JIM BEAM BRANDS COMPANY, INC. 510 Lake Cook Road Deerfield, IL 60015-4964,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. CORP. 02-705
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Jim Beam Brands Company, Inc. ("Taxpayer") for 1993 and 1994 corporate income tax. 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 February 13, 2003. Jim McCann and Steve Bondi represented the Taxpayer. Assistant Counsel Jeff Patterson and J.R. Gaines represented the Department.

ISSUE

Multistate corporations doing business in Alabama are allowed to deduct a portion of their total interest expense in computing their Alabama income tax liability. The issue in this case is how should the Taxpayer's interest expense be apportioned to Alabama during the years in issue. The Department argues that the Taxpayer's interest expense must be apportioned to Alabama using the three-factor formula of property, payroll, and sales specified in the Multistate Tax Compact ("MTC"), Code of Ala. 1975, §40-27-1 et seq., and related regulations. The Taxpayer contends that its deductible Alabama interest should be computed using the single gross income factor set out in Code of Ala. 1975, §40-18-35(2), as that statute read during the years in issue.

FACTS

During the years in issue, §40-18-35(2) allowed foreign corporations an Alabama

interest deduction "determined by the ratio the amount of (the corporation's) gross income from sources within the state of Alabama bears to the amount of (the corporation's) gross income from all sources both within and without the state of Alabama," i.e. the gross income ratio.[1]

The Taxpayer filed an amended 1993 Alabama return and an original 1994 Alabama return on which it apportioned interest to Alabama using the gross income ratio in §40-18-35(2).[2] The Department audited the returns, disallowed the Taxpayer's use of the gross income ratio, and instead apportioned the Taxpayer's interest expense to Alabama using the MTC's three-factor formula, which was also in effect in Alabama in the subject years. That adjustment resulted in the final assessment in issue.[3]

ANALYSIS

This is a difficult case because of the discrepancy during the subject years between the gross income ratio in §40-18-35(2) and the three-factor apportionment formula in the MTC and related regulations. A review of how foreign corporations have been required to compute their Alabama income tax liability, and specifically the interest deduction, will help the reader understand the case.

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[1] The gross income ratio was deleted from the interest deduction at §40-18-35(2) by Act 98-502 in 1998, effective for tax years after 1997. Consequently, the holding in this case applies only to tax years before 1998. The interest deduction was deleted from §40-18-35(2) in 1999 by Act 99-664, 2nd Sp. Sess., p. 124, §1. Under current law, foreign corporations must compute their Alabama interest deduction in accordance with the MTC and related regulations. Section 40-27-1, et seq.; Reg. 810-27-1-4-.01.

[2] The Taxpayer had computed its interest deduction on its original 1993 return using the MTC three-factor formula.

[3] The Department made other minor adjustments that are not contested.

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Alabama's corporate income tax was enacted in 1933, and was substantially amended in 1935. Acts 1935, No. 194, §345, et seq.[4] The 1935 Act levied an income tax on foreign corporations doing business or owning income producing property in Alabama. Acts 1935, §398. The Department subsequently promulgated Reg. 398.2, which required multistate corporations to apportion income to Alabama either by separate geographical accounting, or, if the Department deemed that separate accounting did not accurately reflect the corporation's income attributable to Alabama, by the average of the three factors of property, the cost of manufacturing, etc. (a variation of the payroll factor), and sales.[5] The Department readopted Reg. 398.2 in 1952 and again in 1960 without material change.

The 1935 Act also allowed corporations an interest deduction computed using the gross income ratio. Code 1935, §402. The Department at some point adopted Reg. 402.2 relating to deductions allowed foreign corporations. That regulation in substance required foreign corporations to apportion their deductions to Alabama in the same manner as they apportioned income to Alabama pursuant to Reg. 398.2.[6] The Department readopted Reg.

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[4] Alabama had earlier enacted an income tax in 1919. Act No. 328, Acts of 1919. That law was declared unconstitutional in 1920. *Eliasberg Bros. Mercantile Co. v. Grimes*, 204 Alabama 493.

[5] The earliest copy of Reg. 398.2 I can locate is a copy of the regulation dated September 24, 1943.

[6] The earliest copy of Reg. 402.2 I can locate is in the Department's 1952 regulation booklet.

402.2 in 1952 and again in 1960 without material change. Those versions of the regulation did not mention the gross income ratio, or otherwise specifically address how the interest deduction should be computed.

