

FLOYD & SHELBY MCNEES	§	STATE OF ALABAMA
205 MCNEES DRIVE		DEPARTMENT OF REVENUE
VERNON, AL 35592-0205,	§	ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 06-523
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

FINAL ORDER

The Revenue Department assessed Floyd and Shelby McNeess (jointly “Taxpayers”) for 2002, 2003, and 2004 income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on November 8, 2006. Ray Robbins represented the Taxpayers. Assistant Counsel Mark Griffin represented the Department.

Floyd McNeess (individually “Taxpayer”) resides in Alabama and is a member of Pyramid, LLC, an Alabama limited liability company. Pyramid is the sole member of Steelox Systems, LLC, an Ohio limited liability company.

Steelox incurred net operating losses (“NOLs”) in 2003 and 2004. The NOLs passed from Steelox through Pyramid to the Taxpayer. The Taxpayer deducted his unapportioned distributive share of the NOLs on his joint 2003 and 2004 Alabama returns. He also filed an amended 2002 Alabama return and carried the NOLs back to that year.

The Department disallowed the NOLs in full based on Dept. Reg. 810-3-14-.01(16). Reg. 810-3-14-.01 is entitled “Gross Income In General,” and paragraph (16) reads as follows:

(16) Gross income for a resident partner or member of a subchapter K entity includes the following:

(a) For a multi state subchapter K entity doing business within and without the State of Alabama, only that income which is required to be allocated and apportioned to Alabama under the rules of Section 40 18 22. (If the multi state subchapter K entity is not doing business in Alabama, no income is reportable to Alabama from the subchapter K entity.)

(b) For a subchapter K entity doing business in only one state, whether the State of Alabama or another state, the distributive share of the entire income from that subchapter K entity.

The Department argues that because paragraph (a) of the above regulation requires that an Alabama resident's distributive share of income received from a multistate LLC must be apportioned to Alabama, it follows that the resident's distributive share of any NOL incurred by the LLC must also be apportioned to Alabama. The Department concedes that pursuant to the regulation, the Taxpayer was entitled to claim an apportioned share of the NOLs in issue on his Alabama returns. It disallowed the NOLs in full, however, because the LLC failed to file Alabama returns for the subject years. The Department thus did not have the information needed to apportion the NOLs to Alabama.

The Taxpayer argues that Reg. 810-3-14-.01(16), insofar as it requires resident LLC members to apportion their multistate LLC income and losses to Alabama, is contrary to Alabama law and should be rejected. I agree.

Code of Ala. 1975, §40-18-14 defines "gross income" for Alabama income tax purposes. Section 40-18-14(4) specifies that "[t]he term 'gross income,' in the case of a resident individual, includes income from sources within and outside of Alabama, . . ." The above statute requires that an Alabama resident individual that is a member of a multistate LLC must include as Alabama income his or her entire distributive share of the income received from the LLC.

Code of Ala. 1975, §40-18-22, which is referred to in Reg. 810-3-14-.01(16)(a), provides that all entities required to allocate and apportion their income pursuant to the Multistate Tax Compact (“MTC”) must allocate and apportion their income, losses, deductions, etc. in accordance with Chapter 27 of Title 40, Code of Ala. 1975, i.e., the MTC.¹ The last sentence of §40-18-22 specifies, however, that “[t]his section shall not apply to individuals.” That sentence confirms that resident individuals in Alabama, including resident members of multistate LLCs, are not required to apportion to Alabama the income they receive from multistate sources.

The above is further confirmed by the MTC itself, which defines “Taxpayer” as any one of several types of entities, “but does not include an individual.” Code of Ala. 1975, §40-27-1, Art. II. ¶3. Because the MTC does not apply to individuals, the term “Taxpayers,” as used in §40-18-22, and thus the statute itself, does not apply to individuals (even without the last sentence in the section) because §40-18-22 applies only to those entities subject to the MTC.

The above cited statutes mandate that individuals residing in Alabama must report income from all sources on their Alabama return, including their unapportioned distributions from multistate LLCs and other Subchapter K entities. Reg. 810-3-14-.01(16)(a) is contrary to those statutes because it requires apportionment. Where a regulation conflicts with a statute, as in this case, the statute must prevail and the regulation rejected. *Ex parte City of Florence*, 417 So.2d 191 (1982). Consequently, Reg. 810-3-14-.01(16)(a) is rejected as

¹ Section 40-18-22 is redundant because entities subject to the MTC are already required to allocate and apportion their income, losses, etc. pursuant to the MTC.

contrary to Alabama law.²

If Alabama residents are not required by Alabama law to apportion income received from a multistate LLC to Alabama, they also are not required to apportion losses from such sources to Alabama. This is confirmed by Code of Ala. 1975, §40-18-15.2, which governs NOLs for individuals in Alabama. Section 40-18-15.2(7) specifies that non-residents “shall be allowed only that portion of the net operating loss attributed to income related to Alabama.” This is consistent with the fact that non-residents must only report and pay Alabama tax on income from Alabama sources. See, §40-18-14(4) (“The term ‘gross income’ . . . in the case of a non-resident individual, includes only income from property owned or business transacted in Alabama.”). Likewise, because Alabama resident individuals must report income from all sources, they must also be allowed to deduct NOLs from all sources. The Taxpayers thus must be allowed to deduct in full the NOLs in issue.

The final assessments in issue are voided.

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

² Paragraph (b) of Reg. 810-3-14-.01 (16) further provides that if an Alabama resident is a member of an LLC doing business in only one state, whether Alabama or another state, the member’s entire (unapportioned) distributive share is subject to Alabama tax. Paragraph (b) is technically correct because, as discussed, an individual residing in Alabama must report income from all sources. Paragraph (b) implies, however, that an Alabama resident member of an LLC must report all income to Alabama only if the LLC is doing business in only one state. That is incorrect. The resident member must report all income to Alabama, regardless of where the LLC is (or is not) doing business.

Entered December 12, 2006.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

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