THE SHERWIN-WILLIAMS COMPANY 101 PROSPECT AVENUE, NW CLEVELAND, OH 44115-1075,	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
Taxpayer,	§	DOCKET NOS. BIT. 13-359 BIT. 11-741
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Sherwin-Williams Company ("Taxpayer") filed an amended 2007 Alabama income tax return on December 22, 2009 on which it claimed a refund of $51,574. The refund was based on the Taxpayer's adjustments to its federal income tax paid deduction on Schedule E, and its related members interest and intangible expenses on Schedule AB. The Revenue Department failed to either grant or deny the refund within six months. The refund was consequently deemed denied on June 22, 2010, see Code of Ala. 1975, §40-2A-7(c)(3).

The Taxpayer filed a revised amended 2007 return on September 15, 2011. That return again adjusted the Taxpayer's federal income tax paid deduction, and requested an additional refund of $51,085, or a total refund of $102,659. Also on September 15, 2011, the Taxpayer appealed to the Department's Administrative Law Division, now the Tax Tribunal, concerning the Department's deemed denial of the refund claimed on its amended 2007 return filed on December 22, 2009. That appeal was docketed as BIT. 11-741.

The Department filed an Answer in BIT. 11-741 on October 28, 2011, in which it indicated that it was still auditing the Taxpayer. It also requested that the case be held in

abeyance pending completion of the audit.[1] The request was granted.

The Department entered a final assessment against the Taxpayer for the tax years 2008 and 2009 on March 11, 2013. The Taxpayer timely appealed, and the case was docketed as BIT. 13-359. The dispute in that case concerned the proper computation of the domestic production activities deduction ("DPAD") claimed by the Taxpayer for the 2008 and 2009 tax years.

The Department filed its Answer in BIT. 13-359 on May 22, 2013. BIT. 11-741 and BIT. 13-359 were subsequently consolidated at the Department's request. The parties submitted a joint stipulation of facts on February 6, 2015. The stipulation specified that the only disputed issue was the calculation of the Taxpayer's DPAD for 2007, 2008, and 2009. The Tribunal subsequently directed the parties to file briefs on the issue.

On April 10, 2015, the Taxpayer filed Taxpayer's Motion to Supplement Notice of Appeal and Motion for Stay of Briefing. The Tribunal directed the Taxpayer to file its supplemental notice of appeal by May 15, 2015. The Taxpayer did so on that date.

The Taxpayer indicated in its supplemental notice of appeal that the IRS had audited it for 2008 and 2009. The Taxpayer agreed to the IRS audit results and subsequently filed amended 2008 and 2009 Alabama returns in December 2013 that incorporated the IRS audit adjustments.

The Department apparently audited the amended 2008 and 2009 returns and adjusted the Taxpayer's Alabama liabilities for those years. The Taxpayer contended that it did not receive the audit workpapers until March 13, 2015, and that after reviewing the workpapers it disputed the reduced federal income tax deductions allowed by the

[1] It is assumed that the audit concerned only the 2007 tax year.

Department in its audit concerning the three years in issue.

The Department asserted that the Taxpayer's supplemental appeal should be disallowed because the Taxpayer failed to timely appeal the Department's federal tax paid deduction adjustments. Additionally, the Department requested that, if the supplemental appeal was not dismissed, that the federal income tax deduction issue and the DPAD issue be bifurcated, with the DPAD issue being decided first.

The Tribunal held that the supplemental notice of appeal was proper. It also granted the Department's request for the Tribunal to bifurcate the issues, decide the DPAD issue first, and hold the federal income tax paid deduction issue in abeyance. The parties subsequently briefed the DPAD issue.

The Taxpayer is an Ohio corporation that primarily manufactures, distributes, and sells paint and paint-related products. The Taxpayer is the primary operating company of a group of related companies that files a consolidated tax return for federal income tax purposes. In tax years 2007, 2008 and 2009, the Taxpayer filed on a separate return basis for Alabama income tax purposes, as allowed by Alabama law.

Congress enacted a new federal income tax deduction in 2004 for income attributable to domestic production activities. 26 U.S.C. §199. The amount of the allowable DPAD in the tax years at issue is 6% of the lesser of (1) the qualified production activities income of the corporation or the corporate group for the subject tax year, or (2) the taxable income of the corporation or the corporate group (disregarding the DPAD) for the year. 26 U.S.C. §199(a)(1). The predecessor to the Tribunal, the Department's Administrative Law Division, held in *GKN Westland Aerospace, Inc. v. State of Alabama*, Docket BIT. 10-988 (Admin. Law Div. 7/25/2011), that the DPAD taxable income limitation

should be applied on a separate entity basis rather than a consolidated basis when a taxpayer filing a consolidated federal income tax return files on a separate entity basis in Alabama.

It is undisputed that a Taxpayer determines its Alabama tax by starting with federal taxable income calculated on a separate entity basis and adjusting that income pursuant to Code of Ala. 1975, §§40-18-34 and 35. Alabama taxable income is then determined by multiplying this adjusted federal taxable income, or apportionable income, by an apportionment factor determined under Chapter 27, Title 40, Code of Ala. 1975. The dispute in this case is the amount of taxable income upon which the limitation is based.

The Department argues that the DPAD limitation is computed using the Taxpayer's separate entity federal taxable income, the taxable income reported on Line 30 of a taxpayer's pro forma separate entity federal income tax return – a methodology upheld by the Administrative Law Division in *GKN*.

