

GKN WESTLAND AEROSPACE, INC. §
550 WARRENVILLE ROAD, SUITE 400
LISLE, IL 60532-4311, §

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayer, §

DOCKET NO. BIT. 10-988

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER

This appeal involves a disputed final assessment of 2007 business income tax entered against the above Taxpayer. The case was submitted on stipulated facts and briefs. Chris Grissom and Jimmy Long represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

The Taxpayer manufactures various products for the aviation industry. It operated a manufacturing facility in Tallassee, Alabama during the years in issue, 2005 through 2007.

The Taxpayer is a wholly-owned subsidiary of GKN America Corporation. It consequently was included as part of the GKN Group's consolidated federal income tax returns during the subject years. It filed on a separate return basis for Alabama income tax purposes in those years, as provided by Alabama law.

Congress enacted a new federal income tax deduction in 2004 for income attributable to domestic production activities (the "DPAD"). 26 U.S.C. §199. The amount of the allowable DPAD is the lesser of (1) the qualified production activities income ("QPAI") of the corporation or the corporate group for the subject tax year,¹ or (2) the

¹ A corporation's QPAI is the excess of the corporation's domestic production gross receipts for the year over the total of the corporation's cost of goods sold allocable to such receipts, and other expenses, losses, or deductions allocable to such receipts.

taxable income of the corporation or the corporate group (disregarding the DPAD) for the year. 26 U.S.C. §199(a)(1). Because of the above taxable income limitation, a corporate group that incurs a consolidated net operating loss (“NOL”) in a year cannot claim a DPAD for federal purposes. The GKN Group incurred consolidated NOLs in the subject years. The Group’s otherwise allowable DPAD was thus limited to zero for federal purposes in those years.

The Taxpayer computed its DPAD for Alabama purposes on a separate return basis during the years in issue. It consequently reported a DPAD on the returns for those years in the amounts of \$396,734, \$530,073, and \$1,414,343, respectively.

The Department audited the Taxpayer in 2008 for the tax years 2002 through 2006. It notified the Taxpayer by letter dated October 9, 2008 that “no additional income tax liability is due the State of Alabama nor any refund of income tax is due for the audit period.” Stipulation of Facts, Exhibit B.

The Department subsequently reviewed the Taxpayer’s 2007 Alabama return and disallowed the DPAD claimed on the return. It consequently entered a preliminary assessment against the Taxpayer for that year on March 8, 2010. The Taxpayer timely petitioned for a review of the preliminary assessment.

The Department subsequently entered a “revised” 2007 preliminary assessment against the Taxpayer. It notified the Taxpayer by letter dated May 19, 2010 that it had reexamined the Taxpayer’s 2005 through 2007 Alabama returns, and that “adjustments to the Federal Taxable Income in the aforementioned years (2005 and 2006) reduced the net operating losses available to carry forward to the (“Taxpayer”) 12/31/2007 tax period return.” Stipulation of Facts, Exhibit C. The “adjustments” referred to was the

Department's denial of the DPAD claimed by the Taxpayer on its 2005 and 2006 Alabama returns, which, as indicated, reduced the NOL available in those years for carryforward to 2007. The 2007 final assessment in issue is thus based on the Department's disallowance of the DPAD claimed by the Taxpayer on its 2005 through 2007 Alabama returns.

The Department argues that the Taxpayer cannot be allowed a DPAD for Alabama purposes because it was not entitled to a DPAD on its federal consolidated returns for the subject years. "Since the (GKN) Groups' (federal) DPAD for the audit period is zero, there is no DPAD to allocate to the Taxpayer (for Alabama purposes)." Department' Brief at 4.

The Taxpayer contends that because it filed Alabama returns during the subject years on a separate return basis, it should compute its DPAD deduction for Alabama purposes on a separate return basis. That is, the fact that the Taxpayer's consolidated group incurred consolidated losses in the subject years that limited the group's federal DPAD to zero "is irrelevant in calculating the Taxpayer's (DPAD) deduction for Alabama purposes. The Taxpayer's entitlement to the (DPAD) is mandated by Alabama's conformity to federal taxable income, its status as a separate return filing state, and the Alabama Department of Revenue's own regulation and long-standing administrative practice that requires taxpayers to apply certain limitations that are applied on a consolidated basis for federal income tax purposes on a separate company basis for Alabama tax purposes." Taxpayer's Brief at 1.

The Taxpayer also argues that the Department's adjustments to its 2005 and 2006 returns, i.e., the disallowance of the DPAD in those years, as reflected in the Department's May 19, 2010 letter to the Taxpayer, constituted an impermissible second audit of those years by the Department. See, Code of Ala. 1975, §40-2A-7(b)(2)j. That issue need not be

decided, however, because as explained below, the Taxpayer is entitled to compute and claim the DPAD on a separate company basis for Alabama purposes in the subject years.

The starting point for calculating a corporation's Alabama income tax liability is federal taxable income, with certain adjustments and limitations not relevant to this case. Code of Ala. 1975, §40-18-33. The Department concedes that the "DPAD is a deduction available to a corporation in computing a corporation's 'federal taxable income.' Accordingly, a DPAD can be used in computing a corporation's taxable income for Alabama income tax purposes." Department's Brief at 2.

