 1994, September 20, 1995, and September 18, 1996, respectively. It received refunds in 1993 and 1995, and timely paid the 1994 tax due by electronic funds transfer. The statute of limitations for the last year in issue, 1995, thus expired on September 18, 1999. The Taxpayer failed to file refund petitions for any of the years in issue before that date.[6]

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[6]There is also no evidence the Taxpayer raised the sales factor issue before the August 17, 2000 hearing.

The above result is not altered by the fact that the Taxpayer timely appealed the final assessment in issue. The appeal of a final assessment does not stay the statute of limitations at §40-2A-7(c)(2)a. under which a taxpayer is required to claim a refund for the subject period. In fairness, the filing of a petition for refund for a tax period also does not stay the statute of limitations at Code of Ala. 1975, §40-2A-7(b)(2) within which the Department is required to enter a preliminary assessment for the period.

The above result also is not changed by Code of Ala. 1975, §40-2A-7(b)(5)d.1. That statute provides that on appeal, the Administrative Law Division may increase or decrease a final assessment to reflect the correct amount due. The statute does not authorize the Administrative Law Division to order a refund that is otherwise barred by the statute of limitations at §40-2A-7(c)(2)a.

Issue (4). The abatement of interest.

The Department's Taxpayer Advocate is authorized to abate interest that accrues due to undue delay by the Department. Code of Ala. 1975, §40-2A-4(b)c. This issue is moot because no additional tax is due.

The final assessment is dismissed. Any overpayment in the subject years is time-barred, and cannot be refunded. Judgment is entered accordingly.

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

Entered February 9, 2001.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

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