UNIROYAL TIRE COMPANY, INC. 70 Great Hill Road Naugatuck, Connecticut 06770,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. CORP. 96-183
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

FINAL ORDER

The Revenue Department assessed corporate income tax against Uniroyal Tire Company, Inc. ("Taxpayer") for 1990. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a. A hearing was conducted on August 19, 1996. Daniel Markstein and Tom Brinkley represented the Taxpayer. Assistant Counsel Jeff Patterson represented the Department.

This case involves the definition of "business income" found at Code of Ala. 1975, '40-27-1, Art. IV. The primary issue is whether the Taxpayer's gain from the sale of a partnership interest in 1990 was business income, as defined by the above statute, and thus apportionable to Alabama, or "nonbusiness income," and thus allocable entirely to the Taxpayer's state of commercial domicile, Connecticut.

If the gain is deemed business income apportionable to Alabama, a second issue is whether the gain should be included in the numerator of the Taxpayer's sales factor.

Again, if the gain is business income apportionable to Alabama, a third issue is whether the Taxpayer should be assessed a penalty for failing to report the income on its 1990 Alabama return.

The facts are undisputed.

Uniroyal Incorporated's various operating divisions were spun off into separate corporations in 1985 in response to a hostile takeover attempt. The tire division was transferred to the Taxpayer in this case, Uniroyal Tire Company, Inc. The Taxpayer's state of commercial domicile is Connecticut.

In 1986, the Taxpayer and B.F. Goodrich entered into a joint partnership venture known as Uniroyal-Goodrich Tire Company. Both corporations transferred their assets to the partnership in return for a 50 percent partnership interest. The Taxpayer retained no assets other than its 50 percent interest in the partnership.

The partnership re-capitalized in 1988 due to financial and management problems. Under the plan, the Taxpayer received $80 million cash, a one percent general partnership interest, a one percent senior preferred partnership interest, and a one percent junior convertible preferred partnership interest.

The Taxpayer sold its entire partnership interest to the Michelin Group in 1990. The Taxpayer grossed approximately $260.6 million from the sale, and realized a capital gain of approximately $99.7 million. The Taxpayer liquidated by distributing the sale proceeds to its parent, Uniroyal Holding, Inc. The Taxpayer is now a dormant corporation.

The Taxpayer treated the income received from the partnership in 1986 through 1989 as business income, and consequently apportioned the income to Alabama on its

Alabama returns for those years.

However, the Taxpayer treated the capital gain from the sale of the partnership in 1990 as nonbusiness income, and thus excluded the gain from its Alabama apportionable income on its 1990 Alabama return. The Taxpayer also failed to report the income in the numerator of its gross receipts factor on its 1990 Connecticut tax return.

The Department audited the Taxpayer, treated the $99.7 million gain as business income, and accordingly apportioned the gain to Alabama. Based thereon, the Department entered a final assessment against the Taxpayer on February 28, 1996 for tax and interest totalling $2,148,178. The Taxpayer appealed to the Administrative Law Division.

Alabama computes a foreign corporation's Alabama income tax liability in accordance with the Multistate Tax Compact ("MTC"), which was substantively adopted by Alabama at Code of Ala. 1975, '40-27-1.[1] The MTC in substance incorporated the allocation and apportionment provisions established in the Uniform Division of Income for Tax Purposes Act ("UDITPA").[2]

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[1]The Alabama Legislature passed the MTC in 1967, subject to certain conditions. However, although the Department generally followed the MTC apportionment rules in practice, it refused to recognize the MTC until 1993. The Alabama Court of Civil Appeals ruled in that year that the MTC at '40-27-1 had been in full force and effect in Alabama since 1977. State Dept. of Revenue v. MGH Mgt. Inc., 627 So.2d 408 (Ala.Civ.App. 1993).

[2]UDITPA was approved by the National Conference of Commissioners on Uniform Statutes in 1957 as an attempt to make uniform the methods by which states tax multi-state corporations.

Generally speaking, UDITPA requires a corporation to apportion its business income among the various states in which the corporation does business using a standard three factor formula of property, payroll, and sales. All other nonbusiness income is allocated directly to the corporation's state of commercial domicile. See, Dept. Reg. 810-3-31-.02(1)(a)1.

Section 40-27-1, Art. IV 1.(a) defines business income, as follows:

> "Business income" means income arising from a transaction 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.

Nonbusiness income is defined as "all income other than business income." '40-27-1, Art. IV 1.(e).

At least 35 states have adopted this seemingly simple definition of business income. However, there is a major split among the states as to how the definition should be interpreted. Two tests have evolved - the transactional test and the functional test.

