WEYERHAEUSER USA SUBSIDIARIES P.O. BOX 9777 FEDERAL WAY, WA 98063-9777,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. CORP. 04-511
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Weyerhaeuser USA and Subsidiaries ("Weyerhaeuser") for corporate income tax for the tax year beginning January 1, 1999. Weyerhaeuser appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on September 23, 2004. Nick Mullan represented Weyerhaeuser. Assistant Counsel Jeff Patterson represented the Department.

ISSUES

Two members of Weyerhaeuser's Alabama affiliated group of corporations incurred net operating losses ("NOL") from 1985 through 1998. Alabama law required all corporations to file separate Alabama returns in those years. Alabama law was amended by Act 98-502 in 1998 to allow affiliated groups of corporations to file consolidated returns beginning in 1999. The issue in this case is whether the NOLs incurred by Weyerhaeuser's two subsidiaries can be carried over to the affiliated group's consolidated 1999 Alabama return. That issue turns on the applicability of Code of Ala. 1975, §40-18-39(h), which during the year in issue read as follows:

> If, in a taxable year before the corporation became a member of an Alabama affiliated group that has elected to file an Alabama consolidated return, the corporation incurred a net operating loss, the deductibility of the loss on the Alabama consolidated return shall be limited in accordance with the separate return limitation year ("SRLY") rules contained in 26 U.S.C. § 1502.

Two sub-issues are involved. First, are the NOLs subject to the separate return limitation year ("SRLY") rules contained in 26 U.S.C. §1502? If the SRLY rules are applicable, a second issue is whether the SRLY rules prohibit the Weyerhaeuser group from claiming the NOLs in full on its consolidated 1999 Alabama return.

FACTS

The facts are undisputed.

Two members of Weyerhaeuser's Alabama affiliated group, Weyerhaeuser Distribution, Inc. and Weyerhaeuser Packaging, Inc., filed separate Alabama income tax returns from 1985 through 1998. The corporations incurred cumulative post-apportionment losses of over $301 million in those years.

The two corporations were included in the Weyerhaeuser group's consolidated 1999 Alabama return. The group claimed the NOL on the return in the amount needed to offset the group's post-apportionment Alabama taxable income of $10,676,436.

The Department audited the return and applied the SRLY rule limitation at 26 U.S.C. §1502. That is, the Department allowed the NOL only to the extent it offset the income that the two corporations reported on the return. The excess of the NOL was disallowed, which resulted in the final assessment in issue.

ANALYSIS

The Alabama Legislature amended Code of Ala. 1975, §40-18-39 by Act 98-502 in 1998 to allow for an Alabama affiliated group of corporations that files a consolidated federal income tax return to also elect to file an Alabama consolidated return. Code of Ala. 1975, §40-18-39(c)(1). The amendment was effective for all tax years beginning after

December 31, 1998.

The Act also added the above quoted §40-18-39(h) concerning the applicability of the federal SRLY rules. Subparagraph (j) of the Act provided that the Department of Revenue shall "promulgate regulations interpreting the provisions of this section that are consistent, to the maximum extent possible, with applicable Treasury regulations." Section 40-18-39(j). The Department subsequently promulgated Reg. 810-3-35.1-.03, which is entitled "Carryforward of Net Operating Losses for Corporations Filing Alabama Consolidated Returns." That regulation is discussed below.

Sub-Issue (1). Are the NOLs subject to the federal SRLY rules?

This issue involves the statutory interpretation of §40-18-39(h). The federal SRLY rules apply pursuant to §40-18-39(h) if the NOLs in issue were incurred "in a taxable year before the corporation became a member of an Alabama affiliated group that has elected to file an Alabama consolidated return, . . ."

Weyerhaeuser argues that the phrase "that has elected to file an Alabama consolidated return" refers to the current year (1999) for which the NOL is being claimed. Weyerhaeuser thus contends that because the two corporations were members of its affiliated group in the loss years, and because the group elected to file an Alabama consolidated return in 1999, the SRLY rules do not apply.

The Department asserts that the phrase "that has elected to file an Alabama consolidated return" refers to the loss year. The Department thus argues that because the losses were incurred in tax years before the Weyerhaeuser group elected to file an Alabama consolidated return, the deductibility of the losses shall be limited by the SRLY rules.

The Department argues that the statute must be given its plain, commonly understood meaning, and that the plain language of §40-18-39(h) supports its interpretation of the statute. But the phrase in issue is not "plain" on its face because reasonable minds can, and do, disagree as to whether "has elected to file an Alabama consolidated return" refers to the return on which the NOL carryover is claimed or the year in which the NOL was incurred.

The controlling rule of statutory construction is that the intent of the legislature should control. *Gholston v. State*, 620 So.2d 719 (Ala. 1993). The intent of §40-18-39(h) was to apply the federal SRLY rules in Alabama. As discussed below, those rules limit the amount of an NOL carryover that an affiliated group can claim on a consolidated return if the NOL was incurred by a group member in a year before the member joined the group, i.e. "before the corporation became a member of an Alabama affiliated group." It is irrelevant under the SRLY rules whether the affiliated group elected to file a consolidated return in the year in which the then unaffiliated corporation incurred the loss. Consequently, the more reasonable interpretation is that the phrase "that has elected to file an Alabama consolidated return" refers to the current tax year in which the NOL is being claimed. Applying that interpretation, the SRLY rules would not apply in this case because, as indicated, the two corporations that incurred the losses were members of Weyerhaeuser's affiliated group in the loss years.

