PLANTATION PIPE LINE CO. 900 SHELBY COUNTY ROAD 62 E. HELENA, AL 35080,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. CORP. 05-948
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department audited Plantation Pipe Line Company ("Taxpayer") for 1999, 2000, and 2001 corporate income tax. It determined that the Taxpayer owed $159,996 in additional 2000 tax. It subsequently assessed the Taxpayer for the 2000 tax due, plus interest of $39,127 computed from the March 15, 2001 due date of the tax. The Department also eliminated the payroll factor from the Taxpayer's 2001 apportionment formula, which reduced the refund due the Taxpayer for that year.

The Taxpayer timely appealed to the Administrative Law Division. The appeal raised two issues: (1) did the Department correctly eliminate the payroll factor from the Taxpayer's 2001 apportionment formula; and (2) does the Taxpayer owe interest on the additional tax due for 2000.[1] A hearing was conducted on February 23, 2006. Roy Crawford and Brian Wilson represented the Taxpayer. Assistant Counsel Jeff Patterson

[1] The Administrative Law Division docketed the case as an appeal of a final assessment concerning 1999, 2000, and 2001 because the Taxpayer's notice of appeal stated that the final assessment involved those years. As indicated, however, the Department only entered a final assessment concerning the 2000 tax year. Consequently, the appeal should have been docketed as an appeal of the 2000 final assessment, and also an appeal of a reduced or partially denied refund of 2001 tax. In any case, the Administrative Law Division has subject matter jurisdiction, and will decide both issues in this Order.

represented the Department.

Issue (1) The Payroll Factor.

FACTS

The Taxpayer is an interstate petroleum pipeline company that conducts business in Alabama and numerous other states. The Taxpayer is owned by three entities – an affiliate of ExxonMobil Pipeline Company ("Exxon"), Kinder Morgan Operating L.P. "D" ("KMLP-D"), and Kinder Morgan Operating L.P. "A" ("KMLP-A").

The Taxpayer entered into an Operations and Reimbursement Agreement with Plantation Services, LLC ("PS LLC") in December 2000. PS LLC is wholly owned by Exxon and KMLP-D. The Agreement required PS LLC to perform all of the Taxpayer's operational and administrative functions. PS LLC thereafter subcontracted for KMLP-D to actually perform those functions for the Taxpayer beginning in 2001.

Pursuant to the above Agreement, the Taxpayer transferred all of its employees to KMLP-D, effective January 1, 2001. Those employees thereafter continued to perform the same operational and administrative functions and services for or on behalf of the Taxpayer in Alabama and elsewhere as they had performed as direct employees of the Taxpayer before 2001.

The Taxpayer paid $878,395 to KMLP-D in 2001 for the services performed by the transferred employees in Alabama. It reported that amount as the numerator, i.e., its "Alabama payroll," in the payroll factor on its 2001 Alabama return. It also included the amount in the payroll factor denominator. The Taxpayer consequently reported a 2001 payroll factor of 7.7379 percent. It had previously reported payroll factors of 6.1614 percent and 6.6165 percent on its 1999 and 2000 Alabama returns, respectively.

On audit, the Department eliminated the payroll factor from the Taxpayer's 2001 apportionment formula. It thereafter apportioned the Taxpayer's 2001 income to Alabama using only the property and sales factors. The Department cited Dept. Reg. 810-27-1-4-.09 in support of its position. That regulation states in part – "If any factor is not utilized in the production of business income, it shall be eliminated and the denominator reduced accordingly." The Department audit report further stated that "[s]ince taxpayer had no employees during CY2001 and the payroll factor is not utilized in the production of business income, the payroll factor is eliminated from the apportionment formula and the denominator reduced accordingly." Eliminating the payroll factor reduced the refund otherwise due the Taxpayer for 2001.

