UNION TANK CAR COMPANY 111 West Jackson Blvd. Chicago, IL 60604-3589,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. CORP. 04-247
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Union Tank Car Company ("Taxpayer") for corporate income tax for 1994 through 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 September 9, 2004. Will Sellers represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

This case involves two issues. The threshold issue is whether the Taxpayer was "doing business in Alabama or deriving income from sources within Alabama" during the subject years, and thus subject to the Alabama income tax levied at Code of Ala. 1975, §40-18-2(3). If the Taxpayer was subject to Alabama income tax, a second issue is whether Alabama is constitutionally prohibited from taxing the Taxpayer by the Due Process and/or Commerce Clauses of the United States Constitution, Amendment 14 and Article I, §8, cl. 3, respectively.

The Taxpayer is a Delaware corporation and is headquartered in Illinois. It manufactures and then leases specialty railroad cars, i.e. tank cars, hopper cars, etc., to customers throughout the United States. It had one Alabama-based lease customer during the years in issue. The Taxpayer maintained regional sales offices and repair and service centers throughout the country during the subject years, although none were located in

Alabama.

The Taxpayer manufactured its railcars in Illinois and Texas during the years in issue. All leasing agreements were executed in Illinois. The leases were for a fixed monthly amount, which the lessees remitted to the Taxpayer in Illinois. Once a lease was executed, the lessee arranged for a railroad to pick up the railcar from the Taxpayer's manufacturing facility and then haul the railcar to a location designated by the lessee. The lessee was also responsible for returning the railcar to the Taxpayer after the lease term expired.

The Taxpayer had no control over where the leased railcars were used. It was, however, responsible for maintaining and repairing the railcars. The Taxpayer performed the repairs and maintenance at one of its repair facilities outside of Alabama, except emergency repairs may have been performed by a railroad in Alabama, in which case the Taxpayer reimbursed the railroad for the cost of the repairs.

The Taxpayer conducted no business, had no employees, and owned no property in Alabama during the subject years, except that some of its railcars were used by the lessees in interstate commerce in Alabama. The Taxpayer was liable for Alabama license tax on the railcars during the subject years pursuant to Code of Ala. 1975, §40-21-52. That section levies an annual license tax on freight line and equipment companies that own, rent, or otherwise furnish railcars being operated in Alabama. The tax is in lieu of a property tax, and is based on the miles the railcars travel in Alabama.

The Department had previously assessed the Taxpayer for Alabama franchise tax for 1983 through 1986. The Taxpayer operated substantially the same in those years as it did during the years in issue in this case. The Taxpayer appealed the franchise tax

assessment to the Administrative Law Division, which held that the Taxpayer was not doing business in Alabama, and thus was not subject to the Alabama franchise tax.

> In this case, the Taxpayer had no employees and owned no property in Alabama, maintained no manufacturing or repair facilities in Alabama, and none of the leases were executed in Alabama. The Taxpayer's only connection with Alabama was that its leased rail cars occasionally traveled through Alabama in interstate commerce while under the control of the lessees. The fact that the Taxpayer occasionally billed a lease customer at an Alabama address is inconsequential. Given the Taxpayer's minimal connection with Alabama, the Taxpayer was not "doing business" in Alabama and therefore cannot be held liable for Alabama franchise tax.

State of Alabama v. Union Tank Car Company, F. 90-154 (Admin. Law Div. 3/19/92) at 4.

The Department did not appeal the franchise tax case to circuit court.

The Taxpayer stopped filing Alabama corporate income tax returns after 1993, presumably based on the Administrative Law Division's holding in the above franchise tax case that the Taxpayer was not doing business in Alabama.

The Department audited the Taxpayer and determined that the Taxpayer was liable for Alabama income tax in 1994 through 1998 because the lessees used the Taxpayer's railcars in Alabama in those years. The Department apportioned the Taxpayer's lease income to Alabama based on the miles its railcars traveled in Alabama versus the total miles traveled everywhere. The mileage information was obtained from the railroads on which the railcars were used.

The Taxpayer argues that it was not doing business in Alabama during the years in issue. It also contends that it did not have the minimum contacts or nexus with Alabama sufficient to satisfy the Due Process and Commerce Clauses of the U.S. Constitution.

The Department contends that the Taxpayer conducted its leasing business in

Alabama and derived income from the lessees' use of its railcars in Alabama in the subject years. "It conducts its leasing business throughout the United States, including Alabama. Further, UTC derived income from its property located in Alabama." Department's Brief at 3. The Department also asserts that Alabama is not constitutionally barred from assessing the Taxpayer.

