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| TATE & LYLE SUCRALOSE, INC.<br>2200 E. ELDORADO STREET<br>DECATUR, IL 62525-1578, | § | STATE OF ALABAMA<br>DEPARTMENT OF REVENUE<br>ADMINISTRATIVE LAW DIVISION |
| Taxpayer, | § | DOCKET NO. CORP. 06-1275 |
| v. | § | |
| STATE OF ALABAMA<br>DEPARTMENT OF REVENUE. | § | |

**FINAL ORDER**

The Revenue Department assessed Tate & Lyle Sucralose, Inc. ("Taxpayer") for corporate income tax for the fiscal year ending March 31, 2005. 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 May 1, 2007. John Crowley represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

**OVERVIEW**

A corporation is allowed an Alabama income tax deduction for the federal income tax that it pays in a given year. Code of Ala. 1975, §40-18-35(a)(2). If the corporation only earns income in Alabama, it can deduct 100 percent of its federal tax paid. If, however, the corporation also earns income in another state, the allowable deduction is determined by multiplying the total tax paid by the ratio that the corporation's taxable income allocated and apportioned to Alabama bears to the corporation's taxable income everywhere. See again, §40-18-35(a)(2).

An additional calculation is also required if the corporation is a member of a group of corporations that files a consolidated federal return. In that case, the federal tax paid by each member group is not self-evident because the income and losses of the group members are netted to arrive at the group's net federal taxable income. The federal tax

rate is then applied to arrive at the group's consolidated federal liability. To determine the amount or portion of the group's consolidated liability that is "paid" by each member, the consolidated liability must be allocated among the various group members. The federal tax allocated to a member subject to Alabama tax is then multiplied by the taxable income ratio specified in §40-18-35(a)(2) to arrive at the corporation's Alabama federal tax paid deduction.

As discussed below, the Taxpayer is a member of a related group of corporations, the Tate & Lyle group, that files a consolidated federal return. The dispute in this case involves how the Tate & Lyle group's consolidated 2005 federal liability should be allocated to the Taxpayer for purposes of Alabama's federal tax paid deduction. Dept. Reg. 810-3-35.01 specifies that a corporate group's consolidated federal liability shall be allocated to the various members in accordance with the method elected by the group to allocate earnings and profits under 26 U.S.C. §1552. Section 1552 provides a choice of three allocation methods at paragraphs (a)(1), (a)(2), and (a)(3).[1] Reg. 810-3-35.01(b)(3) provides the same three allocation methods at paragraphs (b)3.(i), (b)3.(ii), and (b)3.(iii).

Section 1552(a) also specifies that a consolidated group must elect a method on the first federal consolidated return filed by the group. It must thereafter use that method on all subsequent returns. If no election is made on the first return, §1552(b) requires that the

[1] Method (a)(1) allocates based on the ratio that the taxable income of each group member having taxable income bears to the total taxable income of all the group members having taxable income. Method (a)(2) allocates based on the ratio that a group member's total tax computed on a separate return basis bears to the total tax of the group members computed on a separate return basis. Finally, method (a)(3) allocates based on the contribution of each group member to the consolidated taxable income of the group, with some adjustments.

default (a)(1) method must be used. Reg. 810-3-35.01(b) also specifies that "[w]hen no election has been made for any taxable year in which a consolidated federal return is filed, the method described above (the default federal (a)(1) method) shall apply." See, Reg. 810-3-35.01(b)3.(iv)(I).

Reg. 810-3-35.01 also provides an additional step in computing the (b)3.(i), (b)3.(ii), and (b)3.(iii) methods. The additional step or limitation, which is found in subparagraph (I) following each of the three methods, prevents any member of the consolidated group from having a negative tax liability for purposes of the calculation. That is, only group members that have positive taxable income are considered in allocating the group's federal tax paid among the group members.

## ISSUES

This case involves two issues:

Issue (1): Is the Taxpayer required to use the default (b)3.(i) method to allocate the group's federal tax paid in the subject year, as argued by the Department, or the (b)3.(iii) method, which the Taxpayer claims it has used for federal §1552 purposes since at least 1988.

Issue (2): Once the method is determined, the second issue is how should the Taxpayer's deduction for the subject year be computed using that method.

## FACTS

The Taxpayer was formed in 2004, and is a wholly owned subsidiary of Tate & Lyle Holdings (U.S.), Inc. (formerly Tate & Lyle, Inc.). The Taxpayer operates a manufacturing facility in Alabama, and is a member of Tate & Lyle's consolidated group for federal income

tax purposes.

The Tate & Lyle group filed its first consolidated federal income tax return with the IRS in 1979. The group, including the Taxpayer, also filed a federal consolidated return for the fiscal year ending March 31, 2005. The 2005 consolidated return reported a total federal liability of $19,654,668.

