RHEEM MANUFACTURING CO., INC. 405 LEXINGTON AVENUE NEW YORK, NY 10174-0307	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NOS. F. 00-132A F. 00-174A F. 00-175A
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

These appeals involve contested franchise tax refunds requested by Rheem Manufacturing Company, Inc. for 1994 through 1999.[1] Rheem had filed a prior appeal in March 1998 concerning the Department's denial of Rheem's petition to use an alternative franchise tax apportionment method for 1998, as provided at Code of Ala. 1975, §40-14-41(c)(3). That appeal was docketed as F. 98-208, and a hearing was conducted in the case on August 11, 1998. However, before the case was decided, all franchise tax appeals pending before the Administrative Law Division were held in abeyance pending a decision by the U.S. Supreme Court in a case challenging the constitutionality of Alabama's foreign franchise tax.

The U.S. Supreme Court ruled in 1999 that Alabama's foreign franchise tax was unconstitutional. *South Central Bell Telephone Co., et al. v. Alabama, et al.*, 119 S.Ct. 1180 (1999). On May 17, 2002, the Alabama Supreme Court decertified and dismissed for lack of subject matter jurisdiction a class action involving franchise tax refunds. *Michael L. Patterson v. Gladwin Corp.*, 835 So.2d 137 (Ala. 2002). The Court held in *Gladwin* that to obtain a refund, a taxpayer must first comply with the administrative procedures specified in

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[1] Alabama's franchise taxes on both foreign and domestic corporations were repealed by
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the Uniform Revenue Procedures Act ("URPA"), Code of Ala. 1975, §40-2A-7, et seq.

While *Gladwin* was pending in the Alabama Supreme Court, Rheem appealed to the Administrative Law Division in January 2000 concerning the Department's denial of franchise tax refunds for 1994, 1995, and 1996. That appeal was docketed as F. 00-132, and was held in abeyance pending a final decision in *Gladwin*.

In February 2000, Rheem filed appeals with the Administrative Law Division concerning the Department's denial of franchise tax refunds for 1997 and 1998. The appeals were docketed as F. 00-174 and F. 00-175, respectively, and were also held in abeyance pending *Gladwin*. (As indicated, F. 98-208 involved the Department's disallowance of Rheem's petition for use of an alternative apportionment method for 1998.)

In September 2001, Rheem appealed to the Administrative Law Division concerning the Department's denial of a franchise tax refund for 1999. The appeal was not separately docketed. Rather, the Administrative Law Division entered a Second Preliminary Order in Docket Nos. F. 00-132, F. 00-174, and F. 00-175 on September 14, 2001 indicating that Rheem "has amended the appeal to include a denied refund of 1999 franchise tax. The case will continue to be held in abeyance."[2]

Act 99-665, effective for all tax years beginning after December 31, 1999.

[2] In hindsight, the Administrative Law Division should have docketed the 1999 appeal as a separate appeal. The Second Preliminary Order also did not indicate which prior appeal was being amended. It is clear, however, that Rheem appealed concerning the denied 1999 refund, and that the appeal was consolidated with one or all of the pending Rheem appeals.

As indicated, the Alabama Supreme Court ruled in *Gladwin* that to obtain a franchise tax refund, a foreign corporation must comply with the appeal procedures in URPA. Over 500 corporations had filed protective appeals with the Administrative Law Division pending the *Gladwin* case. After *Gladwin* was decided, all of the franchise tax appeals pending before the Administrative Law Division, including the Rheem appeals in issue, were administratively transferred for handling to the Attorney General's Administrative Hearings Division in March 2003.

