KANE-MILLER CORPORATION 555 White Plains Road Tarrytown, New York 10591-5109,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NOS. F. 94-468 F. 95-183
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed franchise tax against Kane-Miller Corporation ("Taxpayer") for the years 1988 through 1994. Separate appeals were filed concerning the 1989 final assessment (Docket F. 94-468) and the 1989 through 1994 final assessment (Docket F. 95-183). The appeals were consolidated and heard together on July 11, 1995. Paul S. Leonard and Alton B. Parker, Jr. represented the Taxpayer. Assistant Counsel Dan Schmaeling represented the Department.

The issues in this case are as follows:

(1) Did the Department timely assess the tax for 1988 through 1991. The Taxpayer concedes that the tax for 1992 through 1994 was timely assessed;

(2) Did the Department properly calculate the Taxpayer's "capital employed" in Alabama during the subject years. The Taxpayer argues that it properly reported capital employed in Alabama using the average value of its plant, equipment, real estate, and inventories in Alabama. That method is commonly known as the "summation" method. The Department disagrees and argues

that the Taxpayer must use the appropriate apportionment formula set out on the franchise tax return; and,

(3) Should the penalty included in the final assessment for 1989 through 1994 be waived.

The Taxpayer is a foreign corporation that operated in Alabama and was subject to Alabama franchise tax during the subject years. The Taxpayer filed Alabama franchise tax returns on or before the due date of each year's return. (1988 return filed before September 15, 1988, etc. . . .).

The Taxpayer calculated capital employed in Alabama on the returns based on (1) the average value of its property, plant, and equipment in Alabama, (2) the average value of its land in Alabama, and (3) the average value of its inventory in Alabama during each year. As stated, that method is known as the summation method.

The Taxpayer also submitted a separate statement with each return notifying the Department that an alternative method had been used instead of the apportionment formula on the return. The Taxpayer explained that the apportionment formula would have resulted in an unfair and inequitable result. The Taxpayer provided a copy of its federal income tax return with each return, and also included all financial data necessary to complete the apportionment formula on the return.

The Department reviewed the returns, rejected the Taxpayer's use of the summation method, and instead recomputed the Taxpayer's liability using the return apportionment formula. The Department

entered a preliminary assessment for the 1988 tax due on July 21, 1994. A preliminary assessment for 1989 through 1994 was entered on January 11, 1995. The 1989 through 1994 assessment included a penalty. The 1988 assessment did not. Final assessments were subsequently entered for all years, from which the Taxpayer timely appealed.

Issue 1 - Statute of limitations.

Code of Ala. 1975, §40-2A-7(b)(2) provides that a preliminary assessment must be entered within three years from the due date of the return or three years from the date the return was actually filed, whichever is later.[1] However, Code of Ala. 1975, §40-2A-7(b)(2)b. provides a special six year statute of limitations if a return omits more than 25 percent of the tax required to be shown on the return.

The preliminary assessments for 1988 through 1991 were entered more than three years (but less than six years) after the returns

[1]The statute of limitations set out in §40-2A-7 is applicable generally to all years in issue in this case because the previously applicable five years statute of limitations for franchise tax set out at Code of Ala. 1975, §6-2-35(2) had not expired on the effective date of §40-2A-7, October 1, 1992. See, Act 92-186, §83.

for those years were filed. Consequently, those years were timely assessed only if the six year statute was applicable.

If the Department correctly recomputed the Taxpayer's liabilities for the subject years, then clearly more than 25 percent of the tax was omitted from the returns. The Taxpayer nonetheless argues that the six year statute does not apply because the Department was notified that an alternative method was being used, and also because the returns included sufficient information from which the Taxpayer's liability using the return apportionment formula could be computed. The Taxpayer cites 26 U.S.C. §6501(e)(1)(A)(ii), which provides that in determining the amount omitted from a return, the IRS should not consider any amount disclosed on the return or on a statement attached to the return sufficient to notify the IRS of the nature and amount of such item.

Unfortunately for the Taxpayer, Alabama law did not include a provision similar to §6501(e)(1)(A)(ii) during the period in question.[2] Rather, during the subject period, the special six year statute applied, without exception, if the taxpayer omitted 25 percent or more of the correct amount of tax required to be shown on the return. The fact that a taxpayer may have included sufficient information to put the Department on notice concerning

[2]Section 40-2A-7(b)(2)b was amended by Act 95-607 to include a provision modeled after §6501(e)(1)(A)(ii). The six year statute clearly would not apply in this case under the statute, as amended. However, Act 95-607 did not become effective until July 31, 1995, after entry of the assessments in issue.

the omitted tax is irrelevant. Consequently, if the Department correctly recomputed the Taxpayer's liability in each year, then more than 25 percent of the correct tax due was omitted from the returns, and the assessments in issue were timely entered.

