

STATE OF ALABAMA
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

§

v.

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DOCKET NO. F. 87-224

COMDISCO, INC.
6400 Shafer Court
Rosemont, IL 60018,

§

§

Taxpayer.

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ORDER

The Revenue Department entered preliminary assessments of foreign corporation franchise tax against Comdisco, Inc. ("Taxpayer") for the calendar years 1983, 1984, 1985 and 1986. The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on July 7, 1988. Michael D. Felish, Esq. appeared for the Taxpayer. The Department was represented by assistant counsel Ron Bowden. Based on the evidence presented by the parties, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

The relevant facts are undisputed.

The Taxpayer is a foreign corporation engaged in the business of selling and leasing computer equipment within Alabama. The Taxpayer filed a foreign corporation franchise tax return with the Revenue Department during each of the years 1983 through 1986. The Taxpayer computed liability on each return under the allocation method as set out on page 3 of the return. The lines utilized from Section C of the return were 2, 6, 7 and 9

(the "2-6-7-9" method).

Under the "2-6-7-9" method, an allocation factor is computed in Sections C and D of the return by averaging the Alabama percentages of sales (Section C, line 2), salaries, wages, etc. (Section C, line 6), tangible property (Section C, line 7), and inventories (Section C, line 9). The allocation factor is then multiplied by net capital subject to allocation as computed in Section E to arrive at the Alabama franchise tax base. Various Section C line combinations are used to compute the allocation factor for different taxpayers, depending on the type of business conducted by the corporation, see Section D of the return.

The Department's instructions on page 3, Section D of the return indicate that the "average allocation factor as determined will be applicable unless it is apparent that it produces an unfair and inequitable result".

The Department reviewed the Taxpayer's returns and determined that the allocation method provided an unfair and inaccurate tax base in each of the subject years. The Department's decision was based on the fact that Alabama capital as computed on the return was substantially lower than the book value of the Taxpayer's Alabama property as shown on Section C, line 8 of the return. The assessments in issue are based on the Department's use of the summation method to compute liability.

Consequently, the Department recomputed the Taxpayer's tax base

using the "summation method". Under that method, the Department obtains the book value of all cash, accounts receivable, inventory, tangible property and all other assets used in Alabama. The sum of those amounts is then used as the tax base (capital employed) in computing the Taxpayer's franchise tax liability.

Department employee Robert Holmes testified that the Department customarily uses the allocation method in computing a foreign corporation's liability, but that the, summation method is used when in the Department's opinion the allocation method does not fairly reflect capital employed in the State. Mr. Holmes further testified that the summation method more accurately reflects capital employed in the State, but that the allocation method is used because it is less expensive to verify and administer.

The summation method must be used by all newly qualified corporations when filing its first return in Alabama. However, the Department has no regulations governing the two methods of computing capital employed or indicating when either of the two methods can or should be used.

The Department's position is that the franchise tax is measured by the value of a corporation's assets employed in Alabama. The Department argues that the summation method and the allocation method both provide an accurate and reasonable measure of a corporation's capital employed within the State, and that the Department can use either to compute liability.

On the other hand, the Taxpayer accepts the allocation method as

reasonable, but rejects the summation method as nothing more than an additional property tax on assets.

CONCLUSIONS OF LAW

The determinative issues are (1) what constitutes "capital employed in this state", and (2) which method of computation more accurately reflects a corporation's actual capital employed within Alabama.

The Alabama franchise tax is not a property tax, but rather is an excise tax on the privilege of doing business within Alabama. State v. Southern Natural Gas Corp., 170 So. 178 (1938); State v. Pullman-Standard Car Mfg. Co., 179 So. 541 (1938).

Prior to 1961, Code 1940, Title 51, §348 (presently §40-14-41) did not define "capital". As a result, Alabama's courts determined that capital employed should be defined as the market value of a corporation's assets used in Alabama. State v. P.R. Mallory, Inc., 138 So.2d 693 (1961). That is, the measure of the tax was the "fair value of property at the due date of the levy". Dowling v. Texas Company, 26 So.2d 590 (1946). Use of the summation method would be appropriate under the above definition of capital.

However, Title 51, §348 (§40-14-41(b)) was amended by Act No. 912, Acts of Alabama 1961 to include a statutory definition of "capital". That section sets out that capital shall include (1) outstanding capital stock, (2) surplus and undivided profits, (3) bonds, notes, debentures and other evidences of indebtedness

maturing and payable more than one year after the beginning of the tax year, (4) various other bonds, notes, etc., and (5) the amount required to adjust for accelerated depreciation. Subsection (c) provides that capital employed shall be computed using generally accepted accounting principles. Finally, subsection (d) includes various exclusions and deductions.

Thus, with the passage of the 1961 amendment, the Legislature rejected the case law definition of capital in favor of the statutory definition set out in the amendment.

Capital is computed under the allocation method (in Section E of the return) using the various elements of capital set out in §40-14-41(b). After exclusions, net capital subject to allocation is then multiplied by an allocation factor derived from an average of various items in Section C.¹

In short, the measure of the franchise tax is not the market value of the corporation's assets used in the State, as under pre-1961 case law. Rather, the tax must be computed in accordance with the §40-14-41(b) definition of capital, as is done on the return under the allocation method.

Further, the summation method does not reflect a corporation's

¹An allocation factor (comprised of sales, property and payroll) is also used by multistate corporations in the apportionment of income among the various states. The method used in computing the allocation factor on the franchise tax return is not disputed by either party and is not in issue.

capital employed within Alabama as defined by the statute. Rather, it constitutes in effect a tax on the corporation's property within Alabama.

A corporation's capital is generally defined to be assets minus liabilities, or net worth. "Capital" is defined in the American Heritage Dictionary, Second College Ed., as follows:

Capital . . . 3.a. Accounting The remaining assets of a business after all liabilities have been deducted; net worth.

Consequently, even if capital was not defined by the statute, under generally accepted accounting principles a corporation's capital would constitute assets reduced by the liabilities associated with the assets. A corporation's capital is not the book value of its assets.

In summary, capital is properly computed under the allocation method (Section E) in accordance with the specific statutory definition set out in §40-14-41(b). The summation method, which would have been proper under pre-1961 case law, does not reflect capital as set out in the above statute should not be used as presently computed by the Department.

If the tax as computed under the allocation method is deemed "unfair and inequitable" by the Department, then the allocation factor in Section C can be changed if the Department can establish that the present factors being used ("2-6-7-9") are unreasonable and do not reflect a clear percentage of the Taxpayer's total capital

employed in Alabama. However, total capital must be computed using the various items set out on Section E of the return.

The above considered, the Department is hereby directed to reduce and make final the assessments in issue showing no additional tax due.

Entered this 3rd day of August, 1988.

BILL THOMPSON
Chief Administrative Law Judge