All foreign corporations that filed protective appeals with the Administrative Law Division, including Rheem, contend that they are entitled to refunds in full because the U.S. Supreme Court declared the foreign franchise tax unconstitutional. However, Rheem also raised various non-constitutional issues in its appeals concerning the use of an alternative apportionment formula and the applicability of push-down accounting. In January 2004, Rheem petitioned for those non-constitutional issues to be severed from the constitutional issues and transferred back to the Administrative Law Division. The petition was granted, and the cases were returned to the Administrative Law Division for a decision on the non-constitutional issues.[3]

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[3] For administrative purposes, the non-constitutional issues that were severed and transferred back to the Administrative Law Division have been redocketed as separate appeals. The non-constitutional issues relating to 1994, 1995, and 1996 have been docketed as F. 00-132A. Those issues relating to 1997 have been docketed as F. 00-174A, and those relating to 1998 have been docketed as F. 00-175A. The non-constitutional issues relating to 1999 are also included in the redocketed appeals. The original appeals, Docket Nos. F. 00-132, F. 00-174, and F. 00175, now involve only the constitutional issues, and if necessary, will be heard and decided by the Attorney General's Administrative Hearing Division in due course.

The Administrative Law Division consolidated Rheem's appeals, and a pre-hearing conference was conducted on March 8, 2004. The parties agreed at the conference that the applicability of push-down accounting was the overriding issue, and thus should be decided first. The parties agreed to submit the matter on a joint stipulation of facts. They also filed briefs, reply briefs, and proposed Orders in the case.

ISSUE

This Order addresses the applicability and effect of push-down accounting. The specific issue is whether the push-down of $593,899,000 in goodwill to Rheem's financial statements for financial accounting purposes resulted in an increase in Rheem's capital base for Alabama franchise tax purposes.

FACTS

Rheem is a diversified manufacturing company principally engaged in the manufacture and sale of air conditioning and heating equipment and water heaters. Rheem has manufacturing facilities in several states, including Alabama.

On April 7, 1988, all the capital stock of PACE Industries, Inc., a Delaware corporation and Rheem's corporate great-grandparent ("PACE"), was acquired by Paloma Industries Limited, a Japanese corporation ("Paloma"). Rheem was the operating company in the "PACE Group," with each of PACE, PACE Group Holdings, Inc. (first tier subsidiary), and PACE Group, Inc. (second tier subsidiary) being non-operating holding companies. The acquisition of all of the capital stock of PACE by Paloma was accomplished via a cash merger of Paloma Acquisition Corporation, a Delaware corporation and a subsidiary of Paloma ("Paloma Acquisition"), with and into PACE, with PACE being the surviving

corporation. Before and after the acquisition of PACE by Paloma, both Paloma and the PACE Group were privately owned companies and were not required to register or file with the Securities and Exchange Commission.

All of the merger consideration, approximately $900,000,000 in cash, was paid to PACE's shareholders, warrant holders, and debenture holders to repay bank debt owed by PACE. None of the merger consideration was paid to Rheem. For both accounting and tax purposes, the merger was treated as a purchase of PACE stock by Paloma. The merger consideration greatly exceeded both the book value and the fair market value of Rheem's operating assets on the date of the acquisition, which were $377,669,000 and $390,595,000, respectively.

Pursuant to Paragraphs 66 through 96, inclusive, of Opinion 16 of the Accounting Principles Board ("APB 16"), which was the prevailing accounting rule governing the acquisition on April 7, 1988, the acquisition of the capital stock of PACE by Paloma was accounted for pursuant to the "purchase method of accounting." Specifically, the merger consideration was first allocated to Rheem's operating assets in amounts equal to their fair market values, with the excess over the aggregate fair market values of the operating assets - $593,899,000 – being allocated to goodwill. APB 16, ¶87.

Paragraph 87 of APB 16 provides that "all identifiable assets acquired [Rheem's operating assets], either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company [PACE], should be assigned a portion of the cost of the acquired company, normally equal to their fair market values at date of acquisition." Paragraph 87 of APB 16 further provides

that "the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets less liabilities assumed should be recorded as goodwill." Although APB 16 required that the excess purchase price be recorded as goodwill on the financial statements of the acquiring entity, neither APB 16 specifically, nor generally accepted accounting principles ("GAAP") generally, required Paloma or PACE to "push down" the resulting goodwill to the books of Rheem. Since "push-down" accounting was not required under GAAP, the use thereof with regard to the goodwill created by the acquisition of PACE's capital stock by Paloma was optional, not mandatory.

