STATE OF ALABAMA DEPARTMENT OF REVENUE,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. F. 90-173
ARCH OF ALABAMA, INC. City Place One St. Louis, MO 63141,	§ §	
Taxpayer.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Arch of Alabama, Inc. ("Taxpayer") for franchise tax for the years 1987, 1988 and 1989. The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on March 10, 1992. Thomas J. Mahoney, Jr. represented the Taxpayer. Assistant counsel Dan Schmaeling represented the Department. An amicus brief was also filed in support of the Taxpayer by Rich's Brookwood Village Real Estate, Inc., Rich's Department Stores, Inc., Rich's Real Estate, Inc. and Rich's, Inc.

This case involves two issues: (1) Should long-term black lung and reclamation reserve accounts be included as capital for Alabama franchise tax purposes pursuant to Code of Ala. 1975, §40-14-41(b); and (2) Should intercompany receivables be allowed as an exclusion or deduction from capital.

Issue (1) above was decided by the Alabama Court of Civil Appeals in West Point-Pepperell, Inc. v. State, 624 So.2d 579, writ

quashed as improvidently granted, 624 So.2d 582.[1] The Court held in that case that long-term reserve accounts should not be included in a foreign corporation's capital base. Accordingly, the reserve accounts in issue should be removed from the Taxpayer's capital base, and the final assessment should be adjusted accordingly.

The remaining issue is whether or to what extent should intercompany receivables be allowed as a deduction or exclusion from a foreign corporation's capital base. Intercompany receivables are debts owed to a corporation by a related corporation.

"Capital" is defined for Alabama franchise tax purposes at §40-14-41(b). The parties agree that intercompany payables must be included as capital pursuant to §40-14-41(b)(4) ("bonds, notes, debentures and other evidences of indebtedness"). Intercompany payables are debts owed by a corporation to a related corporation.

Various exclusions and deductions from capital are also set out at Code of Ala. 1975, §40-14-41(d). Intercompany receivables cannot be deducted or excluded from capital pursuant to §40-14-41(d), or pursuant to any other statute or Department regulation.

Nonetheless, the Department allows all foreign corporations to reduce their capital base by deducting or "netting" intercompany receivables against intercompany payables, but only to the extent

[1] This case was held in abeyance pending a final decision in West Point-Pepperell, which was finally decided on September 10, 1993.

that intercompany payables are reduced to zero. The Department does not allow intercompany receivables to be deducted from capital in excess of intercompany payables. The Department has allowed netting since the mid-1980's as an unwritten policy in an attempt to be "fair" to foreign corporations.

The Taxpayer deducted all of its intercompany receivables from capital during the subject years, including net receivables in excess of payables. The Department allowed the Taxpayer to net intercompany receivables against intercompany payables, but added back to the Taxpayer's capital base all intercompany receivables in excess of intercompany payables. The issue thus as framed by the parties is whether intercompany receivables in excess of intercompany payables can be deducted from capital. However, the real issue is whether any intercompany receivables should be deducted from capital. An administrative agency cannot usurp legislative authority, nor by regulation or policy subvert or enlarge upon statutory policy. Ex parte Jones Mfg. Co., Inc., 589 So.2d 208; Jefferson Co. Board of Ed. v. Alabama Board of Cosmetology, 387 So.2d 913; Iglesias v. U.S., 848 F.2d 362. As stated, there is no statutory authority for deducting or excluding intercompany receivables from capital. Accordingly, the Department's unauthorized policy of allowing foreign corporations to net intercompany receivables against intercompany payables is rejected. If netting cannot be allowed, obviously intercompany

receivables in excess of intercompany payables also cannot be deducted. The Taxpayer argues that intercompany receivables should be allowed as a deduction from capital based on generally accepted accounting principles ("GAAP"). I disagree.

A foreign corporation's total capital base must be determined using the statutory definition of "capital" at §40-14-41(b), and the statutory exclusions and deductions from capital at §40-14-41(d). Those statutes must control.

<u>All</u> intercompany payables must be included as capital pursuant to §40-14-41(b)(4). There is no provision that intercompany payables should be reduced or off-set by intercompany receivables, nor can intercompany receivables be deducted from capital pursuant to §40-14-41(d). Consequently, §§40-14-41(b) and (d) clearly require that gross intercompany payables, without deducting or netting out intercompany receivables, must be included in a foreign corporation's capital base for Alabama franchise tax purposes.

The only statute in which GAAP is mentioned is Code of Ala. 1975, §40-14-41(c), which reads in part that "total capital as herein defined which is employed in this state shall be determined in accordance with generally accepted accounting principles . . ."

Section 40-14-41(c) does not require that GAAP should be used in computing a corporation's total capital (or in deciding the issue of whether intercompany receivables can be netted against intercompany payables or otherwise deducted from total capital).

Rather, it provides only that after total capital "as herein defined" is determined pursuant to §§40-14-41(b) and (d), GAAP may then be used in determining what portion of that total capital is employed in (apportioned to) Alabama. That is, GAAP does not control what items should be included in or excluded from total capital, but only in determining what part of total capital should be apportioned to Alabama.