ANALYSIS

Multistate corporations doing business in Alabama are required to allocate and apportion their income to Alabama pursuant to the Multistate Tax Compact ("MTC"). Code of Ala. 1975, §40-27-1, et seq. See generally, *State, Dept. of Revenue v. MGH Mgt., Inc.*, 627 So.2d 408 (Ala. Civ. App. 1993). The MTC requires multistate corporations to apportion their business-related income and deductions among the various states in which they do business pursuant to an equal-weighted three-factor formula of property, payroll, and sales (gross receipts). 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). "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*, 103 S.Ct. at 2949. Payroll is an essential factor in

the formula because it recognizes the contributions a corporation's employees make in producing goods and/or providing services, and thereby generating income for the corporation.

The Administrative Law Division previously addressed the issue of whether compensation paid for loaned or leased employees should be included in a taxpayer's payroll factor in *C&D Chemical Products, Inc. v. State of Alabama*, Corp. 00-288 (Admin. Law Div. 2/9/01). C&D Chemical owned a partnership that operated in Alabama using loaned employees provided by a related corporation. The partnership in turn compensated the related corporation for the cost of the employees. C&D Chemical included the compensation paid for the loaned employees in its Alabama payroll factor. As in this case, the Department removed the compensation from the payroll factor because the employees were not direct employees of the partnership.

The Administrative Law Division rejected the Department's position, holding that the amounts paid for the loaned employees were properly included in the payroll factor. The relevant portion of the holding in *C&D Chemical* is set out below:

> Relating to the payroll factor, Reg. 810-27-1-4-.13(a)(3) provides that the "term 'compensation' means wages, salaries, (etc.) paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded. Only amounts paid directly to employees are included in the payroll factor." Reg. 810-27-1-4-.13(a)(4) defines "employee" in part as "any individual who, under the usual common law rules applicable in determining the employer/employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if he is included by the taxpayer as an employee for purposes of the payroll taxes . . ."
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> I agree that the C&D and (the related corporation's) employees that performed services for the Partnership were not employees of the Partnership within the scope of the Department's regulation. But a regulation must comply with the statute to which it relates, and cannot enlarge or add to the language of the statute. *Ex parte Uniroyal Tire Co.*, 2000 WL 1074041

(Ala. 2000). The ultimate question thus is whether the Department's regulation is consistent with the language and purpose of the statute it interprets.

Alabama law defines the "payroll factor" as "a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the tax period." Section 40-27-1, Art. IV, ¶13. That statute does not require that the compensation must be paid to an employee. Further, "compensation" is defined as "something given or received as payment or reparation, as for a service . . ." *American Heritage Dictionary*, 2nd College Edition, at 301. That definition also does not require that compensation must be something paid to an employee. Consequently, the amounts paid by the Partnership for the services provided by the C&D and (the related corporation's) employees constituted "compensation paid" within the scope of the statute, and should be included in the payroll factor. The regulations are rejected to the extent they conflict with that finding. (footnote omitted)

The above result was also reached in *Cincinnati, New Orleans and Texas Pacific Railway Co. v. Kentucky Dept. of Revenue*, 684 S.W.2d 303 (Ky. App. 1984). In that case, a parent corporation's employees performed services for a subsidiary. The subsidiary reimbursed the parent for the cost of the employees' services. The Kentucky Court of Appeals held that the subsidiary should include the indirect compensation in its payroll factor.

> The purpose of (Kentucky's apportionment statute) is to adopt a formula to determine the business income attributable to activity in Kentucky. To include the compensation of the employees in the formula of the (subsidiary) for whom service was performed would promote this purpose.

Cincinnati, New Orleans, 684 S.W.2d at 305.

