DANOV CORPORATION c/o KPMG Peat Marwick P.O. Box 190 Jacksonville, FL 32201,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. CORP. 97-283
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Danov Corporation (ADanov@ or Acorporation@) for corporate income tax for the fiscal year ending November 30, 1993, and the short year ending May 31, 1994. Danov appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a. A hearing was conducted on January 6, 1998.[1] Gerald Hartley and Laura Crum represented Danov. Assistant Counsel Jeff Patterson represented the Department.

ISSUES

The issue in this case is whether Alabama may tax dividend income received by Danov in the subject years. That issue turns on two questions:

(1) Is Alabama prohibited from taxing the dividends by the Commerce Clause, Article I, '8, cl. 3, and the Due Process Clause, Amendment 14, of the United States Constitution?

[1]The case was held in abeyance pending a final decision in *Ex parte Uniroyal*, ____ So.2d ____ (Ala. S.Ct. 1981928, August 4, 2000). *Uniroyal* was finally decided by the Alabama Supreme Court on August 4, 2000. The parties were thereafter directed to file supplemental briefs. Those briefs were filed on November 21, 2000.

(2) If Alabama is not constitutionally prohibited from taxing the dividends, did the dividends constitute nonbusiness income allocable in full to Florida, Danov=s state of commercial domicile, or business income apportionable in part to Alabama?

FACTS

Danov is a Florida corporation headquartered in Jacksonville, Florida. The corporation is owned by the James E. Davis segment of the Davis family, the founders of the Winn Dixie grocery chain. Danov was formed in 1950 to acquire land, build stores, and lease the stores to Winn Dixie as grocery stores. That was Danov=s sole business until the early 1970s, when the Securities and Exchange Commission required Danov to stop building and leasing buildings to Winn Dixie. Danov sold all of its existing buildings to Winn Dixie at that time.

Also in the 1970s, Danov began acquiring working interests in oil and gas wells. None of the wells were in Alabama. In 1988, Danov and others formed a limited partnership, J&N Exploration and Production, Ltd. Danov contributed its oil and gas working interests to the partnership, and as a limited partner owns 21 percent of the partnership.

The limited partnership is managed from its headquarters in Montana, and a satellite office in Texas. The partnership has its own management team, accounting system, and bank account. Neither Danov nor any of Danov=s shareholders have any input into the management or operation of the limited partnership. There is no commingling of funds between Danov and the partnership. Danov paid none of the partnership=s expenses, and received no cash or other distributions from the partnership

during the years in issue.

Danov acquired approximately 2,000 acres of timberland in the Jacksonville, Florida area beginning in the 1970s. Danov has sold a small portion of the land either to related parties or through condemnation, including 30 acres it sold to American Heritage Insurance Company in 1993. The property is managed by Danov at its headquarters in Jacksonville.

Danov held a large stock portfolio during the subject years. The stocks are also managed from Danov=s headquarters in Jacksonville. Seven of the stocks are part of a Apermanent@ portfolio, which Danov holds for long-term investment.

Danov also held an Ainvestment@ portfolio during the subject years. The stocks in the investment portfolio were actively traded at the direction of James E. Davis during his lifetime. Stocks in the permanent portfolio were used as collateral for loans used to purchase stocks in the investment portfolio. Danov sold all of the investment portfolio stocks in 1993, subsequent to James E. Davis=s death earlier that year.

Danov received dividends from its stock portfolios during the subject years. Those dividends are the income in issue in this case. The dividends were commingled with Danov=s other funds and used to purchase stocks in the investment portfolio, and to pay taxes, administrative expenses, and dividends to Danov=s shareholders. Danov claimed the dividends as a dividends received deduction pursuant to 26 U.S.C. ' 243 on its federal returns.

The limited partnership purchased an interest in oil and gas wells in Alabama in 1993. Other than its 21 percent limited partnership interest in the partnership, Danov

conducted no business in Alabama, owned no property in Alabama, and had no employees in Alabama during the subject years.

Because the limited partnership had invested in Alabama oil and gas wells, Danov filed Alabama corporate income tax returns for the two years in issue. Danov had not previously been required to file Alabama returns. Danov reported four items of income on the returns as allocable nonbusiness income, including the dividends in issue. The Department recharacterized the income as business income apportionable in part to Alabama. Danov appealed.

Danov conceded two of the items at the administrative hearing, and contested only the dividends and the gain on the sale of the 30 acres in Florida. The Department now concedes, based on the Alabama Supreme Court=s holding in *Uniroyal*, that the gain on the land sale was nonbusiness income. Consequently, as indicated, the only remaining issue is whether Danov=s dividend income should be apportioned to Alabama.

ANALYSIS

Issue (1) Can Alabama constitutionally tax the dividend income?

