COMPUTER SCIENCES CORP. 2100 East Grand Avenue El Segundo, CA 90245,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. CORP. 01-113
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

FINAL ORDER

The Revenue Department assessed corporate income tax against Computer Sciences Corporation (ATaxpayer@) for the fiscal years ending March 1994 and March 1995. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a.[1] A hearing was conducted on April 12, 2001. Larry Severn and Sheridan Cranmer represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

ISSUES

The Taxpayer received interest income from 13 subsidiary corporations during the subject years. The issues are:

(1) Is Alabama constitutionally prohibited from taxing the income by the Due Process and Commerce Clauses of the United States Constitution, Amendment 14 and Article I, '8, cl. 3, respectively; and,

(2) If Alabama is not constitutionally barred from taxing the income, does the income constitute apportionable Abusiness income,@ as that term is defined at Code of Ala. 1975, '40-27-1, Art. IV, &1(a)?

FACTS

[1]The Department separately assessed the Taxpayer for the fiscal years ending March 1991 and March 1993. The Taxpayer also appealed that final assessment, but now concedes that it is correct.

The Taxpayer is commercially domiciled in California, and provides computer and data processing services for various government entities worldwide. The Taxpayer provided its services to NASA on Redstone Arsenal in Huntsville, Alabama during the subject years.

The Taxpayer has over 200 subsidiary corporations. It made loans to or had loans outstanding with 13 of those subsidiaries during the subject years. The loans were evidenced by open-ended demand notes, with interest payable at prime plus 2 percent. The funds used to make the loans came from the Taxpayer=s regular business operations. Likewise, the Taxpayer used the interest income from the loans in its regular business operations.

The Taxpayer issued monthly billing statements to the subsidiaries for the interest due on the loans. However, the subsidiaries may or may not have paid some or all of the monthly interest due, depending on their financial ability to pay at the time. Four of the subsidiaries paid off the loans in full during the subject years. Some borrowed additional funds during those years, while the balance owed by others increased due solely to accrued interest.

The Taxpayer=s subsidiaries were also primarily engaged in the computer services/data processing business. The subsidiaries contracted with the private sector, whereas, as indicated, the Taxpayer contracted primarily with government entities. There is no evidence whether any of the subsidiaries were engaged in business in Alabama during the two years in issue.

The subsidiaries had their own management teams, but were ultimately controlled by the Taxpayer from its headquarters in California. The subsidiaries filed combined California returns with the Taxpayer during the subject years for purposes of the California corporate franchise (income) tax levied at Cal. Rev. & Tax. '25101.

The Taxpayer reported the interest income from its subsidiaries as nonbusiness income on its Alabama returns for the years in issue, and accordingly allocated 100 percent of the income to California, its state of commercial domicile. The Department recharacterized the income as business income, apportioned a part of it to Alabama, and entered the final assessment in issue. The Taxpayer appealed.

ANALYSIS

Issue (1). The Constitutional Question - Is Alabama prohibited from taxing the income by the Due Process Clause and the Commerce Clause?

Alabama requires that a corporation operating in Alabama and other states must allocate and apportion its income to Alabama pursuant to the Multistate Tax Compact (AMTC@), Code of Ala. 1975, '40-27-1 et seq., and related regulations. Code of Ala. 1975, '40-18-31, et seq. However, the Due Process and the Commerce Clauses of the United States Constitution require that before a state can tax even a portion of income arising from interstate activities, there must be a Aminimal connection@ or Anexus@ between the state and the interstate income it seeks to tax. *Allied-Signal,* 112 S.Ct. 2251 (1992); *Container Corp. of America v. Franchise Tax Board*, 103 S.Ct. 2933 (1983); *ASARCO, Inc. v. Idaho State Tax Comm=n*, 102 S.Ct. 3103 (1982); *F.W. Woolworth Co. v. Taxation and Rev. Dept. of New Mexico*, 102 S.Ct. 3128 (1982); *Exxon Corp. v. Wisconsin Dept. of Revenue*, 100 S.Ct. 2109 (1980). A. . . in the case of a tax on an activity, there must be a connection to the activity itself, rather than only to the actor the State seeks to tax.@ *Allied-Signal*, 112 S.Ct. at 2258, quoting

Quill Corporation v. North Dakota, 112 S.Ct. 1904, 1909 (1992).[2] That constitutional requirement is satisfied if the income is derived from the taxpayer=s unitary business, a part of which is being conducted in the taxing state. Indeed, the U.S. Supreme Court has stated that the unitary business principle is the linchpin of apportionability in the field of corporate income taxation. *Mobil Oil Corp. v. Comm=r of Taxes of Vermont*, 100 S.Ct. 1123, 1232 (1980).