The above interpretation is supported by the language of the statute. The statute limits the "deductibility of the loss on the Alabama consolidated return." Consequently, the prior phrase "that has elected to file an Alabama consolidated return" can only be referring to the Alabama consolidated return on which the loss was claimed. The statute should be

construed as follows: If a corporation that is currently a member of an Alabama affiliated group incurred an NOL before it became a member of the group, the deductibility of the NOL on the group's consolidated return, i.e. the return on which it is claimed, shall be limited by the federal SRLY rules at 26 U.S.C. §1502. That interpretation conforms with the federal SRLY rules, and thus the intent of §40-18-39(h).

The above interpretation is also confirmed by Act 2001-1089, by which §40-18-39(h) was amended in 2001. While the original §40-18-39(h) stated only that the loss shall be limited by the federal SRLY rules, the amendment specified that the loss "shall be limited to only the amount necessary to reduce to zero the Alabama taxable income, calculated on a separate return basis, of the corporation that incurred the net operating loss." Thus, instead of referring generally to the SRLY limitation, as did the original provision, Act 2001-1089 simply set out the substance of the SRLY limitation relating to NOL carryovers. But for the limitation to apply for either federal or Alabama purposes, the loss must still have been incurred "in a taxable year before the corporation (that incurred the loss) became a member of an Alabama affiliated group."

And as discussed below, even if the Department's interpretation is accepted, and the federal SRLY rules are applied, those rules do not limit or prohibit the Weyerhaeuser group from claiming the NOLs in issue in full.

Sub-Issue (2). Do the federal SRLY rules limit the NOLs in issue?

Generally, NOLs incurred by all members of an affiliated group are allowed in full on the group's consolidated return. An exception is contained in the federal SRLY rules at IRC Reg. 1-1502-21(c), which limits the amount of an NOL incurred by a member of an affiliated group in a separate return limitation year. The rule and the exception are explained in

Wolter Construction Co., Inc. v. C.I.R., 634 F.2d 1029, 1032-1033 (1980) as follows:

> The calculus for computing the consolidated income for an affiliated group and the corresponding income tax is not spelled out within the Code. Rather, Congress in § 1502 of the Code has authorized the Secretary of the Treasury to promulgate regulations that outline the requisites for and effects of filing a consolidated income tax return.
>
> > **SEC. 1502 REGULATIONS**
> >
> > The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporation making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such a manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.
>
> Pursuant to his delegation the Secretary has issued extensive legislative regulations, and the bulk of the "law" dealing with consolidated returns is contained in those regulatory provisions.
>
> Reg. 1.1502-21(b)(1) is concerned with the use of net operating losses on a consolidated return. That regulation permits an affiliated group to use net operating losses sustained by any members of the group in "separate return years" if the losses could be carried over pursuant to the general principles of § 172 of the Code. A "separate return year" is defined as any year in which a company filed a separate return or in which it joined in the filing of a consolidated return by another group. Reg. 1.1502-1(e).
>
> As a general rule, then, net operating losses reported on a separate return can be carried over to and used on a consolidated return. An important exception to this rule is found in Reg. 1.1502-21(c). That section provides that the net operating loss of a member of an affiliated group arising in a "separate return *limitation* year" which may be included in the consolidated net operating loss deduction of the group shall not exceed the amount of consolidated taxable income contributed by the loss-sustaining member for the taxable year at issue. The term "separate return limitation year" is defined in Reg. 1.1502-1(f), in essence, as a separate return year in which the member of the group (except, with qualifications, the common parent) was either: 1) not a member of the group for its entire taxable year; or 2) a member of the group for its entire taxable year, that enjoyed the benefits of multiple surtax exemptions. In summary, losses incurred by a brother or

> sister corporation or by a corporation which is unrelated at the time of its losses to its subsequent affiliates, before it becomes a member of an affiliated group filing a consolidated return, can only be carried forward and used on the consolidated return to the extent that the corporation that incurred the losses has current income reflected on the consolidated return. (footnotes omitted)

Wolter Const., 634 F.2d at 1032-1033.

The years in which Weyerhaeuser's two subsidiary corporations incurred the losses in issue were separate return years because Alabama law required separate returns before 1999. However, the §1502 SRLY limitation only applies to an NOL incurred in a separate return *limitation* year, which, as indicated, is a year in which the member that incurred the loss was not a member of the group for the entire year. The two corporations that incurred the NOLs in issue were members of the Weyerhaeuser group in the loss years. Consequently, those years were not separate return limitation years, in which case the SRLY limitation does not apply. Weyerhaeuser is thus entitled to claim the NOLs in full on its consolidated 1999 Alabama return.

The above conclusion is supported by Dept. Reg. 810-3-35.1-.03(2)(a)3(ii). That paragraph specifies that the "term separate return limitation year (or SRLY) does not include . . . [a] separate return year of any corporation which was a member of the group for each day of such year, . . ." Thus, under both the federal SRLY rules and the Department's own regulation, the NOLs in issue are not limited by the SRLY rules.

The final assessment is dismissed.

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 March 11, 2005.

_____
BILL THOMPSON
Chief Administrative Law Judge