ARMSTRONG WORLD INDUSTRIES P.O. Box 3001 Lancaster, PA 17604,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. CORP. 01-189
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Armstrong World Industries, Inc. ("Taxpayer") for 1993 and 1994 Alabama corporate income tax. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. Bruce Ely and Chris Grissom represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department. The case was submitted for decision on a joint stipulation of facts and briefs.

ISSUE

The Department assessed the Taxpayer for the tax in issue outside of the general three year statute of limitations at Code of Ala. 1975, §40-2A-7(b)(2), but within the special six year 25 percent omission statute at Code of Ala. 1975, §40-2A-7(b)(2)b. The issue is whether the six year statute applies.

FACTS

The Taxpayer timely filed its 1993 Alabama corporate income tax return on August 30, 1994. It filed an amended 1993 return on January 15, 1996.

The Taxpayer timely filed its 1994 Alabama return on September 8, 1995.

The Department audited the 1993 and 1994 returns and adjusted both returns. Specifically, the Department (1) reclassified as apportionable business income certain dividends reported by the Taxpayer as nonbusiness income; (2)

substantially increased the nonbusiness interest expense reported on the 1994 return; and (3) adjusted the property factor as reported on the 1994 return.

The Department entered a preliminary assessment for the additional tax due on July 31, 2000. A final assessment was entered on January 18, 2001. The Taxpayer timely appealed. The Taxpayer does not contest the audit adjustments. Rather, as indicated, the only issue is whether the assessment was timely entered within the six year 25 percent omission statute.

ANALYSIS

The Department is generally allowed three years to enter a preliminary assessment for additional tax due. Section 40-2A-7(b)(2). The Department is also authorized to assess tax within six years if a taxpayer omits from the taxable base on a return more than 25 percent of the taxable base that should have been reported on the return. Section 40-2A-7(b)(2)b. That statute currently reads as follows:

> A preliminary assessment may be entered within six years from the due date of the return or six years from the date the return is filed with the department, whichever is later, if the taxpayer omits from the taxable base an amount properly includable therein which is in excess of 25 percent of the amount of the taxable base stated in the return.
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> For purposes of this paragraph:
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> > 1. The term "taxable base" means the gross income, gross proceeds from sales, gross receipts, capital employed, or other amounts on which the tax paid with the return is computed; and
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> > 2. In determining the amount omitted from the taxable base, there shall not be taken into account any amount which is omitted from the taxable base stated in the return if the amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the department of the nature and amount of the item.

The Taxpayer argues that the Alabama 25 percent omission statute is modeled after its federal counterpart, 26 U.S.C. §6501(e), and consequently, that

federal case law should control, citing, *State, Dept. of Revenue v. Robertson*, 733 So.2d 397 (Ala.Civ.App. 1998), and *Best v. State, Dept. of Revenue*, 417 So.2d 197 (Ala.Civ.App. 1981). The federal 25 percent omission statute applies only if a taxpayer fails to report some taxable item on the return. It does not apply if a taxpayer only overclaims a deduction or makes a computation error on the return.

The leading federal case on point is *Colony, Inc. v. Commissioner of Revenue*, 78 S.Ct. 1119 (1958). In *Colony*, the taxpayer understated its profit on the sale of real estate by overstating its basis in the property. The U.S. Supreme Court held that the 25 percent omission statute did not apply because the underreporting of basis was not an omission of a taxable item, as required by the statute.

> We think that in enacting §275(c) (the predecessor to §6501(e)) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage.

Colony, 78 S.Ct. at 1124.

Likewise, in *Phoenix Electronics v. U.S.*, 164 F.Supp. 614 (1958), the court cited *Colony* in holding that the overclaiming of a deduction is not an omission from income within the meaning of (§6501(e)).

The Department concedes that the federal statute applies only if a taxable item is omitted from a return, but argues that the language of the Alabama statute is much broader than the federal statute. Specifically, the Department claims that by defining "taxable base" to include "other amounts on which the tax paid with the return is computed," the Alabama statute is sufficiently broad to include an

erroneously claimed deduction or any other amount necessary to compute the tax paid with the return. The Department thus argues that the Taxpayer's underreporting of nonbusiness interest expense, which is an amount necessary in computing the Taxpayer's apportionable business income, was an omission pursuant to the statute.[1] See, Department's Reply Brief at 2,3.

Before 1992, each tax administered by the Revenue Department had a separate statute of limitations for assessing the tax. For income tax purposes, Code of Ala. 1975, §40-18-45(a) provided a general three year statute. It also contained a five year statute "if the taxpayer omits from the gross income reported on said return . . . an amount which is in excess of 25 percent of the amount of gross income so reported on said return." That provision was enacted in 1951 (Acts 1951, No. 826, p. 1457, §2), and was clearly modeled after the federal 25 percent omission statute in effect at the time, §275(c), IRC 1939. The Alabama and federal statutes both referred to an omission from "gross income," and both allowed the same extended five year statute.[2]

By Act 92-186 in 1992, the Alabama Legislature repealed §40-18-45(a) and the other statutes of limitation in the Alabama Revenue Code relating to the

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[1]The beginning figure on the Alabama corporate income tax return is federal net income, from which total interest expense has already been deducted. Certain adjustments are then required to arrive at income apportionable to Alabama. Because only business income is apportionable, only business-related interest expense should be deducted in arriving at apportionable business income. Consequently, nonbusiness-related interest previously deducted in arriving at federal net income must be added back to apportionable income. Thus, if a taxpayer understates nonbusiness interest expense on a return, as the Department claims the Taxpayer did in this case, an insufficient amount is added back, which results in the underreporting of apportionable income. See generally, *Alco Standard Corp. v. State of Alabama*, Inc. 94-355 (Admin. Law Div. 6/25/97).