I agree that the Taxpayer was not doing business in Alabama or deriving income from sources in Alabama in the subject years. The Taxpayer was doing business and earning income in Illinois, not Alabama. Its lease contracts were executed in Illinois, the railcars were picked up and returned by the lessees in Illinois (or Texas), and the lessees made the lease payments to the Taxpayer in Illinois. The amount of the lease payments were fixed, and it was irrelevant where the railcars were thereafter used by the lessees. In short, the Taxpayer was deriving income from the lease transactions in Illinois, not from the lessees' later use of the railcars in Alabama.

This same issue was addressed by the Kentucky Court of Appeals in *Kentucky Tax Comm. v. American Refrigerator Transit Co.*, 294 S.W.2d 554 (1956). The taxpayer in that case leased railcars in Missouri. The lessees thereafter controlled the railcars, and paid a monthly rental to the taxpayer in Missouri based on the miles traveled by the railcars.[1] The

[1] This case can be distinguished from the Kentucky case because in this case, the Taxpayer's leases were for a fixed amount, regardless of the number of miles traveled. The distinction is, however, not relevant to the case.

railcars traveled a portion of their total miles in Kentucky.

The State of Kentucky argued that the taxpayer owed Kentucky income tax based on the lessees' use of its railcars in the State. The taxpayer countered that it was not doing business in Kentucky, and that the source of its leasing income was the leasing contracts executed in Missouri. The Kentucky Court agreed with the taxpayer.

> While the presence of its leased cars in the state may possibly subject them to ad valorem taxation, (cite omitted) it is not their presence here but the contract or lease, negotiated and executed in the State of Missouri, which is the *source* of the appellee's income, and neither that instrument nor its owner is located in this state. If the appellee were forced to sue any of the lessee railroads or their connecting carriers for the use of the cars, the basis of the action would be the leasing contract and the tariff regulations, and the mileage traversed by the cars in the various states would be only evidence tending to establish the amounts due under the leasing contract and would not be the basis of the action itself. For analogous reasoning, see *Commonwealth ex rel. Luckett v. Radio Corporation of America*, 299 Ky. 44, 184 S.W.2d 250, at page 252.
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> Viewing the leasing contract which was negotiated and executed in the State of Missouri, as the *source* of the income, we are forced to the conclusion that it is not subject to Kentucky income taxation . . . "

American Refrigerator, 294 S.W.2d at 555.

The Indiana Tax Court has also twice ruled that a lessee's use of leased property in Indiana does not subject the out-of-state lessor to Indiana income tax.

In *First National Leasing and Financial Corp. v. Indiana Dept. of State Revenue*, 598 N.E.2d 640 (1992), an Illinois-based company, First National Leasing, leased heavy equipment to a related company, Hulcher, that used the equipment in Indiana. The State of Indiana assessed First National for Indiana income tax based on its position that the lease payments were from sources within Indiana, i.e. the lessees' use of First National's equipment in Indiana. The Tax Court disagreed.

> First National, on the other hand, does not derive its rental income from the use of the (leased) equipment in Indiana. The same rental payments are required under the lease no matter how rarely or how frequently Hulcher uses the equipment. Nor is the rental income based on the possession of the equipment in Indiana. Indeed, the rental payments are the same regardless of the state in which Hulcher bases the equipment. Consequently, although First National owns the equipment that Hulcher leases, locates, and uses in Indiana and elsewhere, the activities related to the lease formation and execution and the activities related to the purpose of the lease, the use and possession of the equipment, are overwhelmingly in quantity and quality activities conducted by Hulcher, not by First National. The court therefore finds that First National's ownership of equipment located in Indiana is an activity that is not more than minimal, but is remote and incidental to the lease transaction from which its income is derived. Ownership alone is therefore not the degree of activity contemplated by the Indiana gross income tax statute.

First National Leasing, 598 N.E.2d at 645.

The Indiana Tax Court again addressed the issue in 2002 in *Enterprise Leasing Company of Chicago, et al. v. Indiana Dept. of State Revenue*, 779 N.E.2d 1284 (2002). In that case, various rental companies located outside of Indiana leased motor vehicles to lessees in Indiana. The issue again was whether the rental income received by the out-of-state lessors was from sources within Indiana. The Tax Court, citing its earlier decision in *First National Leasing*, again held that the lessors were not subject to Indiana income tax on the rental income:

> The sole activity by the (out-of-state lessors) in Indiana is ownership of vehicles that are located here pursuant to the lessees' direction. The critical transaction is this case is the leasing of vehicles. All the leases at issue were executed in the (lessors') out-of-state headquarters, not in Indiana. Furthermore, the leases were not negotiated in Indiana, nor were the lease payments received in Indiana. Consequently, none of the (lessors') activities related to the lease contracts themselves are conducted in Indiana.
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> The purpose of a lease is to transfer for consideration certain rights in property, generally use and possession, *Indiana Dep't of State Revenue v. Indianapolis Transit Sys., Inc.*, 171 Ind. App. 299, 356 N.E.2d 1204, 1209-10 (Ind. Ct. App. 1976). The (lessors) do not exert control over the lessees' use

> or possession of the vehicles. The decision as to where the vehicles are located and used rests with the lessees alone.
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> Finally, the (lessors) do not derive their lease income from the use of the vehicles exclusively in Indiana. Indeed, if the lessees choose to relocate their leased vehicles from Indiana to another state (or vice versa), there is no change in the rental payments or rental terms – they remain the same wherever the lessees use their vehicles.
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> In the instant case, the activities related to the lease formation and execution, as well as their activities related to the purpose of the lease (i.e., the use and possession of the vehicles) are activities performed by the (lessors') lessees. The Court, therefore, finds that the (lessors') ownership of vehicles located in Indiana is an activity that is not more than minimal, and is remote and incidental to the lease transaction from which their gross income is derived. "Ownership alone is . . . not the degree of activity contemplated by the Indiana gross income tax statute." *First Nat'l Leasing Co.*, 598 N.E.2d at 645.
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> For the reasons stated above, the Court finds that the income the (lessors) have derived from leasing vehicles to its customers, which are subsequently located, titled and registered in Indiana is not income "derived from sources within Indiana." Accordingly, the income is not subject to Indiana's gross income tax.

Enterprise Leasing, 779 N.E.2d at 1292.

I recognize, as did the Indiana Tax Court in *First National Leasing*, 598 N.E.2d at 646, that there is a split of authority on the issue. In support of its position, the Department cites *Truck Rental and Leasing Assoc., Inc. v. Comm. of Revenue*, 746 N.E.2d 143 (Mass. 2001); *Pa. v. Universal Carloading and Distributing Co., Inc.*, 372 A.2d 41 (1977); *American Refrigerator Transit Co. v. State Tax Comm.* 395 P.2d 127 (1964); *Oklahoma Tax Comm. v. American Refrigerator Transit Co.*, 349 P.2d 746 (1959); and *Comm. of Revenue v. Pacific Fruit Express Co.*, 296 S.W.2d 676 (1956). However, as noted by the Indiana Tax Court in *First National Leasing*, at 646, the two *American Refrigerator Transit* cases and the *Pacific Fruit Express* case were decided largely on constitutional grounds, not whether the

taxpayers were statutorily subject to taxation in the state. The 1977 Pennsylvania case and the 2001 Massachusetts case cited above were also decided primarily on constitutional grounds. In this case, the Department also primarily addressed the constitutional issues in its brief, after first concluding, without analysis, that the Taxpayer was doing business in Alabama and deriving income from Alabama sources. But the constitutional issues need not be addressed because, as found, the Taxpayer was not doing business in Alabama or deriving income from Alabama sources, and thus was not subject to the Alabama income tax levied at §40-18-2.

The Department's position, if accepted, would also cause practical concerns. The miles traveled in Alabama by the Taxpayer's railcars could be readily determined in this case only because the third-party railroads monitored how much the lessees used the railcars on their tracks. For most other types of lease property, however, there is no way of knowing where the property is being used. For example, if a Georgia company leased motor vehicles in Columbus, Georgia, the company would not know how many miles the lessees drove the vehicles in Alabama, or Georgia, or any other state. According to the Department, however, the Georgia company would owe Alabama tax on that part of its lease income related to the lessees' use of the vehicles in Alabama. But because it would be impossible to determine how many miles the vehicles traveled in Alabama, it would be impossible to determine the income taxable in Alabama.

Conversely, a car rental business located a few miles from the Georgia border in Phenix City, Alabama would, according to the Department, be deriving income from Alabama sources only concerning the lessees' use of the vehicles in Alabama. But again, the company would have no way of knowing how much the vehicles were used in Alabama

versus Georgia or any other state.

The Department's position is an incorrect application of the law. If a leasing business located in Alabama leases tangible property in Alabama, all of the lease proceeds derived from the leases would be subject to Alabama income tax, regardless of where the leased property was used. Likewise, an out-of-state leasing business with no other contacts with Alabama would not be liable for Alabama income tax because some of the leased property was used by the lessees in Alabama. That is the situation in this case.

The final assessment in issue is dismissed.

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

Entered January 11, 2005.

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BILL THOMPSON
Chief Administrative Law Judge