The Alabama Revenue Code, Title 40, Code 1975, does not directly address how the DPAD should be calculated for Alabama purposes; nor does the Department have a regulation specifically relating to the DPAD calculation. The Department does, however, have a regulation concerning adjustments to federal deduction limitations. Dept. Reg. 810-3-1.1-.01 reads in pertinent part as follows:

(4) Adjustments to Federal Limitations. Alabama's income tax laws are tied to various federal income tax limitations. Certain fundamental differences in the calculation of federal taxable income and Alabama taxable income require that adjustments be made to the federal limitation before they can be used in the calculation of Alabama taxable income as described below.

(a) Federal limitations calculated at the corporate consolidated group level and used in the calculation of consolidated federal taxable income for the corporate group, must be adjusted to reflect the fact that Alabama corporate taxpayers, even those participating in the filing of a post 2001 Alabama consolidated return, must calculate Alabama taxable income on a separate-company basis. For this reason, federal limitations applicable in the calculation of Alabama corporate taxable income must be calculated on a separate-entity basis.

The GKN Group's otherwise allowable federal DPAD was limited to zero in the

subject years because the Group incurred consolidated NOLs in those years. Reg. 810-3-1.1-.01(4)(a) requires, however, that for Alabama purposes, the Taxpayer's DPAD, and specifically the taxable income limitation in issue, must be calculated on a separate entity basis. The limitation thus did not apply for Alabama purposes in the subject years because, unlike the Group, which had consolidated losses in those years, the Taxpayer had taxable income as a separate company in those years greater than the allowable DPADs.

The Department cites *Standard Oil Company v. State of Alabama*, 313 So.2d 532 (Ala. Civ. App. 1975), in support of its position. The Court held in *Standard Oil* that if a corporation subject to Alabama tax is a member of a consolidated group that files a consolidated federal return, the corporation's Alabama federal income tax ("FIT") paid deduction, as allowed at Code of Ala. 1975, §40-18-35(a)(2), must be an apportioned part of the federal tax actually paid by the group, not what the corporation would have paid had it filed on a separate return basis. See also, *Tate & Lyle Sucralose, Inc. v. State of Alabama*, Docket. Corp. 06-1275 (Admin. Law Div. 11/2/1997).

The Alabama FIT deduction is not analogous to the DPAD. I agree with the Taxpayer that unlike the DPAD, the "deduction for FIT paid during the year is not included in the calculation of a corporation's federal income tax for purposes of Alabama Code section 40-18-33." Taxpayer's Reply Brief at 2.

Computing the DPAD taxable income limitation on a separate return basis for Alabama purposes is also consistent with how the Department requires corporations to compute the ten percent of taxable income limitation applicable to charitable contributions on a separate return basis. A federal consolidated group's charitable contributions deduction is limited to ten percent of the group's consolidated taxable income. See, 26

U.S.C. §170(b)(2). The Department requires, however, that in computing the charitable deduction for Alabama purposes, the ten percent limitation must be computed using the corporation's separate company taxable income, not the consolidated group's taxable income. See, Reg. 810-3-1.1-01(4)(a)1. It follows that the DPAD taxable income limitation must also be computed using the corporation's separate company taxable income.

The Department attempts to distinguish the charitable contribution deduction from the DPAD in a March 8, 2010 letter to the Taxpayer. Exhibit D. Specifically, the Department claims that the DPAD differs from the charitable deduction because “[a] charitable contribution deduction comes from an actual expense incurred by a taxpayer at the separate company level. . .”, whereas “[t]he DPAD is not an item of expense that is associated with the outlay of an asset by a separate company. The DPAD is an additional deduction a taxpayer is entitled to take for federal income tax purposes if they meet certain criteria. GKN Westland Aerospace, Inc. does not meet these criteria,” I disagree.

To be entitled to a DPAD, a corporation must expend money and other resources that produce qualified production activity income. The corporation must also incur certain wage expenses. The DPAD thus reflects or results from certain positive economic outlays or activities engaged in by a corporation, i.e., the Taxpayer in this case, just as the charitable deduction reflects certain economic outlays by a corporation.

In summary, the Department concedes that “a DPAD can be used in computing a corporation's taxable income for Alabama income tax purposes.” Department's Brief at 2. The parties stipulated that the Taxpayer's reported DPAD as computed on a separate return basis was \$364,734, \$530,073, and \$1,414,343 in 2005, 2006 and 2007, respectively. Reg. 810-3-1.1-.01(4)(a) also clearly requires that the DPAD taxable income

limitation “must be calculated on a separate-entity basis.” The taxable income limitation that zeroed out the GKN Group’s federal consolidated DPAD thus does not apply for Alabama purposes because the Taxpayer had sufficient taxable income as a separate entity in the subject years against which the DPAD could be applied.

It is assumed that the 2007 final assessment in issue is based solely on the Department’s disallowance of the DPAD claimed by the Taxpayer on its 2005, 2006, and 2007 Alabama returns. Because those deductions should be allowed, the final assessment is voided.

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

Entered July 25, 2011.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

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