Alabama enacted the MTC in 1967. Acts 1967, No. 395. The MTC established a fair and uniform system for taxing multistate corporations. At the heart of the MTC are the uniform allocation and apportionment rules established in the late 1950's in the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Those rules do not rely on the geographical sourcing of income and deductions. Rather, UDITPA requires that a multistate corporation's business-related income and deductions, including its business-related interest expense, must be apportioned among the various states in which the corporation does business pursuant to an equal-weighted three-factor formula of property, payroll, and sales.[7] Nonbusiness related income and deductions are allocated directly to a single state, usually to the corporation's state of commercial domicile or the state in which the income producing property is located.

Although enacted in 1967 and included as part of Alabama's Revenue Code, the Revenue Department did not formally recognize the MTC until 1993. See, *State, Dept. of Revenue v. MGH Management, Inc.*, 627 So.2d 408 (Ala. Civ. App. 1993). The Department did, however, amend Reg. 398.2 in September 1967 to in substance adopt the uniform MTC allocation and apportionment rules. The 1967 amendment to Reg. 398.2 read in part – "The State of Alabama, recognizing the need for a uniform method of

[7] The U.S. Supreme Court has recognized the three-factor formula as "something of a benchmark against which other apportionment formulas are judged." *Container Corp. of America v. Franchise Tax Board*, 103 S.Ct. 2933, 2943 (1983).

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apportioning or allocating income to the various states by foreign corporations engaged in multistate operations, adopts by this regulation the uniform division of income recommended by the National Conference of Commissioners on Uniform State Laws (the UDITPA rules) . . . ." After adopting the UDITPA rules in 1967, Alabama no longer allowed a multistate corporation to use separate accounting, unless allocation and apportionment did not fairly reflect the corporation's business activities in the state. Code of Ala. 1975, §40-27-1, Art. IV., para. 18.

The Department readopted the Reg. 398.2 allocation and apportionment rules in 1971 and again in 1975. The regulation was renumbered as Reg. 31.2 in 1979, and again as Reg. 810-3-31-.02 in 1982. That regulation, which still applied the MTC allocation and apportionment rules first adopted by Alabama in 1967, was in effect during the years in issue.[8]

The Department also amended Reg. 402.2 to provide that a multistate corporation that apportioned income pursuant to the MTC apportionment rules in Reg. 398.2 must also apportion its deductions to Alabama in a manner that fairly reflected its net income attributable to Alabama. That amended version first appears in the Department's 1971 regulation booklet. Interestingly, as shown in the 1971 booklet, Reg. 402.2, as amended, also for the first time included a paragraph specifying that interest shall be apportioned to

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[8] The Department in substance repealed Reg. 810-3-31-.02 after the years in issue and enacted MTC Reg. 810-27-1-4-.01. That regulation, which is substantially similar to prior Reg. 810-3-31-.02, is currently in effect in Alabama.

Alabama using the statutory gross income formula. Reg. 402.2 was readopted in 1975 without material change. It was renumbered as Reg. 35.2 in 1979 (the same year that Reg. 398.2 was renumbered as Reg. 31.2). The 1979 version also no longer specified that the interest deduction shall be computed using the gross income ratio. Rather, it only stated that corporations required to apportion income pursuant to the MTC regulation shall also apportion deductions in like manner. Reg. 35.2 was renumbered as Reg. 810-3-35-.02 in 1982. That regulation, with changes in 1989 not relevant to this case, was in effect during the years in issue.

In 1969, the Alabama Legislature, pursuant to Acts 1969, Ex. Session, No. 24, p.55, added the following introductory paragraph to §402, Title 51, Code 1940 (currently, §40-18-35(a):

> In computing the net income of foreign corporations doing business in this state subject to the tax imposed by section 398 of this title (now 40-18-31), there shall be allowed as deductions the items described in the following numbered subdivisions of this section, but only if, and to the extent that, such items are referable to or arise in connection with income of such corporations arising from sources within the state of Alabama; the proper apportionment and allocation of deductions of such foreign corporations with respect to the income arising from sources within and without the state of Alabama shall be determined under the rules and regulations prescribed by the department of revenue; provided that in the case of foreign corporations doing business partly within and partly without Alabama where income is apportioned and allocated to Alabama the expense incurred by such corporation in connection with earning such income shall be apportioned to Alabama in such manner as shall fairly reflect the net income of the corporation attributable to its operations in Alabama. . . Subject to the limitations contained in the preceding sentence, there shall be allowed as deductions in computing the net income of corporations:

Turning to this case, as indicated, the Taxpayer computed its interest deduction on its amended 1993 and original 1994 Alabama returns using the gross income ratio specified in §40-18-35(2), as that statute read during those years. The mechanics of how

the Taxpayer computed the interest deduction is not readily apparent on the returns because the Alabama return form requires use of the three-factor formula, and does not provide a line or space on which the interest deduction can be separately computed using a gross income factor. In substance, the Taxpayer independently computed its income apportioned to Alabama using an interest deduction calculated by the gross income ratio. That independent calculation is shown on Taxpayer Ex. 1, concerning 1993, and Taxpayer Ex. 2, concerning 1994. The Taxpayer then claimed an interest adjustment on the actual returns sufficient to result in the same amount of income apportioned to Alabama on the returns as independently calculated on Taxpayer Exs. 1 and 2 using the gross income ratio.

Taxpayer Ex. 1 illustrates the Taxpayer's method concerning 1993. The Taxpayer's line 1 federal net income in 1993 was $28,716,639. The Taxpayer added back to that amount its total interest expense of $75,803,338, and made other minor adjustments not relevant to this case, to arrive at total net income of $103,276,623. That net income was multiplied by the Taxpayer's three-factor average of .002733 to arrive at income apportioned to Alabama, excluding the interest deduction, of $282,289. The Taxpayer then separately computed its Alabama interest deduction by multiplying total interest of $75,803,338 by its gross income (gross receipts) factor of .00702935. The resulting interest deduction of $532,848 was then subtracted from the income of $282,289 otherwise apportioned to Alabama, which resulted in Alabama apportioned income of -$250,559.

To arrive at the same negative income amount of its amended 1993 return, the Taxpayer claimed an interest expense adjustment of -$119,141,290 on Statement 1 of the amended return, which, when otherwise adjusted by items not relevant to this case,

resulted in a reconciliation adjustment of -$120,384,644 on line 2 of the amended return. That adjustment resulted in line 6 apportionable income of -$91,668,005. That amount was multiplied by the Taxpayer's three-factor ratio of .00273331 to arrive at income apportioned to Alabama of -$250,557.[9] As shown on Taxpayer Ex. 1, the Taxpayer claimed an Alabama interest deduction of $209,899 on its original 1993 return using the three-factor formula, and an Alabama interest deduction of $532,848 on its amended 1993 return using the gross income ratio.[10]

The Taxpayer argues that it is entitled to use the gross income ratio in §40-18-35(2) based on the Administrative Law Division's 1997 decision in *Alco Standard Corp. v. State of Alabama*, Inc. 94-335 (Admin. Law Div. 6/25/97).[11] The Administrative Law Division held

[9] The difference between the Alabama apportioned income of -$250,559 shown on Taxpayer Ex. 1 and the -$250,557 shown on the amended 1993 return is due to rounding. See, Taxpayer's Brief at 2. The Taxpayer computed its 1994 Alabama liability using the same method.

[10] The Department contends that the Taxpayer claimed an additional interest expense of $119,141,290 on its amended 1993 return, which is more than the total interest expense of $75,803,338 incurred by the Taxpayer in 1993. As explained, however, the $119,141,290 on Schedule 1 of the amended 1993 return was only a reconciliation adjustment that the Taxpayer used to back into the same Alabama apportioned income on line 8 of the amended return that it had arrived at independently on Taxpayer Ex. 1.

[11] *Alco Standard* not only addressed whether the gross income ratio controlled over the MTC and related regulations, but also how nonbusiness interest should be computed and added back to apportionable income. The nonbusiness interest issue is not relevant in this case because none of the Taxpayer's interest expense during the subject years was nonbusiness.

in *Alco Standard* that while the gross income ratio in §40-18-35(2) was contrary to the UDITPA/MTC apportionment provisions, it must be followed.

> The interest expense deduction should be simple to calculate. Alabama can only tax that portion of a foreign corporation's gross income from sources in Alabama. Code of Ala. 1975, §40-18-34. It follows that the corporation's interest expense deduction must "be apportioned to Alabama in such manner as shall fairly reflect the net income of the corporation attributable to its operations in Alabama." Section 40-18-35(a). The Department thus allocates and apportions a foreign corporation's income and expenses to Alabama under the generally accepted UDITPA/MTC rules adopted in Regs. 810-3-31.02 and 810-27-1-4. (footnote omitted). Those uniform rules properly allocate and apportion a corporation's income and expenses to Alabama, and specifically allow an interest deduction in proportion to the corporation's income derived from Alabama sources.
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> But the statutory gross income ratio set out in §40-18-35(a)(2) cannot be ignored, even though it is contrary to UDITPA. . . . Consequently, 100 percent of the Taxpayer's total interest expense must be apportioned to Alabama using the statutory gross income ratio, ...