The courts have used GAAP as an interpretive aid to help define the specific items of capital at §40-14-41(b), and the specific deductions and exclusions at §40-14-41(d). For example, the Court of Civil Appeals used GAAP to decide that long-term reserve accounts should not be included in the definition of capital either as "surplus and undivided profits" at §40-14-41(b)(2), or as "other evidences of indebtedness" pursuant to §40-14-41(b)(3). West Point-Pepprell, Inc., supra. However, GAAP cannot be used to add to or take away from the specific items of capital at §40-14-41(b), or the specific deductions and exclusions at §40-14-41(d). Specifically, GAAP cannot be used to allow an additional deduction from capital for intercompany receivables that is clearly not allowed by statute.

Intercompany payables and receivables are combined in consolidated reporting by related corporations under GAAP. The Taxpayer argues that the net account balance must be included in capital, even if it is a net receivable and thereby reduces

capital. Taxpayer's brief at p.5. However, §40-14-41(b) does not require balance sheet "accounts" to be included in capital. Rather, it requires that the specific items or sources of capital set out therein must be included as capital. The entire capital item must be included, notwithstanding that the capital item account may be off-set or reduced for accounting purposes under GAAP.

Finally, consolidated reporting under GAAP is an income tax reporting method that is not relevant for franchise tax purposes. "Separate accounting" is required for Alabama franchise tax purposes, and each corporation must compute and report its liability separately.

The Department allows foreign corporations to reduce their capital by negative retained earnings. The Taxpayer argues that by analogy, net intercompany receivables should also be allowed as a negative capital figure. The Department attempts to distinguish negative retained earnings and net intercompany receivables by arguing that receivables are assets that cannot be used to reduce capital.

I disagree with both parties because the premise that negative retained earning should be allowed to reduce capital is wrong.

Again, the language of §40-14-41(b) must control. Retained earnings must be included in capital as "surplus and undivided profits" pursuant to §40-14-41(b)(2). Surplus and undivided

profits are in effect the net excess of profits over losses. See, "undivided profits" as defined in Black's Law Dictionary (5th Ed.), at page 794; see also, Willicuts v. Milton Dairy Co., 275 U.S. 215, cited in Taxpayer's brief at page 6. If a corporation has excess profits or surplus, i.e. retained earnings, then that amount must be included as capital. If a corporation has a net loss, then obviously there would be zero surplus and undivided profits to include in capital under subsection (b)(2). However, surplus and undivided profits by definition cannot be a negative figure. If a corporation has a loss, it has zero retained earnings, not negative retained earnings. "Negative retained earning" is only a euphemism for a loss, and there is no statutory authority for deducting a net loss from capital. Likewise, there is no statutory authority for deducting or reducing capital by intercompany receivables.

The statutory definition of"capital" at §40-14-41(b) is unique and does not necessarily fit the GAAP concept of capital, but the statute must control. The Department cannot allow unauthorized deductions or exclusions from capital, nor can a corporation use GAAP to reduce or eliminate a statutory item of capital, or, as attempted in this case, to create a new deduction from capital for net intercompany receivables.

The Taxpayer argues that a tax statute must be construed against the Department, citing Ex parte Zewen Marine Supply, Inc., 477 So.2d 417. However, this case involves a claimed deduction

from taxation. The applicable rule of construction in that case is that a deduction must be construed against the taxpayer and for the Department, and should be allowed only if clearly authorized by statute. Ex parte Kimberly-Clark Corp., 503 So.2d 304. A deduction from capital for intercompany receivables is clearly not authorized by statute, and thus cannot be allowed.

If intercompany receivables cannot be deducted from capital, the next question is whether those intercompany receivables excluded from capital through the Department's erroneous netting policy should also be added back to the Taxpayer's capital during the period in issue, and the assessment increased accordingly. On appeal, a final assessment may be decreased or increased to reflect the correct tax due. Code of Ala. 1975, §40-2A-7(b)(5)d.1.

The Department is not bound by a prior mistake or misinterpretation of the law. Smith v. Russellville Prod. Credit Ass'n, 777 F.2d 1544. This is especially true concerning an informal Department policy as opposed to a Department regulation. In that case, the Department may correct its erroneous interpretation, and the correct interpretation may be applied retroactively even if a taxpayer has relied on the prior incorrect interpretation. Dickman v. C.I.R., 465 U.S. 330, 104 S.Ct. 1086; Anderson, Clayton and Company v. U.S., 562 F.2d 972.

However, a factor to be considered is whether retroactive application would cause unequal treatment among similarly situated

taxpayers. Anderson, Clayton and Company v. U.S., supra, at page 981.

The Department allowed all foreign corporations to net intercompany receivables against intercompany payables during the years in issue. The Taxpayer would thus be treated unequally compared to all other foreign corporations if the intercompany receivables excluded through netting were retroactively added back to the Taxpayer's capital base in this case. Accordingly, the Department should discontinue its erroneous netting policy prospectively only so as to treat all foreign corporations equally.

The above considered, the Department properly added back and included in the Taxpayer's capital base all intercompany receivables in excess of intercompany payables. All reserve accounts included as capital by the Department should be removed. The Department is directed to recompute the Taxpayer's liability as set out above. A Final Order will be then be entered. The Final Order, when entered, may be appealed to circuit court pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered on July 22, 1994.

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BILL THOMPSON
Chief Administrative Law Judge