Issue 2 - Computation of "capital employed".

The Taxpayer argues that it should be allowed to use the summation method because the apportionment formula on the Alabama return did not fairly and equitably reflect capital employed in Alabama. However, the summation method does not follow the statutory definition of "capital" set out in §40-14-41(b), and has been rejected previously in Docket F. 87-224, decided August 3, 1988, and Intergraph Corp. v. State, Admin. Law Docket F. 91-171, decided October 19, 1993, Order on Application for Rehearing entered August 30, 1995.

> The following statement from F. 87-224 is also applicable in this case:
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> In short, the measure of the franchise tax is not the market value of the corporation's assets used in the State (summation method), 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 capital employed within Alabama as defined by the statute. Rather, it constitutes in effect a tax on the corporation's property within Alabama.

* * *

> 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 and should not be used as presently computed by the Department.

Admin. Law Docket F. 87-224, at pages 4, 5.

Apportionment formulas by their nature are imprecise, but they are still widely accepted by most states and the United States Supreme Court. See generally, Container Corp. of America v. Franchise Tax Board, 103 S.Ct. 2933 (1983); Moorman Manufacturing Co. v. Bair, 98 S.Ct. 2340 (1978). The specific apportionment formulas set out on the Alabama foreign corporation franchise tax return have also been upheld as reasonable. See generally, Intergraph Corp. v. State, supra; Automotive Rentals, Inc. v. State, Admin. Law Docket F. 89-173, decided January 5, 1994; U.S. Steel Mining Company, Inc. v. State, Admin. Law Docket F. 94-184, decided May 30, 1995; and Bethlehem Steel Corp. v. State, Admin. Law Docket F. 92-151, decided January 13, 1994.

Act 95-564 amended §40-14-41(c) to provide that if the return apportionment formula as prescribed by Department regulation does not fairly represent the actual capital employed by the corporation in Alabama, the corporation may petition for, or the Department may require, exclusion or inclusion of one or more factors, or use of any other method that results in an equitable apportionment of capital employed in Alabama. However, Act 95-564 is effective only for tax years beginning after December 31, 1995, with some exceptions not relevant to this case. Consequently, prior to 1996, the appropriate apportionment formula set out in the franchise

return must be followed. The Department thus properly recomputed the Taxpayer's franchise tax liability for the subject years using the apportionment formula on the Alabama return.

Issue 3 - Waiver of penalties.

Finally, the Taxpayer argues that if additional tax is due, at least the penalty assessed by the Department should be waived for reasonable cause. During the period in issue, Code of Ala. 1975, §40-2A-11(h) authorized the Department to waive a penalty for reasonable cause. That statute provided that "reasonable cause shall include, but not be limited to, those instances where the taxpayer has acted in good faith in filing a return or reporting or paying any tax".

The Taxpayer clearly acted in good faith and did not attempt to deceive the Department when it attached a statement to its returns notifying the Department that it was using an alternative method for computing capital employed in Alabama. The Taxpayer even reported all relevant financial information from which capital employed could be computed using the return apportionment formula.

However, during the period in question, the discretion to waive a penalty was solely with the Department, not the Administrative Law Division or a circuit court. State v. Leary and Owens Equip. Co., 304 So.2d 604, 609 (1974); see also, Fusco v. State, Admin. Law Docket Inc. 95-138, and Penn v. State, Admin. Law Docket Inc. 95-257. The exception was if the Department contributed to the circumstances surrounding or causing the penalty

to be applied. That clearly did not occur in this case. Consequently, the Department's decision not to waive the penalties cannot be disturbed.

Section 40-2A-11(h) was amended by Act 95-607. Arguably, §40-2A-11(h), as amended, could be construed as giving the Department's Administrative Law Judge or a circuit court the discretion to a waive a penalty for reasonable cause, although a valid argument could be made to the contrary. However, that issue need not be decided in this case because, as stated, the effective date of Act 95-607 was July 31, 1995, after the assessments in issue were entered. Consequently, Act 95-607 is not applicable in this case. The discretion to waive penalties assessed prior to July 31, 1995 was solely with the Department.

Finally, the Taxpayer complains that even if the assessments are upheld, the Department incorrectly calculated the tax due for 1992 because it failed to average the "cost of manufacturing" percentage and the "sales" percentage for that year. Instead, according to the Taxpayer, the Department used only the "cost of manufacturing" percentage. The Department is directed to recompute the Taxpayer's 1992 liability by averaging the above two factors. The adjusted liability should be submitted to the Administrative Law Division, and a Final Order will then be entered setting out the Taxpayer's liability for all years.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may then be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered December 21, 1995.

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BILL THOMPSON
Chief Administrative Law Judge