A Aunitary business@ is not defined by Alabama law or regulation. But the term has been much litigated and analyzed in a long line of U.S. Supreme Court cases. See, *Allied-Signal*, and cases cited therein.[3] Simply stated, separate corporations form a unitary business if they are so closely related as to constitute a single business enterprise. The

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[2]The constitutional issue in *Quill* was whether North Dakota had the authority to tax Quill in the first place. The Taxpayer in this case clearly had *Quill*-type nexus with Alabama through its activities and physical presence on Redstone Arsenal in Huntsville, Alabama during the subject years. As indicated, the threshold issue in this case, as it was in *Allied-Signal*, concerns the scope of a state=s authority to tax. See, *Allied-Signal*, 112 S.Ct. at 2258. Specifically, did the activity/income that the state is attempting to tax have a constitutionally sufficient connection with the state.

[3]For a general discussion of the unitary-business principle, see, Hellerstein & Hellerstein, *State Taxation*, 3rd Ed. at &8.07 et seq; M. McIntyre, P. Mines & R. Pomp, *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, State Tax Notes, Sept. 3, 2001, at 741, 749.

relevant inquiries in deciding if corporations are engaged in a unitary business are whether there is an Aexchange or transfer of value, which may be evidenced by functional integration, centralization of management, and economies of scale.@ *Allied-Signal*, 112 S.Ct. at 2257.

The record in this case is woefully lacking in evidence concerning the Taxpayer=s relationship with its subsidiaries. The Taxpayer argues that the subsidiaries have independent management teams, but concedes that it ultimately controls the subsidiaries from its headquarters in California. The Taxpayer attempts to distance the subsidiaries by emphasizing that the subsidiaries contract with private industry, while it contracts with government entities. But that fact has no bearing on whether there is a flow of values between the Taxpayer and its subsidiaries sufficient to establish a unitary relationship.

The nature of the loan transactions in issue also suggests that the subsidiaries are part of the Taxpayer=s unitary business. The Taxpayer apparently loaned a subsidiary cash if it had excess operating funds and the subsidiary needed the funds. Likewise, the Taxpayer called the loan, or the accrued interest on the loan, only when the subsidiary was financially able to pay and the Taxpayer needed operating capital. The informal, non-arm=s-length manner in which the transactions were handled evidences the centralized control that exists in a unitary relationship.

Finally, the fact that the Taxpayer included the subsidiaries on its combined California franchise tax returns during the subject years indicates a unitary relationship. Because of inconsistencies in the tax laws of the various states, it is generally irrelevant for Alabama tax purposes how a corporation reports (or doesn=t report) income in another state. *Uniroyal Tire Co., Inc. v. State of Alabama*, Corp. 96-183 (Admin. Law Div. 3/27/97). But the scope of a

unitary business, at least for constitutional purposes, is the same for all states. Consequently, if the Taxpayer and its subsidiaries were unitary for California purposes, they were likewise unitary for Alabama purposes.

Even if the subsidiaries were not part of the Taxpayer=s unitary business, Alabama could still constitutionally tax a part of the interest income if the loans and resulting interest income served an operational function in the Taxpayer=s business.

> We agree that the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. *Container Corp.* says as much. What is required instead is that the capital transaction serve an operational rather than an investment function.

Allied-Signal, 112 S.Ct. at 2263.

The Taxpayer routinely loaned excess working capital to its subsidiaries, and used the resulting interest income to pay normal operating expenses. The transactions, and the income derived therefrom, clearly served an operational function in the Taxpayer=s business. The U.S. Supreme Court has recognized that interest income from the investment of idle funds that is used for operating capital may be apportioned. AHence, for example, a state may include within the apportionable income of a non-domiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation=s unitary business. . .@ *Allied-Signal*, 112 S.Ct. at 2263.[4]

The burden was on the Taxpayer to prove that by taxing a part of the interest income, Alabama was improperly attempting to tax extraterritorial income with no connection with

[4]For a case emphasizing that interest income from short-term investments can be apportioned only if actually used as operating capital, and not merely available for such use, see *Home Interiors and Gifts, Inc. v. Dept. of Revenue*, 741 N.E.2d 998 (Ill. App. 2000).