The Taxpayer filed a separate Alabama income tax return for the fiscal year ending March 31, 2005, as required by Alabama law. See, Dept. Ex. 1. It reported $65,250,949 on the return as income apportioned to Alabama. It also claimed a federal income tax paid deduction of $22,580,437. The Taxpayer failed, however, to check the box on Schedule E of the Alabama return indicating whether it had elected the §1552(a)(1), (a)(2), or (a)(3) allocation method on its consolidated federal return for the year.

The Department audited the Taxpayer's 2005 Alabama return and requested a copy of the Tate & Lyle consolidated 1979 federal return on which it had made its original §1552 election. Tate & Lyle was unable to locate that part of the 1979 return on which the election had been made. Consequently, because the group's 1979 federal consolidated return could not be found, and because the Taxpayer had failed to indicate on its 2005 Alabama return which §1552 method the group had used on its 2005 federal consolidated return, the Department recomputed the federal tax paid deduction using the default (b)3.(i) method. It also applied the subparagraph (I) limitation, which reduced the federal tax paid deduction to $2,633,376. It subsequently assessed the Taxpayer for the additional tax due, plus penalties and interest.

Other facts are stated as necessary in the analysis of the issues.

## ANALYSIS

### Issue (1). Which allocation method must the Taxpayer use?

The Department argues that because the Taxpayer cannot provide a copy of the Tate & Lyle group's 1979 consolidated federal return on which it made its initial §1552 election, the Taxpayer must use the default (a)(i) method. I disagree.

The undisputed evidence is that the Tate & Lyle group has used the §1552(a)(3) method for federal purposes since 1988, and that it specifically elected the (a)(3) method on its 2005 consolidated federal return. The IRS has consistently audited the group's consolidated federal returns since 1988, and has never challenged or questioned the group's election of the (a)(3) method.

The Department is correct that all taxpayers are required to keep records from which their correct tax liability can be determined or verified. Code of Ala. 1975, §40-2A-7(a)(1). Consequently, if, for example, a taxpayer claims a charitable deduction, but fails to maintain records verifying the contribution, the deduction must be denied. See, *Tisaby v. State of Alabama*, Inc. 05-657 (Admin. Law Div. 12/14/2005). The deduction would still be disallowed, even if the taxpayer had consistently and successfully claimed charitable deductions in prior years, because each annual contribution must be separately verified.

Concerning this case, however, a consolidated group elects the §1552 method only once on its first consolidated return. It is thereafter required to use the same method in each subsequent year. Consequently, the fact that the Tate & Lyle group has consistently elected the §1552(a)(3) method on its federal returns for almost 20 years is strong circumstantial evidence that the group initially elected that method on its first federal

consolidated return.

The Alabama Court of Civil Appeals has held (in a tax case) that "[a] fact may be established by either direct or circumstantial evidence, and the proof is sufficient if, from the facts and circumstances adduced, it can be reasonably inferred." *State v. Ludlum*, 384 So.2d 1089, 1092, cert. denied 284 So.2d 1094 (Ala. 1980), citing *Armstrong v. State*, 29 So.2d 330 (Ala. 1947). The fact that the Tate & Lyle group has elected the (a)(3) method on its consolidated federal returns for almost 20 years is sufficient evidence from which it can be reasonably inferred that the group elected the (a)(3) method on its original 1979 federal return.[2] Consequently, the Taxpayer must use that same (a)(3) allocation method in computing its 2005 Alabama federal tax paid deduction.

**Issue (2). The calculation of the deduction.**

Although the Taxpayer can use the (a)(3) allocation method, it apparently did not use that method (or any other §1552 method) in actually computing the federal tax paid deduction on its 2005 Alabama return.

As discussed, the group's consolidated 2005 federal liability was $19,654,668. The federal tax paid deduction claimed by the Taxpayer on its 2005 Alabama return was $22,580,437. See, Dept. Ex. 1, page 1, line 11. The Taxpayer apparently arrived at the deduction amount by determining the federal tax it would have paid on a separate return basis ($26,240,223), and then applying the apportionment ratio (85.9357 percent) specified

[2] A government official once asked Will Rogers for a copy of his birth certificate. Rogers replied that where he came from, the fact that a fellow was alive and walking around was sufficient proof that he had been born. That is admittedly a loose analogy to the current situation, but if a corporate group has consistently elected the §1552(a)(3) method on its federal returns for almost 20 years, it can likewise be reasonably inferred that the group elected the (a)(3) method on its first federal consolidated return. It could also be argued

in §40-18-35(a)(2). See, Dept. Ex. 1, Schedule E, and T. at 27 – 39.

The above method used by the Taxpayer was specifically rejected by the Alabama Court of Civil Appeals in *Standard Oil Company v. State of Alabama*, 313 So.2d 532 (Ala. Civ. App. 1975). In *Standard Oil*, the Court held that if a corporate taxpayer subject to Alabama tax is a member of a group that files a consolidated federal return, the taxpayer's Alabama federal tax paid deduction must be a portion of the actual federal tax paid by the group parent to the IRS, not what the corporation would have paid had it filed on a separate return basis.[3] Consequently, the Taxpayer's deduction in this case must be computed by allocating a portion of the group's $19,654,668 federal liability to the Taxpayer using the §1552(a)(3) allocation method. The resulting federal tax "paid" by the Taxpayer must then be multiplied by the taxable income ratio in §40-18-35(a)(2) to arrive at the allowable deduction.