Nonetheless, for preparation of its financial statements, Paloma/PACE chose to use "push-down" accounting with regard to the goodwill created by the acquisition of the PACE capital stock by Paloma. As a result of Paloma/PACE's decision to apply push-down accounting, $593,899,000 of goodwill instantly appeared on Rheem's balance sheet. However, the $593,899,000 increase to goodwill on Rheem's balance sheet was not the result of, nor did it result in, Rheem receiving an additional dollar of "hard assets" on its balance sheet.

ANALYSIS

Code of Ala. 1975, §40-14-41(b), as amended by Ala. Act 95-564[4], provides that "capital," as defined by that section for Alabama franchise tax purposes, shall be "determined in accordance with generally accepted accounting principles appropriate in the particular case, as promulgated by the Financial Accounting Standards Board or a similar

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[4] Section 6 of Ala. Act 95-564 provides, in pertinent part, that "[t]he amendments to Section 40-14-41(b), Code of Alabama 1975, relating to the use of Generally Accepted Accounting Principles in the determination of total capital and useful lives of assets . . . are retroactively

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or successor agency or board . . . ." The American Institute of Certified Public Accountants ("AICPA") has defined GAAP as follows:

> The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

AICPA Professional Standards §411.02.

The AICPA further instructs that GAAP "recognizes the importance of reporting transactions and events in accordance with their substance." *Id.* §411.06.

Rheem contends that GAAP did not require the creation of $593,899,000 of goodwill on its books as the result of Paloma's acquisition of PACE. Rheem notes that GAAP, as it stood on the date of the merger (April 7, 1988) and during the tax years here at issue (1994 through 1999), did not address push-down accounting, much less require its use. Task Force, Push Down Accounting ¶5, at 4 (1979) ("The authoritative accounting literature contains no specific requirement relating to push down accounting. The Accounting Principles Board (APB), in APB Opinion 16, 'Business Combinations,' did not address push down accounting in the separate financial statements of acquired entities . . . .").

Rheem further asserts that the Financial Accounting Standards Board's Emerging Issues Task Force likewise found in 1986 that "[t]he Task Force reached a consensus that push-down accounting is not required for companies that are not SEC registrants." EITF Issue 86-9. Neither Paloma nor the PACE Group are SEC registrants.

Rheem also notes that the relevant accounting conventions, rules, and procedures

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effective for all open tax years."

did not provide whether "the new accounting basis recorded in the financial statements of the acquiring entity [should] also be recognized in any separate financial statements of the acquired entity[.]" *Id* ¶3.a, at 2. Addressing APB 16, the Task Force found:

> APB Opinion 16, "Business Combinations," establishes the principle that when an entity purchases the business of another entity, a new cost basis, based on the exchange transaction, is established for the assets and liabilities of the acquired entity in the consolidated statements of the acquirer. The Opinion also provides principles for the acquiring entity to assign values to the assets and liabilities of the acquired entity, but it does not address whether those new values should be reflected in the separate statements of the acquired entity . . . .

Id. ¶6, at 4 (emphasis added); see APB 16, ¶87.

Based on the foregoing accounting authorities, I agree that GAAP did not require the push-down of the goodwill created as the result of the acquisition to the separate financial statements of PACE, or the further push-down of the goodwill to the separate financial statements of Rheem. *Speedring, Inc. v. State of Alabama*, F. 95-237 & F. 95-288 (Admin. Law Div. 4/26/96) ("'Push-down' accounting is not required under GAAP, but may be used at the option of the taxpayer."). Because push-down accounting was not required by GAAP as of the date of the Paloma acquisition of PACE and at all relevant times thereafter, it necessarily follows that GAAP did not require that the $593,899,000 of goodwill created on the financial statements of Paloma as the result of its acquisition of PACE, be pushed down onto the separate financial statements of Rheem, a third tier subsidiary of the acquired entity.