Alabama. *Container Corp.*, 103 S.Ct. at 2939, 2940, citing *Exxon Corp.*, 100 S.Ct. at 2119. The Taxpayer has clearly failed to carry that burden.

Issue (2). Was the interest income apportionable Abusiness income@?

Having determined that Alabama may constitutionally tax a portion of the interest income, the next question is whether the income should be included in the Taxpayer=s apportionable tax base under Alabama=s statutory taxing scheme. That issue turns on whether the income constituted apportionable Abusiness income,@ which is defined at ' 40-27-1, Art. IV, &1(a), as follows:

> ABusiness income@ means income arising from transactions and activity in the regular course of the taxpayer=s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer=s regular trade or business operations.

The above definition of business income originated in 1957 with the Uniform Division of Income for Tax Purposes Act (UDITPA), was adopted into the MTC in the 1960's, and became effective in Alabama in 1977. *State, Dept. of Revenue v. MGH Mgt., Inc.*, 627 So.2d 408 (Ala. 1993). It has been adopted by numerous other states, and has been the subject of much debate and numerous court cases. The issue usually is whether the definition includes both a transactional test and a separate functional test. For an excellent discussion of the issue, see, W. Hellerstein, *The Business-Nonbusiness Income Distinction and the Case for Its Abolition*, State Tax Notes, Sept. 3, 2001, at 725.

The only Alabama appellate court case on the issue is *Ex parte Uniroyal Tire Co.*, 779 So.2d 227 (Ala. 2000). The Alabama Supreme Court held in *Uniroyal* that the UDITPA

definition of business income contains only a transactional test, and not a separate functional test.

The transactional test is expressed in the first part of the definition. To qualify as business income under the transactional test, income must arise from Atransactions and activity in the regular course of the taxpayer=s trade or business.@[5] Numerous courts in other states have held, and I agree, that interest income derived from the short-term investment of operating profits that is subsequently used to satisfy a taxpayer=s capital needs in its regular business operations constitutes apportionable business income. *A.L. Laboratories v. Zehnder*, 96 L 50934 (Cir. Ct. of Cook County, Ill., Dec. 23, 1998); *NCR Corp. v. Comptroller of Treasury*, 544 A.2d 764 (Md. 1988); *Lone Star Steel Co. v. Doland*, 668 P.2d 916 (Col. 1983); *Sperry & Hutchinson Co. v. Dept. of Revenue*, 527 P.2d 729 (Ore. 1974). AIf temporarily idle funds, whatever their origin, are being held to satisfy the needs for liquid capital in the taxpayer=s business, the interest those funds generate should be characterized as business income, as the *Sperry & Hutchinson* case properly held.@ Hellerstein &

[5]What constitutes business income under UDITPA=s transactional test is similar in concept to what may be constitutionally apportioned under *Allied-Signal*=s operational function test. Obviously, the statutory definition of the term cannot exceed the constitutional bounds enunciated in *Allied-Signal.* The statutory tail cannot wag the constitutional dog. Professor Hellerstein argues in his article, cited above at page 7, that the conflicting state court interpretations on the issue could be largely resolved by replacing the statutory definition of business/nonbusiness income with a constitutional standard of apportionability. He points out that at least two states, Pennsylvania and Iowa, have statutorily adopted a constitutional standard. But under Alabama=s current definition of the term, as construed in *Uniroyal*, business income cannot be interpreted to include all income that may be constitutionally apportioned to Alabama.

Hellerstein, supra, at &9.09(1)(b)(III). The Department thus properly included the interest income in the Taxpayer=s apportionable tax base.

The final assessments in issue are affirmed. Judgment is entered against the Taxpayer for 1991 and 1993 tax and interest of $26,542, and 1994 and 1995 tax and interest of $50,506. Additional interest is also due from the date of entry of the final assessments, December 4, 2000.

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

Entered September 12, 2001.