A statute must also be construed to satisfy its intent and purpose. *Gulf Coast Media, Inc. v. The Mobile Press Register, Inc.*, 470 So.2d 1211 (1985). The purpose of factor apportionment is to fairly divide the income of a multistate corporation between the various states in which it does business. "Formula apportionment is a device for dividing the income of a corporation among States through determining the proportionate location of certain income-producing activities." *Report of Special Subcommittee on State Taxation*, infra, Vol. 1 at 194. A fair apportionment formula insures that a state taxes only that part of "a corporation's income that is 'reasonably related to the (corporation's) activities conducted in the taxing state.'" *Exxon Corp. v. Wisconsin Dept. of Revenue*, 100 S.Ct. 2109, 2120 (1980), citing *Moorman Mfg. Co. v. Bair*, 98 S.Ct. 2340, 2341 (1978). Payroll is included in the

> formula because the activities of a corporation's employees directly contribute to the production of apportionable business income.
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> Substance over form must govern in tax matters. (footnote omitted) *EZY Rental, Inc. v. Dept. of Revenue*, F. 96-401 (Admin. Law Div. 5/8/97); *Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala. Civ. App. 1994); *Boswell v. Paramount Television Sales, Inc.*, 282 So.2d 892 (Ala. 1973). For apportionment purposes, there is no substantive difference between an employee of a corporation and a non-employee that performs the same services as an employee. Both contribute to the production of income. Consequently, including the C&D and (related corporation's) employees in the Partnership's payroll data is necessary to accurately determine what part of the Partnership's income was attributable to Alabama. (footnote omitted)
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> Limiting the payroll factor to only compensation paid directly to employees also allows a corporation to manipulate the factor. For example, the Partnership could hire several employees outside of Alabama in lieu of using several C&D shared employees. The Partnership would then have a payroll, and unquestionably the Taxpayer would be allowed an Alabama payroll factor. But because the (related corporation's) employees that operate the Partnership's Alabama facility would not be recognized, the Taxpayer would have a zero Alabama payroll numerator, and thereby reduce its Alabama liability. Such manipulation would be prevented if states required corporations to include in the payroll factor all compensation paid to employees, independent contractors, shared employees, etc. that contribute to the production of business income.

C&D Chemical at 5 – 9.

The above rationale also applies in this case.[2] The individuals that performed the Taxpayer's operational and administrative functions in 2001 were the same individuals that performed those duties as direct employees of the Taxpayer in prior years. The Taxpayer correctly included the compensation paid directly to the individuals in its Alabama payroll factor in the prior years. It should also include the compensation it paid for the same

[2] The Department applied for a rehearing in *C&D Chemical*. The parties subsequently settled the case pursuant to a Closing Agreement in which C&D Chemical agreed that it was not entitled to a payroll factor in the subject years. However, C&D Chemical entered into the agreement for settlement purposes only. Consequently, the underlying rationale of *C&D Chemical* is still valid.

employees to perform the same functions in its payroll factor in 2001. The employees contributed to the Taxpayer's production of business income in 2001 the same as they did in the prior years. The goal of factor apportionment is to accurately attribute to a state that portion of a corporation's income-producing activities that occur in the state. In this case, the Taxpayer's income producing activities would be most accurately identified and attributed to Alabama only if the compensation paid by the Taxpayer for the transferred employees is included in its Alabama payroll factor.

Professor Walter Hellerstein addresses "loaned" employees and the payroll factor in his leading treatise on state and local taxation. See, J. Hellerstein & W. Hellerstein*, State Taxation,* ¶9.17(1) (3rd ed. 2000). Specifically, Professor Hellerstein discusses the *Cincinnati*, *New Orleans* case, which was relied on by the Administrative Law Division in *C&D Chemical*. As discussed, in that case a subsidiary corporation reimbursed its parent corporation for the work performed by the parent's employees on behalf of the subsidiary. The Kentucky Court of Appeals held that the indirect compensation paid by the subsidiary to the employees should be included in the subsidiary's payroll factor. Professor Hellerstein agrees that the holding in *Cincinnati, New Orleans* "is consonant with the policy underlying the payroll factor, which is to assign a taxpayer's income to the states in which it employs labor to generate income." *State Taxation* at ¶9.17(1).