Alco Standard, F.O.A.R. at 4, 5.

In deciding *Alco Standard*, the Administrative Law Division relied on the rule of statutory construction that if a "regulation is contrary to the plain language of a statute, the regulation must be rejected and the statute followed," *Ex parte City of Florence*, 417 So.2d 191 (1982). See, *Alco Standard*, O.P.O. at 4, 5.

After further review, I now believe that *Alco Standard* was incorrectly decided. It is true that if there is a conflict between a statute and a Department regulation, the statute must control. However, §40-18-35 itself mandated that the Department's regulations shall control the apportionment and allocation of deductions to Alabama. The introductory paragraph of §40-18-35, as it read during the years in issue, specified that – "The proper apportionment and allocation of deductions of such foreign corporations with respect to the income arising from sources within and without the state of Alabama shall be determined

under the rules and regulations prescribed by the department of revenue; . . ." The paragraph further provided that a foreign corporation shall be allowed deductions "only if, and to the extent that, such items are referable to or arise in connection with the income of (the corporation) arising from sources within the state of Alabama," and also that such deductions "shall be apportioned to Alabama in such manner as shall fairly reflect the net income of the corporation attributable to its operations in Alabama; . . ." Finally, and importantly, the paragraph concluded with the proviso that the specific deductions allowed therein, including the subparagraph (2) interest deduction, shall be "[s]ubject to the limitations contained" in the introductory paragraph.

The opening paragraph of §40-18-35 clearly provided that the Department's regulations shall control in the computation of deductions. As discussed, Reg. 810-3-31-.02 was in effect during the subject years and required the use of the MTC three-factor formula in apportioning income and deductions to Alabama. Reg. 810-3-35-.02(b) also specified that corporations required to apportion income to Alabama pursuant to Reg. 810-3-31-.02 must also apportion their deductions to Alabama pursuant to that regulation. Applying the above regulations, the Taxpayer's interest deductions in the subject years must be computed using the MTC three-factor formula.

The Taxpayer's use of a single gross receipts factor to compute its Alabama interest deduction in the subject years also would not fairly reflect its income-producing activities in Alabama in those years. For example, in 1993, the Taxpayer had an Alabama property factor of .117061 percent, a .0 percent payroll factor, and a sales or gross receipts factor of .702935 percent. Those three factors together provide an average apportionment factor of .273331 percent, which best reflects that part of the Taxpayer's total business activities

attributable to its operations in Alabama.[12] Obviously, the Taxpayer's use of the single gross receipts factor of .702935 percent would not fairly reflect that part of its overall activities attributable to Alabama because the Taxpayer's manufacturing and payroll costs incurred in producing the goods sold in Alabama would not be accounted for or represented in the formula.

Finally, the Department has consistently required corporations to allocate and apportion their income and deductions, including the interest deduction, to Alabama pursuant to the UDITPA rules since it incorporated those rules in Reg. 398.2 in 1967. The long-standing interpretation of a statute by an administrative agency charged with its enforcement, the Revenue Department in this case, must be given great weight. *Pilgrim v. Gregory*, 594 So.2d 114 (Ala. Civ. App. 1991). That rule of construction further confirms that the MTC three-factor formula must be used to compute the Taxpayer's interest deductions in the subject years.

The Department has requested that the Administrative Law Division increase the final assessments in issue by adding the negligence, frivolous return, and frivolous appeal penalties levied at Code of Ala. 1975, §§40-2A-11(c), (e), and (f), respectively. Those penalties are not appropriate, however, because the Taxpayer's position is based on the Administrative Law Division's decision in *Alco Standard*, which the Department did not appeal. Penalties are not appropriate under those circumstances.

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[12] The U.S. Supreme Court has recognized that the three-factor formula "has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. *Container Corp.*, 103 S.Ct. at 2949.

The issuance of this Order was delayed by an administrative oversight by the Administrative Law Division.[13] Consequently, a copy of this Opinion and Preliminary Order is being forwarded to the Department's Taxpayer Advocate with a recommendation that a taxpayer assistance order be issued abating the interest that has accrued beginning two months after the February 13, 2003 hearing in the case. Code of Ala. 1975, §40-2A-4(b)(1)c. Two months would have been a reasonable period within which the case could have been decided.

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

Entered May 4, 2004.

[13] The delay was due to the Judge's oversight, not his co-workers in the Administrative Law Division.