[2]The federal statute was extended to six years with the enactment of §6501(e) in 1954. As discussed below, the Alabama statute was also extended to six years in 1992.

assessment of taxes, and simultaneously enacted a “unified” statute of limitations, §40-2A-7(b)(2), for all taxes administered by the Department. Section 40-2A-7(b)(2)b. provided a six year statute (conforming to the post-1954 six year federal statute) if a return omitted more than 25 percent of the “correct amount of tax required to be shown on said return.”

The 1992 Act tied the 25 percent omission statute to the underreporting or omission of tax so that it would apply to all taxes administered by the Department, not just income tax. Under the broad 1992 version of the statute, it was irrelevant whether the underreported tax resulted from omitted income, an overstated deduction, or any other reporting mistake or omission by the taxpayer. This was illustrated in *Nappier v. State of Alabama*, Inc. 95-366 (Admin. Law Div. 2/13/96).

In *Nappier*, the Department disallowed certain automobile expenses claimed by the taxpayers, which increased their tax liability for the subject years by more than 25 percent. The Department assessed the taxpayers outside the general three year statute, but within the special six year statute. The Administrative Law Division held that although the overreporting of the automobile expenses did not constitute an omission of income pursuant to the federal statute, it did result in a 25 percent omission of the correct tax due, as required to trigger the 1992 Alabama statute. The assessments were accordingly affirmed.

The Alabama Legislature was apparently displeased with the 1992 statute because it substantially amended §40-2A-7(b)(2)b. in 1995. The 1995 amendment was clearly an attempt by the Legislature to again model the provision after its federal counterpart at §6501(e). The operative language in the Alabama statute - “if the taxpayer omits from the taxable base an amount properly includable therein which is in excess of 25 percent of the amount of the taxable base stated in the return” - is identical to the language in §6501(e)(1)(A), except “taxable base” is substituted for “gross income.” Section 40-2A-7(b)(2)b.2. also mirrors the

language of §6501(e)(1)(A)(ii), except again “taxable base” is substituted for “gross income” and also “the department” is substituted for “Secretary.”

The Legislature used the generic term “taxable base” so that the 25 percent omission statute would apply to all taxes administered by the Department. The term clearly refers to that amount on which each particular tax is based. For example, “gross income” clearly relates to income tax. Consequently, for income tax purposes, a taxpayer’s taxable base is gross income, the same as under the corresponding federal statute. Likewise, “gross proceeds of sales” is the taxable base for sales and use tax purposes; “gross receipts” is the taxable base for the gross receipts “sales” tax on public places of amusement; and “capital employed” was the taxable base for the defunct foreign

franchise tax.

The "other amounts" language relied on by the Department does not provide an alternative or expanded definition of "taxable base." Rather, it is only part of a catchall phrase intended to apply the six year statute to all other taxes administered by the Department that are based on some "other amounts" other than those amounts, i.e. gross income, gross proceeds of sales, etc., specifically listed in the statute. For example, the gasoline tax, motor fuel tax, and lubricating oils tax levied in Chapter 17 of Title 40 are computed on a per gallon basis. The oil and gas severance tax levied at Code of Ala. 1975, §40-20-2 is computed on the "gross value of said oil and gas at the point of production." In the above examples, the gallons or gross value required to be reported on a return are the "other amounts" to which the phrase in dispute is referring.

In summary, the current version of §40-2A-7(b)(2)b. is modeled after federal §6501(e), and should be interpreted accordingly. *Robertson, supra; Best, supra*. Consequently, for Alabama income tax purposes, the statute applies only if a taxpayer omits from gross income more than 25 percent of the amount that should have been reported, the same as under federal law. The "other amounts" clause in §40-2A-7(b)(2)b.1. does not enlarge the scope of the provision to include an erroneously claimed deduction or the erroneous omission or reporting of any other amount on a return. Rather, it was only intended to make the statute applicable to all taxes measured by "other amounts" other than those listed in the statute.

Applying the above interpretation to this case, the Taxpayer's failure to properly report nonbusiness interest expense was not an omission from the taxable base within the scope of §40-2A-7(b)(2)b. Rather, it was "an error in reporting an item disclosed on the face of the return," which the U.S. Supreme Court has stated is not an omission under the statute. *Colony*, 78 S.Ct. at 1124. Consequently, it is irrelevant whether the amount was disclosed on the Taxpayer's return in a manner

adequate to notify the Department of the nature and amount of the item, see §40-2A-7(b)(2)b.2.

The Taxpayer's characterization of certain dividends as nonbusiness income, and the exclusion of those dividends from apportionable income, could be considered an omission of gross income. However, the Taxpayer reported the dividends as nonbusiness income on its returns. The "omitted" amounts were thus sufficiently disclosed on the returns to put the Department on notice within the purview of §40-2A-7(b)(2)b.2. Consequently, the amounts cannot be considered as having been omitted from the returns.[3]

The misreported 1994 property factor also was not an omission within the scope of §40-2A-7(b)(2)b.

Based on the above, the six year statute does not apply. Because the Department failed to assess the Taxpayer within the applicable three year statute, the final assessment is dismissed.

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

Entered March 15, 2002.

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[3]The Department apparently concedes that the nonbusiness dividends were disclosed on the Taxpayer's returns. It only argued in its Reply Brief, at pages 3-7, that there was not sufficient disclosure concerning the nonbusiness interest expense. As discussed, that issue is moot.