The Tennessee Supreme Court explained the two tests in <u>General Care Corporation v. Commissioner</u>, 705 S.W.2d 642 (Tenn. 1986), as follows:

> . . . The UDITPA definition of "business income" has given rise to two different judicial interpretations. Several courts have employed what has been termed the "transactional test" in determining whether income is to be classified as business income or non-business income. The transactional test is rooted in the statutory phrase, "earnings arising from transactions and activity in the regular course of the taxpayer's trade or

> business . . . ."
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> Thus, under the transactional test, the "controlling factor by which business income [is identified] is the nature of the particular transaction giving rise to the income." *<u>Western Natural Gas Co. v. McDonald</u>, 202 Kan. 98, 446 P.2d 781, 783 (1968)*.
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> *   *   *
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> Other jurisdictions have concluded that the UDITPA definition of "business earnings" contains an alternative "functional test" by which earnings may be categorized as business income. Adherents of the functional test focus on the statute's second clause: ". . . earnings 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." Whereas proponents of the transactional test treat this clause as clarifying language which merely modifies the substantive part of the definition, proponents of the functional test contend that it creates an independent test by which income may be classified.
>
> Under the transactional test, the use or function of an asset in the taxpayer's business is not a determinative criterion, *<u>Western Natural Gas Co.</u>, 446 P.2d at 783*, but under the functional test, the income from the sale of an asset would be considered business income if the asset produced business income while it was owned by the taxpayer. *<u>District of Columbia v. Pierce Assocs., Inc.</u>, 462 A.2d 1129, 1131 (D.C. App. 1983)* illustrates: "If the property had an integral function in the taxpayer's unitary business, its income properly can be apportioned and taxed as business income, even though the transaction itself does not reflect the taxpayer's normal trade or business." Under the functional test, "the extraordinary nature or the infrequency of a transaction . . . is irrelevant," *<u>Atlantic Richfield</u>, 601 P.2d at 631*, and so no significance is attached to liquidation.

<u>General Care</u>, 705 S.W.2d at 644.

If the transactional test is followed, the gain in issue would be nonbusiness income because the sale of the partnership was not a transaction in the Taxpayer's normal course of business. However, the gain would be business income under the functional test described in General Care above because the partnership was the Taxpayer's trade or business and produced business income while owned by the Taxpayer.

There are numerous cases from other states supporting both sides.[3] But while cases from other states can be persuasive, they are not precedent in Alabama. Rather, this issue of first impression in Alabama must turn on the proper statutory construction of the definition of business income.

There is no dispute concerning the transactional test in the first clause of the definition. The dispute is whether the second clause includes a separate test. In my opinion, it does, although as explained below, in substance the two clauses are very similar.

The second clause begins ". . . and includes. . . ." Consequently, the definition of business income must be construed, without reference to the first clause, to include the income specified in the second clause.

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[3]Some states accepting the transactional test only are Tennessee (General Care Corporation v. Commissioner, *supra*; Associated Partnership I, Inc. v. Comm'r of Revenue, 889 S.W.2d 190 (Tenn. 1994)), New Mexico (McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, 543 P.2d 489 (N.M. 1975)), Kansas (Western National Gas Co. v. McDonald, 446 P.2d 781, 783 (1968)), Colorado (Atlantic Richfield Co. v. Colorado, 601 P.2d 628, 631 (Col. 1979)), and Iowa (Phillips Petroleum Co. v. Iowa Dep. of Rev. and Fin., 511 N.W.2d 608 (Iowa 1993)). Some states that also recognize the functional test are Illinois (Texaco-Cities Service Pipeline Co. v. Illinois Department of Revenue, 1997 Ill. App. LEXIS 20 (Ill. 1997); The Kroger Co. v. Department of Revenue, 673 N.E.2d 710 (Ill. 1996)), Washington, D.C. (District of Columbia v. Pierce Associates, Inc., 462 A.2d 1129 (D.C. 1983)), and Pennsylvania (Welded Tube Co. of America v. Pennsylvania, 515 A.2d 988 (Pa. Commw. Ct. 1986); Laurel Pipe Line Co. v. Commonwealth of Pennsylvania, Bd. of Fin. & Rev., 641 A.2d 472 (Penn. 1994)).

The harder question is how should the second clause be construed. I disagree with the functional test proponents, and the Department in this case, that business income results if the asset sold was used in the taxpayer's regular business. The second clause does not include language supporting that conclusion.

Rather, the second clause contains the words "acquisition, management, and disposition." Use of the conjunction "and" instead of "or" requires that both the use and disposition of the asset must occur in the normal course of the corporation's business operations. I agree with the statutory construction applied by the Tennessee Supreme Court in General Care:

> We find the Commissioner's position that the "disposition" of property need not be within the scope of the taxpayer's regular business operations in order to give rise to business income contrary to the plain language of the statute. The drafters' use of the conjunction "and" clearly indicates that the disposition, as well as the acquisition and management of property must be an integral part of the taxpayer's regular trade or business operations in order to produce business earnings. This Court will presume that every word used in a statute was intended by the General Assembly to convey meaning and purpose. *Marsh v. Henderson, 221 Tenn. 42, 424 S.W.2d 193, 196 (1968)*. "Where, as here, in a legislative act, words are used in a series, effect must be given to every word, and it must be presumed that the Legislature did not use three words where one would do . . . ." *R.J. Reynolds Tobacco Co. v. Carson, 187 Tenn. 157, 213 S.W.2d 45, 48 (1948).* It is the duty of the Court "to construe a statute so that no part will be inoperative, superfluous, void, or insignificant . . . and further to give effect to every word, phrase, clause and sentence of the act in order to carry out the legislative intent." *Tidwell v. Collins, 522 S.W.2d 674, 676-77 (Tenn. 1975)*.