Hellerstein questions the holding in *Cincinnati, New Orleans*, however, because it is not strictly faithful to the language in UDITPA, i.e., the compensation is not paid directly by the taxpayer. He thus concludes that the holding should be limited to situations in which "(1) there is common control of the taxpayer who pays the employee and the taxpayer for whom the labor is performed, and (2) the 'lending' taxpayer does not profit from making its

employees available to others." *State Taxation* at ¶9.17(1). That is the situation in this case. All parties involved were related or commonly owned and controlled, and there is no indication that the lending entity, KMLP-D, profited from the arrangement.

The Administrative Law Division also held in *C&D Chemical* that even if the compensation paid for the loaned employees could not technically be included in a payroll factor, an alternative "compensation" factor should be employed pursuant to MTC §18, Code of Ala. 1975, §40-27-1, Art. IV, ¶18.

> Even if the payroll factor regulations are followed, and the Taxpayer's payroll factor is eliminated, the Taxpayer would be entitled to relief under §40-27-1, Art. IV, ¶18. That statute provides that if the MTC apportionment provisions "do not fairly represent the extent of the taxpayer's business activity" in Alabama, the taxpayer may use an alternative factor, or any other method that fairly apportions its income to Alabama. Section 40-27-1, Art. IV, ¶18(c) and (d).
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> Use of only the property and sales factors would not fairly reflect the Partnership's activities in Alabama because the income producing activities of the C&D and (related corporation) employees would be ignored. Consequently, the Partnership should be allowed an alternative factor pursuant to ¶18 based on the compensation paid by the Partnership for those employees. The net effect would be an alternative factor that is identical to the payroll factor rejected by the Department. But only through use of an alternative "compensation" factor would the Partnership's income producing activities in Alabama be fairly reflected.

C&D Chemical at 10.

Ironically, the Department cites MTC §18 as grounds for excluding the Taxpayer's payroll factor. "The Department's authority for excluding Plantation's payroll factor is found in §40-27-1, Article IV, paragraph 18." Department's Brief at 4. Paragraph 18(b) does allow for the exclusion of one or more of the three factors, but only if the factor or factors "do not fairly represent the extent of the taxpayer's business activity in this state. . . ." That is not the situation in this case. The labor performed by the transferred employees on

behalf of the Taxpayer in Alabama in 2001 clearly represented or reflected the Taxpayer's business-related activities in Alabama in that year. The compensation paid by the Taxpayer for that labor should thus be included in its 2001 payroll factor.

Finally, the Department does not dispute the 6.1614 and 6.6165 payroll factors reported by the Taxpayer on its 1999 and 2000 returns, respectively, which reflected the compensation paid to the employees in those years. Those employees, although technically transferred to another entity, performed the same business-related functions for the Taxpayer in 2001 as in the prior years. Consequently, the comparable 7.7379 percent payroll factor claimed in 2001 also fairly represented the Taxpayer's employee-related business activities in Alabama in that year.

Issue (2) Is Interest Due on the 2000 Liability?

FACTS

The Taxpayer paid a total of $354,382 in 2000 estimated tax before the March 15, 2001 due date of the 2000 return. $23,061 of that amount was an overpayment applied from 1999. The balance of $331,321 was paid when the Taxpayer applied for an extension to file its 2000 return.

The Taxpayer subsequently filed its 2000 return on October 2, 2001 (receipt date) and reported tax due of $194,386. The Taxpayer indicated on line 19a of the return that the reported overpayment of $159,996 (estimated tax paid of $354,382 less reported tax due of $194,386) should be credited to its 2001 estimated tax, as allowed by Dept. Reg. 810-3-83.02(4). The Taxpayer later claimed the $159,996 as a credit on its 2001 return, which resulted in a refund of $67,243 paid to the Taxpayer for that year.

The Department determined per its audit in 2005 that the Taxpayer's correct 2000 liability was $353,777, not the $194,386 reported on its 2000 return. It consequently assessed the Taxpayer for additional tax due of $159,391, plus interest of $39,127 computed from the March 15, 2001 due date of the tax.