Even if GAAP had required Paloma and/or PACE to push down the goodwill to the separate financial statements of Rheem, Rheem's §40-14-41(b) capital still would not include such goodwill, for it is the substance of the transaction, not how it is mechanically

accounted for, that controls for Alabama franchise tax purposes.

> The Department necessarily must rely on a foreign corporation's financial statements in determining capital employed in Alabama. However, if the true nature of an account or other item on a financial statement is established as something other than capital, as that term is defined in §40-14-41(b), then the true nature of the account must govern.

Weavexx Corp. v. State of Alabama, No. F. 94-300 (Admin. Law Div. 1/16/96); see *Pechiney Corp. v. State of Alabama*, F. 96-106 (Admin. Law Div. 1/16/97) ("The Department must necessarily rely on a foreign corporation's financial statements in determining the corporation's capital base for franchise tax purposes. However, substance over form must govern in tax matters . . . ."), citing *Magnolia Methane v. State Dep't of Revenue*, 676 So.2d 341 (Ala. Civ. App. 1996), *State Dep't of Revenue v. Acker*, 636 So.2d 470 (Ala. Civ. App. 1994), and *Weavexx Corp.*, *supra*.

This result is consistent with the mandate of GAAP that for accounting purposes, the substance of a transaction, rather than its form, should govern. AICPA Professional Standards §411.06. Moreover, in requiring that GAAP be applied as is "appropriate in the particular case," §40-14-41(b) codified the "substance over form" rule for purposes of determining a taxpayer's §40-14-41(b) capital. The substance of Paloma's acquisition of PACE was that neither Rheem's capital nor its business changed. Rheem's business and its assets were exactly the same after the acquisition as before. Rheem did not receive a single dollar of capital infusion as the result of the acquisition. Thus, Rheem's capital for Alabama franchise tax purposes, which was to be "determined in accordance with generally accepted accounting principles," must reflect the substance of the transaction and thus remain unchanged. See *Mueller Co. v. State of Alabama*, F. 95-364 (Admin. Law Div.

2/20/97). The "substance over form" principle, as clearly articulated in the penultimate paragraph in *Mueller Co.*, and its application to Paloma's acquisition of the stock of PACE, results in no addition to Rheem's capital:

> In short, the purchase of the Taxpayer by Mueller Holding in 1986, and the purchase of Mueller Holding by Tyco in 1988, <u>did not in substance result in additional capital to the Taxpayer</u>. Consequently, the Taxpayer should not be required to recognize additional capital from the transaction. The final assessment is dismissed.

Mueller Co. at 3.

In an effort to counter the holding in *Mueller Co.*, the Department relies heavily on *E&E Hauling, Inc. v. Ryan*, 713 N.E.2d 178 (Ill. App. 1999). The Department argues that *E&E Hauling* supports its position that Rheem's §40-14-41(b) capital was increased by the goodwill created on Rheem's separate financial statements by the application of push-down accounting. The Department's reliance on *E&E Hauling* is misplaced. First, the definition of a corporation's "paid-in capital" on which the Illinois franchise tax was imposed differs significantly from the definition of "capital" for Alabama franchise tax purposes. See, 805 ILCS 5/1.80(j) (West 1996) (including "amounts added or transferred to paid-in capital by action of the board of directors or shareholders pursuant to a share dividend, share split, or otherwise."). Also, the issue in *E&E Hauling* was "whether an increase in paid-in capital due to push-down accounting adjustments made <u>following a stock sale and section 338 election is akin to a share split or a share dividend</u>." *Id.* (emphasis added). *E&E Hauling* simply did not address the effect of non-GAAP-required push-down accounting as it relates to the computation of capital on a GAAP-dependent basis.

Further, in *E&E Hauling*, the entire step-up in tax and accounting basis was attributable to E&E Hauling's pre-existing operating assets. Thus, the entire increase in paid-in capital was attributable to the step-up in basis of pre-existing operating assets, not to the creation of goodwill. In this case, however, the purported increase in Rheem's §40-14-41(b) capital is attributable entirely to the creation of goodwill, not the revaluation of pre-existing assets, on Rheem's financial statements.