The Taxpayer argues that the DPAD limitation must apply to Alabama taxable income before allocation and apportionment – essentially, the Taxpayer argues that to calculate the deductions used to determine federal taxable income on Line 30 of the pro forma separate entity federal tax return, the limitation is calculated using Alabama taxable income. Specifically, the Taxpayer prepared a pro forma federal return on a separate entity basis without the consideration of the DPAD. The Taxpayer increased its federal taxable income, without consideration of the DPAD, by the adjustments required by §§ 40-18-34 and 35. It then used the resulting calculation to determine the federal DPAD limitation. The resulting limitation amount exceeded what the Taxpayer could have claimed as a deduction if it had filed as a separate entity with the IRS.

The Department correctly points out that the DPAD is allowed for Alabama purposes by using federal taxable income as the starting point for determining Alabama taxable income. There is no Alabama statute or Department regulation specifically addressing the calculation of the DPAD because the DPAD is not an Alabama deduction. Department Reg. 810-3-1.1-.01 does, however, address how to calculate adjustments to federal limitations.

The Taxpayer cites section (2) of the regulation in support of its position. That section provides that "when any gain, loss, income, basis, earnings and profits, or any other item is to be determined in accordance with the provisions of federal law (Title 26, United States Code or public law) which have been adopted by reference or otherwise, into Alabama law, such computations shall be applied in the manner provided in the pertinent federal laws and regulations, but shall be applied to the amount determined under Alabama law." The Taxpayer argues that section (2) of the regulation requires that a federal limitation must be applied to taxable income computed under Alabama law, and by that the regulation means Alabama's definition of taxable income.

The Department argues that "amounts determined under Alabama law" should be construed to mean that federal limitations such as the limitation on charitable contributions and the DPAD are to be applied to the amount of federal taxable income determined under Alabama law, and by that the regulation means as determined by the pro forma separate federal tax return required by Alabama law. I agree.

There is no statutory authority for the Taxpayer to calculate its DPAD by first calculating Alabama taxable income. When read in its entirety, Department Reg. 810-3-1.1-.01 requires that the federal limitation be calculated by using a taxpayer's separate

entity federal taxable income. Section (4) of the regulation entitled "Adjustments to Federal Limitations" provides the following: "certain fundamental differences in the calculation of federal taxable income and Alabama taxable income require that adjustments be made to the federal limitation before they can be used in the calculation of Alabama taxable income *as described below.*" (emphasis added) The adjustment is further described in subsection (a) and an example of the limitation calculation for purposes of charitable contributions follows.

> (a) Federal limitations calculated at the corporate consolidated group level and used in the calculation of consolidated federal taxable income for the corporate group, must be adjusted to reflect the fact that Alabama corporate taxpayers, ... must calculate Alabama taxable income on a separate-company basis. For this reason, federal limitations applicable in the calculation of Alabama corporate taxable income must be calculated on a separate-entity basis.
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> 1. Example. Contributing Corporation C, a member of a federal affiliated group filing a consolidated federal corporate income tax return, contributed $ to the American Red Cross, which is a qualifying charitable contribution under IRC §170(c) and is the group's only such charitable contribution that year. Contributing Corporation C has $20 of separate entity company taxable income before the contribution deduction, but the group has $200 of taxable income before the contribution deduction. Because the ten percent (10%) charitable contribution deduction limitation of IRC §170(b)(2) is calculated at the group level for corporations filing federal consolidated returns, Contributing Corporation C's contribution deduction is not limited for federal purposes. However, because *Alabama tax law requires separate company calculations*, for purposes of calculating Contributing Corporation C's Alabama taxable income only $2 ($20 x 10%) of the $10 contribution is deductible.

Department Reg. 810-3-1.1-.01(4). (e*mphasis added*)

Department Reg. 810-3-1.1-.01, read in its entirety, supports the Department's interpretation of its regulation that "amounts determined under Alabama law" means that federal limitations, such as the limitation on charitable contributions and the DPAD, are to

be applied to the amount of federal taxable income determined by the pro forma separate federal tax return required by Alabama law. Nowhere in this regulation are the federal limitations calculated in the manner proposed by the Taxpayer.

The manner proposed by the Taxpayer – to calculate Alabama taxable income in order to determine separate entity federal taxable income for purposes of the DPAD limitation – was not the methodology upheld by the Administrative Law Division in *GKN*. Further, if the regulation had intended, as the Taxpayer proposes, that the federal limitation be applied to Alabama taxable income, the example provided in subsection (4)(a)(1) would have provided that calculation. Instead, the example's calculation contemplates that the limitation be calculated using the Taxpayer's separate company taxable income before the expense. Nowhere does it say that, for purposes of determining federal limitations, taxpayers are to calculate Alabama taxable income in order to determine separate entity federal taxable income.

Further, the taxpayer's proposed methodology ignores the fundamental principle that the starting point for calculating Alabama taxable income is federal taxable income calculated on the federal form on a separate entity basis. The Department's interpretation of its regulation results in a reasonable methodology for calculating the DPAD limitation – a methodology upheld by the Administrative Law Division in *GKN.*

The methodology used by the Taxpayer to calculate the DPAD in this case is rejected. The parties are ordered to submit their briefs on the federal income tax paid deduction issue by December 30, 2016. Reply briefs should be filed by January 27, 2017. An appropriate Order will then be entered.

Entered November 30, 2016.

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BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
cc: David E. Avery, III, Esq.
Andrew W. Bernat