The Taxpayer concedes that it owes the $159,391 in additional 2000 tax. It argues, however, that it does not owe interest on that amount. It contends that because it paid a total of $354,382 in 2000 estimated tax before the March 15, 2001 due date, it timely paid in full the final amount due for the year of $353,777. It thus contends that there was no underpayment on which interest is required pursuant to Code of Ala. 1975, §40-1-44.

The Department counters that when the Taxpayer elected on its 2000 return to have the reported overpayment of $159,996 credited to its 2001 estimated tax, that amount became a payment for the 2001 tax year, and thus cannot be treated as applying to the 2000 tax year. The Department consequently claims that the Taxpayer owes interest on the additional tax due for 2000, computed from the original March 15, 2001 due date of the tax. Neither party is entirely correct.

ANALYSIS

Section 40-1-44(a) requires that taxpayers must pay interest on any amount not paid by the due date.[3] That section recognizes the time value of money, and thus requires a taxpayer that is holding or using money that rightfully belongs to the State to pay interest

[3] Section 40-1-44(b)(1) also requires that the Department must pay taxpayers interest on any overpayment from the date the tax is overpaid. The same interest rate applies to both overpayments and underpayments. See, §40-1-44(b)(1).

for the use of that money.

The estimated tax of $354,382 paid by the Taxpayer by the March 15, 2001 due date was sufficient to pay in full the Taxpayer's ultimate 2000 liability of $353,777. Consequently, there was no underpayment of 2000 tax at that time on which interest accrued pursuant to §40-1-44. However, when the Taxpayer filed its 2000 return on October 2, 2001, it applied a portion of the estimated 2000 tax, i.e., the reported overpayment of $159,996, as a credit toward its 2001 estimated tax. That amount thus became a payment toward the Taxpayer's 2001 liability at that time. Such election, once made, is irrevocable. See, Reg. 810-3-83.02(4). The Taxpayer's election to apply a portion of the 2000 estimated tax to its 2001 liability in substance created an underpayment of the Taxpayer's 2000 liability in the amount of $159,391. The Taxpayer concedes that the $159,391 is due and unpaid. The Taxpayer thus owes interest on that amount from October 2, 2001, the date the underpayment occurred or was created when the Taxpayer applied the $159,996 to its 2001 liability.

It could be argued that the Taxpayer should not be required to pay interest because the Department had possession and use of the entire $354,382 in 2000 estimated tax from the March 15, 2001 due date. However, the Taxpayer subsequently "used" a part of the money when it applied the $159,996 as a credit to its 2001 liability. By diverting that money to pay its 2001 liability, the Taxpayer ultimately received a refund for 2001. The Taxpayer cannot apply the 2000 estimated tax in full to pay its 2000 liability, and also apply a part of the estimated tax as a credit toward its 2001 liability. Rather, as indicated, when the Taxpayer elected on its 2000 return to apply a portion of the estimated tax to its 2001 liability, that portion ceased being a payment of 2000 tax, which in turn created an

underpayment for that year. Interest is thus due on the underpayment from the date the election was made, October 2, 2001.[4]

The Department is directed to recompute the Taxpayer's 2001 refund by allowing the payroll factor claimed on its 2001 Alabama return. The Department should also recompute the interest owed by the Taxpayer for 2000 as indicated herein. 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 May 23, 2006.

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BILL THOMPSON
Chief Administrative Law Judge

[4] The Taxpayer could have elected on its 2000 return for the Department to issue it a refund of the $159,996 "overpaid" in 2000. It elected not to, and instead applied the overpayment to its 2001 liability. By doing so, the Taxpayer in effect gave the Department the interest-free use of the money, which every taxpayer does when tax is withheld or paid in quarterly estimates, or, as here, an overpayment on a return is voluntarily applied as an estimate to a subsequent liability.