Were it necessary to look outside the State of Alabama for authority addressing the push-down accounting issue, Texas, not Illinois, provides the most relevant authority. In Comptroller of Public Accounts Hearing Nos. 27,377 and 27,378, the administrative law judge expressly found that (1) GAAP did not require push-down accounting for corporations that are not required to file or register with the SEC, and (2) an acquired corporation's "net taxable capital" for Texas franchise tax purposes was not increased by application of push-down accounting upon the acquisition of the corporation's stock. Following the referenced decision, the Texas legislature amended the Texas franchise tax law to specifically preclude the use of push-down accounting in computing a corporation's surplus for franchise tax purposes. See, Tex. Tax Code Ann. §171.109(m). In any case, Alabama law is clear on the issue – GAAP did not require the push-down of the subject goodwill onto Rheem's separate financial statements. Consequently, such goodwill should not have been included in Rheem's §40-14-41(b) capital.

The Department also argues that under Opinion No. 20 ("Accounting Changes") of the Accounting Principles Board ("APB 20"), Rheem must use push-down accounting in determining its §40-14-41(b) capital because Rheem uses push-down accounting in

preparing its financial statements. The Department is correct that APB 20 does apply to the preparation of *financial statements* used for *financial reporting* purposes. APB 20, ¶3. However, application of APB 20 would be inappropriate in determining a taxpayer's §40-14-41(b) capital because (1) it ignores the distinction between preparing financial statements for financial reporting purposes and complying with the statutory requirements for determining capital, and (2) it would completely undermine the holding in *Weavexx Corp.* that the "true nature of the account" must govern in determining the §40-14-41(b) capital of a taxpayer. If APB 20 is applied in determining a taxpayer's §40-14-41(b) capital in those cases where GAAP permits a taxpayer options in determining how it will account for a transaction, the form over substance rule discussed above would be eviscerated.

The Department's final argument relates to Statement of Financial Accounting Standard No. 141 Business Combinations ("FAS 141"). However, FAS 141 defines GAAP only with respect to those business transactions initiated after June 30, 2001 – more than 13 years following the effective date of the merger and 30 months after Rheem's 1999 capital base was determined. Consequently, it is irrelevant to the years in issue. The Department's substantive arguments concerning FAS 141 thus will not be addressed. Clearly, it was APB16 (which was effective for all transactions initiated after October 31, 1970, and before July 1, 2001) that applied on the date of the merger and during all tax years in issue. As stated above and as stipulated by the parties, neither APB 16 specifically, nor GAAP generally, required PACE to push down the resulting goodwill to Rheem's books.

As in *Mueller Co.*, Paloma/PACE's decision to push down the goodwill that was recorded as a result of the merger did not in substance result in additional capital to Rheem. The Department did not appeal the decision in *Mueller Company*. I find no reason to rule differently in this case.

In conclusion, Rheem's capital for Alabama franchise tax purposes must be determined in accordance with GAAP. GAAP did not require the push-down of the goodwill resulting from Paloma's acquisition of PACE to the separate financial statements of PACE, nor did it require the further push-down of the goodwill to Rheem's separate financial statements. Furthermore, the push-down of the goodwill to Rheem's separate financial statements does not reflect the substance of the transaction because Rheem's financial position was not changed. Consequently, Rheem's §40-1-44(b) capital must not be increased by an amount attributable to such goodwill.

The Department is directed to recompute Rheem's franchise tax liabilities for the subject years by excluding the subject goodwill from Rheem's capital tax base in each year. It should notify the Administrative Law Division of the amount of the refund due Rheem in each year. A Final Order will then be entered.[5]

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

Entered March 1, 2005.

[5] In light of the above holding, the issue concerning the use of an alternative apportionment method is moot and need not be addressed.

BILL THOMPSON
Chief Administrative Law Judge