The Department has computed the Taxpayer's federal tax paid deduction under the (a)(1), (a)(2), and (a)(3) allocation methods, including the subparagraph (l) limitation.[4] The computations are shown on two pages attached to the Department's Brief that are identified as "Page 1" and "Page 2." Those pages are attached to and made a part of this Order.

The Department explains the (a)(3) calculations on page 12 of its Brief.

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that it is unreasonable to require a taxpayer to produce a 28 year old document.

[3] In *Standard Oil*, the subsidiary actually remitted to the parent the amount of federal tax it would have paid on a separate return basis. Likewise, in this case, the Taxpayer, for internal accounting purposes, computed and remitted what would have been its separate return liability, $26 million plus, to Tate & Lyle. As indicated in *Standard Oil*, however, the federal tax paid that must be allocated among the group members is the tax actually paid by the group parent to the IRS, not what a group member would have paid on a separate return basis.

[4] There is only a relatively small difference in the deduction when computed under each of

> The second Column G, page 2 begins the FIT calculations pursuant to the (a)(3) method. The second Column G lists the allocation of the lesser of each member's (a)(1) method FIT or (a)(2) method FIT. In the second Column H, if the member's (a)(1) FIT was greater than its (a)(2) FIT, then the difference is listed as a positive number. Eight of the members are treated as having $0 difference because the Rule, at "I" of (iii), requires the zeroing out of a member's negative federal taxable income or negative federal income tax. For this Taxpayer, the difference is $2,515.61. The total difference for the group is $8,726.45.
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> Column I lists each member's percentage share of the difference. The Taxpayer's share is 15.4585%. That ratio is applied to the total difference of $8,726.45 to determine the Column J amounts, "allocation of difference." The Taxpayer's "allocation of difference" amount is added to the second Column G amount to determine the FIT. That figure is brought back to page 1, column 3 to compute the "net federal income tax deduction" by application of the "federal income tax ratio." Pursuant to the (a)(3) method, the net FIT deduction is $2,632,371.00.

The Taxpayer objects that the subparagraph (l) limitation in Reg. 810-3-35.01 improperly eliminates all negative taxable income group members from the allocation computation. The limitation is, however, inherent in the federal §1552 calculation, at least concerning the (a)(1) and (a)(2) methods. In any case, just as the Department can by regulation adopt the various §1552 methods for purposes of allocating a group's consolidated federal tax paid to the various group members, it can also alter or adjust the §1552 calculation by regulation, as it did per subparagraph (l). That is, it can adopt the §1552 methods with limitations and/or adjustments. The only requirement is that the result must reasonably reflect that portion of the group's federal tax paid that is attributable to each member. None of a group's consolidated federal tax paid is attributable to a member that had negative taxable income in the year. It follows that only those group members with positive taxable income in the year should be considered in allocating the federal tax paid

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the three methods.

to the various members, which is what the subparagraph (l) limitation does.

Applying the subparagraph (l) limitation also leads to a reasonable result. The Taxpayer's 2005 federal taxable income of $75,074,195 constituted 15-plus percent of the total taxable income of the group's members that had a positive taxable income. See, attachment page 2, column B. By applying the subparagraph (l) limitation, the group's federal tax paid that is allocated to the Taxpayer also equals 15-plus percent of the total federal tax paid. See again, page 2, column B. If, however, the Taxpayer's position is accepted, the federal tax deemed to have been paid by the Taxpayer (before applying the §40-18-35(a)(2) ratio) is over $26 million, or approximately $7 million more than the total federal tax paid by the group.

Further, if any (or all) of the other group members with positive income were also Alabama taxpayers, they would also be entitled to a federal tax paid deduction. If those positive income group members conducted substantial business in Alabama (thus resulting in a high apportionment ratio per §40-18-35(a)(2)), then the group members together would be allowed a total Alabama federal tax paid deduction many times greater than the actual federal tax paid by the group. Clearly, that cannot be allowed under Alabama law.

The Department's recalculation of the Taxpayer's 2005 federal tax paid deduction is correct. The tax and interest as assessed by the Department is affirmed. Because of the complexity of the issue, the penalty is waived for reasonable cause. Code of Ala. 1975, 40-2A-11(g). Judgment is entered against the Taxpayer for corporate tax and interest of $1,458,219.22. Additional interest is also due from the date the final assessment was entered, November 24, 2006.

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

Entered November 2, 2007.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
attachment
cc: Mark Griffin, Esq.
John Crowley, Esq.
Melody Moncrief
Chris Sherlock, IV