The Alinchpin of apportionability in the field of state income taxation is the unitary-business principle.@ *Mobil Oil Corp. v. Comm. of Taxes of Vermont*, 100 S.Ct. 1223, 1232 (1980). The unitary-business principle requires that for a state to tax the out-of-state income of a nondomiciliary corporation, the interstate activity from which the income was derived must have some minimal connection with the corporation=s activities in the taxing state. AHowever, a state may not tax a nondomiciliary corporation=s income if it is derived from unrelated business activity that constitutes a discrete business enterprise.@ *Allied-*

Signal, Inc. v. Director, Division of Taxation, 112 S.Ct. 2251, 2253 (1992), citing *Exxon Corp. v. Dept. of Revenue of Wis.*, 100 S.Ct. 2109, 2120 (1980). There must be "a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the interstate values of the enterprise." *Mobil Oil Corp. v. Comm. of Taxes of Vermont*, 100 S.Ct. at 1231, citing *Moorman Mfg. Co. v. Blair*, 98 S.Ct. 2340, 2344 (1978). "If, however, the income is not connected with the corporation's trade or business in (the taxing state), it is not apportionable and is instead allocated to the corporation's domicile." *Hercules Inc. v. C.I.R.*, 575 N.W.2d 111, 115 (Minn. 1998).

The Administrative Law Division discussed the unitary-business principle in *Pechiney Corp. v. State of Alabama*, F. 96-106 (Admin. Law Div. Opinion and Preliminary Order 1/16/97). *Pechiney* involved Alabama's now defunct foreign franchise tax measured by capital employed in Alabama. Pechiney was a foreign corporation domiciled in Connecticut. Its only connection with Alabama was that it owned a 99 percent interest in a partnership in Alabama. The Department included capital in Pechiney's apportionable Alabama tax base that was unrelated to Pechiney's activities in Alabama. The Administrative Law Division held that Pechiney's capital employed outside of Alabama and totally unrelated to its activities in Alabama could not be apportioned to Alabama. The constitutional principles set out in *Pechiney* apply in this case.

> To be included in a state's tax base, the unitary-business principle requires that the activity to be taxed, either income earned or capital employed, must be related to or a part of the taxpayer's unitary-business activity carried on in the taxing state. This is rooted in the due process requirement that there must be some "minimum connection" or "nexus" between the interstate activities sought to be taxed and the taxpayer's

> activities in the taxing state. In other words, a state cannot lasso into its apportionable tax base either income earned or capital employed by a foreign corporation in an unrelated business activity outside of the state.
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> The Taxpayer clearly had nexus with Alabama through its investment in (the partnership) in Alabama. But nexus with the Taxpayer is by itself insufficient. There must be some "minimum connection" between the business activity in which capital was employed by the Taxpayer outside of Alabama and the Taxpayer's business activity in Alabama. "In the case of a tax on an activity (capital employed), there must be a connection to the activity itself, rather than a connection only to the actor the state seeks to tax." Allied-Signal, 112 S.Ct. at 2258.

Pechiney, F. 96-106 at 6-7.

In this case, Danov=s only Aactivity@ in Alabama was its 21 percent ownership in a limited partnership that had invested in Alabama. Danov=s other business activities outside of Alabama, including its stock ownership, were discrete business enterprises unrelated to its business activity in Alabama. There was no functional integration, centralization of management, and economies of scale as required for Danov=s out-of-state activities to be unitary with its separate in-state activities. *F.W. Woolworth Co. v. Taxation and Revenue Dept. of N.M.*, 102 S.Ct. 3128, 3135 (1982).

The Department contends that even if a unitary relationship did not exist between the dividend income and Danov=s activity in Alabama, the income may still be apportioned in part to Alabama because the dividends served an operational function for Danov.

Dividends can be apportioned to Alabama if the underlying stock served an operational function in the taxpayer=s business. AEven if the subsidiary is not unitary with the taxpayer, dividends constitute apportionable business income if ownership of the stock serves an operational rather than an investment function.@ *Vulcan Materials Co. v. State of*

Alabama, Corp. 98-157 (Admin. Law Div. Opinion and Preliminary Order 12/13/99), at 7, citing *Allied-Signal*, 112 S.Ct. at 2263. However, the operational function must relate to the taxpayer=s activities in the taxing state.

> Taxation of investment income received from a nondomiciliary taxpayer=s investment in another corporation requires only that the investment income be sufficiently related to the taxpayer=s in-state business, not that the taxpayer=s business and the corporation in which it invests be unitary.
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> In any case, the key question for purposes of due process is whether the income that the State seeks to tax is, by the time it is realized, sufficiently related to a unitary business, part of which operates in the taxing State. In this connection, I agree with the Court that out-of-state investments serving an operational function in the nondomiciliary taxpayer=s in-state business are sufficiently related to that business to be taxed. (emphasis added)

Allied-Signal, 112 S.Ct. at 2266.

The above quote emphasizes that the operational function must relate to the taxpayer=s in-state business, and that Aa state may not tax income which cannot in fairness be attributed to the taxpayer=s activities within the State.@ *In the matter of the Petition of Fairchild Industries*, 2000 WL 290323 (N.Y. Tax.App.Trib. March 9, 2000), quoting *Allied Signal v. Director, Div. of Taxation*, 504 U.S. 768, 119 L.Ed. 2d 533. Even if the dividends constituted business income, there was no connection between the out-of-state operational functions for which the dividends were used, and Danov=s activity in Alabama. Consequently, Alabama is constitutionally prohibited from taxing the dividends.

The second issue of whether the dividends were business or nonbusiness is pretermitted by the above holding.

The Department is directed to remove the dividends and the gain on the sale of the land from the final assessment, and notify the Administrative Law Division of the adjusted amount due. A Final Order will then be entered.

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

Entered December 22, 2000.