General Care, 705 S.W.2d at 646.

Although the second clause includes a separate test, both clauses are similar.

Under the first clause, business income results if a sale is made in the taxpayer's regular trade or business - the sale of chairs by a furniture manufacturer, for example. The second clause requires that the disposition must be an integral part of the taxpayer's regular trade or business "operations," which is a bit broader. For example, if a furniture manufacturer also periodically acquires and sells facilities and equipment, the resulting income may be business income, even though the manufacturer is not in the business of selling facilities and equipment, if such dispositions are regularly made and the proceeds are used for an on-going business purpose. See, Atlantic Richfield, *supra*, (income from sale of major assets by oil company deemed business income because major acquisitions and dispositions of property were systematic and done in normal course of business); Welded Tube, *supra*, (sale of facility and equipment by tube manufacturer resulted in business income because taxpayer regularly acquired property to expand business, and sale proceeds were used for on-going operational purposes). The great majority of states, however, even some supporting the functional test, agree that a sale in complete liquidation, as in this case, results in nonbusiness income. I also agree.

Although corporations sometimes liquidate, they are not in business for that purpose, and liquidation cannot be said to be a normal activity of any business. ". . . [I]n the peculiar context of a liquidation there is no business which the sale or property can benefit." General Care, 705 S.W.2d at 647, citing McVean & Barlow, 543 P.2d at 492-493 (Lopez, J. dissenting). Consequently, based on the specific language in the second clause that business income results only if the asset was used and disposed of in the taxpayer's regular business operations, the Taxpayer's gain from the sale of the partnership must be deemed nonbusiness income.

The Department points out that the gain should be treated as business income pursuant to the MTC regulations adopted by Alabama.[4] Department Regs. 810-3-31-.02(1)(a)4.(ii) and 810-27-1-4-.01(c)(2) both provide that gain from the sale of tangible or intangible property is business income "if the property while owned by the taxpayer was used to produce business income." However, while a Department regulation interpreting a statute should be given weight, it must be rejected if it conflicts with the language of the statute. Jefferson County Board of Education v. Alabama Board of Cosmetology, 380 So.2d 913 (1980).

The Department also cites historical commentary in support of its position. Department's brief, at 13-16; see also, the dissent in Appeal of Chief Industries, Inc., 875 P.2d 278, 286 (Kan. 1994). But again, the language of the statute must control, not what the drafters may have intended. Pilgrim v. Gregory, 594 So.2d 119 (Ala.Civ.App. 1991); Compaq Computer Corp. v. State, F. 95-435 (Admin. Law Div. 2/12/96).

Finally, the Department argues that if the income is not apportioned to Alabama, the Taxpayer will fully escape tax in both Alabama and Connecticut because

[4]The MTC regulations are found at 810-27-1-4. Some of those same regulations are also found at 810-3-31-.02, entitled "Determination of Income from Multistate Operations."

the Taxpayer also failed to "source" the income to Connecticut. The Taxpayer concedes that it may have mistakenly failed to include the income in its Connecticut gross receipts numerator. However, I agree that it is irrelevant for Alabama purposes how the Taxpayer reported or failed to report its income to Connecticut.

The Department's position has merit from a policy standpoint. If a corporation uses an asset in the regular course of its business, and the asset produces business income for the corporation, as in this case, the sale of the asset itself should logically also produce business income. However, a fair reading of the definition of business income requires a different result.

> From a policy standpoint, the functional test has some appeal. The distinction between business and non-business income is really a distinction between business and investment income. If assets are held to produce business income, they are on the business side of the corporation's ledger; their sale should arguably produce business income, even if it is unusual and not part of normal business operations. However attractive the argument, the drafters of UDITPA did not reflect it in their statute, and proponents of the functional test may have to take their battle to the legislatures rather than to the courts.

Peter L. Faber, "When Does the Sale of Corporate Assets Produce Business Income for State Corporate Franchise Tax Purposes?", The Tax Executive, May - June 1995, at 184.

The Tennessee Legislature in substance adopted the functional test by amending the definition of "business earnings" in 1993. The Tennessee statute now defines business earnings to include any income from the "acquisition, use, management or disposition" of assets in the taxpayer's regular business operations. Tenn. Code Ann. '67-4-804(a)(1)(Supp. 1993). For the income in issue to be treated as business income in Alabama, the Alabama Legislature must do the same.

The two remaining issues are pretermitted as a result of the above holding. The final assessment in issue 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 27, 1997.

BILL THOMPSON
Chief Administrative Law Judge