

## NECESSARY ACCOMMODATIONS: RECENT DEVELOPMENTS IN THE ALABAMA FOREIGN FRANCHISE TAX

### I. INTRODUCTION

A corporation doing business in Alabama must pay the state for the privilege.<sup>1</sup> The method of collection used by the state is the corporate franchise tax, which makes a distinction between domestic and foreign corporate taxpayers.<sup>2</sup> A corporation formed under Alabama law is a domestic corporation, and those corporations formed under the laws of other jurisdictions are foreign.<sup>3</sup> Depending on where a corporation files its papers of incorporation, the price for the privilege of doing business in Alabama can vary dramatically.

A corporation organized under the laws of Alabama must pay the franchise tax based on its paid *capital stock*;<sup>4</sup> a corporation organized under the laws of another state pays the franchise tax on the amount of its *capital employed* in Alabama.<sup>5</sup>

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1. See *White v. Reynolds Metals Co.*, 558 So. 2d 373, 390 (Ala. 1989), *cert. denied*, 496 U.S. 912 (1990).

2. ALA. CODE §§ 40-14-40 to -41 (1993 & Supp. 1997). The state also imposes a "shares tax" on certain domestic corporations or their shareholders. *Id.* § 40-14-70 (Supp. 1997). The shareholders of the domestic corporations are liable for the tax, but corporations usually pay the tax as is allowed under the statute. *Id.* §§ 40-14-70(a), -73 (1993 & Supp. 1997). Additionally, state law prohibits a foreign corporation from conducting business within Alabama unless it has paid the qualification tax. *Id.* § 40-14-1 (1993). Like the foreign franchise tax, this tax is based on capital employed in Alabama. *Id.* However, a foreign corporation can avoid a large initial qualification tax and simply pay the statutory minimum by qualifying at least one day before actually employing capital in Alabama. See *International Paper Co. v. Curry*, 9 So. 2d 8, 14 (Ala. 1942); *Dow-United Tech., Inc. v. State*, No. F. 95-174, 1996 WL 226793, at \*2-\*3 (Ala. Dep't Rev. Mar. 12, 1996).

3. ALA. CODE § 10-2B-1.40(11) (Supp. 1997).

4. ALA. CODE § 40-14-40 (1993). The current rate is \$10 on each \$1,000 of capital stock. *Id.* All subscribed and issued stock is considered capital stock. See *State v. Forrester*, 419 So. 2d 231, 233 (Ala. Civ. App. 1982) (holding that a bankrupt corporation conducting no business activity was still liable for the franchise tax because the tax is based on the amount of the corporation's capital stock and not on the value of the corporation's property). Additionally, a professional association is not subject to the franchise tax because it is a non-stock corporation. *State v. Raymond Sims, D.M.D., P.A.*, 519 So. 2d 523, 524 (Ala. Civ. App. 1987).

5. ALA. CODE § 40-14-41(a) (Supp. 1997). The current rate is \$3 on each \$1,000

Alabama is the only state that makes this distinction in imposing a franchise tax.<sup>6</sup> Because the domestic tax rate is based on the par value of the corporation's capital stock, taxpayers can reduce their tax liability to the statutory minimum of fifty dollars by setting the par value at a low amount.<sup>7</sup> The "capital employed" basis, used by foreign corporations, presents a more substantial challenge because it is based on real financial value rather than inconsequential par value.<sup>8</sup>

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of capital employed in Alabama. *Id.* A corporation engaged exclusively in interstate commerce does not have to pay the franchise tax. *North Am. Van Lines, Inc. v. State*, No. F. 95-473, 1996 WL 508540, at \*3 (Ala. Dep't Rev. July 19, 1996). However, a foreign corporation that is a general partner in a partnership operating in Alabama may be subject to the Alabama franchise tax. *See Macol Corp. v. State*, No. 97-401-R (Ala. Cir. Ct. Montgomery County Sept. 29, 1997); *American Television & Communications Corp. v. State*, No. F. 95-258, 1995 WL 521626, at \*1 (Ala. Dep't Rev. Aug. 29, 1995). The definition of "capital" is:

(1) The outstanding capital stock and any additional paid-in capital, whether positive or negative, but excluding the taxpayer's cost of its treasury stock.

(2) Retained earnings, whether positive or negative, which shall include any amounts designated for the payment of dividends until the amounts are definitely and irrevocably placed to the credit of stockholders subject to withdrawal on demand.

(3) The amount of bonds, notes, debentures, or other evidences of indebtedness maturing and payable more than one year after the first day of the franchise tax year, but not including deposit liabilities of banks and other financial institutions as defined by state or federal law.

(4) The amount of bonds, notes, debentures, or other evidences of indebtedness, but not including deposit liabilities of banks and other financial institutions as defined by state or federal law, maturing and payable at the time to: (i) any individual stockholder owning directly or indirectly 10 percent or more of the outstanding capital stock of the taxpayer, or (ii) another corporation owning more than 50 percent of the outstanding capital stock of the taxpayer, or (iii) another corporation owning more than 50 percent of the outstanding capital stock of which is owned by the taxpayer, unless the other corporation referred to in clause (ii) or (iii) is also required to pay a franchise tax to the State of Alabama.

(5) The amount reasonably required to adjust the depreciable or amortizable property accounts for any rapid, excessive, or unreasonable depreciation or amortization charges, so as to restore the depreciable or amortizable property accounts, for franchise tax purposes, to original cost less depreciation or amortization computed on the basis of the useful life of the property to the taxpayer.

ALA. CODE § 40-14-41(b) (Supp. 1997).

6. ALL STATES TAX HANDBOOK, 200-O to 200-Q (Fidel C. Mendoza et al. eds., 1992); see generally JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION (2d ed. 1993) (providing a helpful summary of the constitutional basis for franchise taxes and a discussion of various state franchise taxes).

7. ALA. CODE § 40-14-40 (1993).

8. The foreign corporation must first determine its total capital as defined by

The foreign franchise tax has generated much criticism through the years and has been challenged on constitutional grounds several times.<sup>9</sup> This rather dubious revenue generator, however, has survived these judicial challenges and forced those who desire to lessen the burden of the tax to concentrate their efforts on the political realm.<sup>10</sup> Over the past five years this effort has been substantial, producing two primary legislative acts amending the foreign franchise tax.<sup>11</sup> Additionally, both before and after the passage of this legislation, several administrative and judicial opinions have addressed certain issues in relation to the foreign franchise tax.

While the fundamental constitutional challenges continue,<sup>12</sup> these recent amendments and decisions have changed and

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section 40-14-41(b) excluding any amounts allowed under section 40-14-41(d)(1)-(3). Then the percentage of the total capital employed by the corporation in Alabama is apportioned according to section 40-14-41(c). Finally, the taxpayer deducts any amounts allowed under section 40-14-41(d)(4) from the capital employed figure to arrive at the amount payable under the franchise tax. Allowing the deductions after apportioning capital employed in the state is obviously much more favorable to the taxpayer. See *SouthTrust Mortgage Corp. v. State*, No. F. 95-369, 1996 WL 226789, at \*2 (Ala. Dep't Rev. Mar. 5, 1996).

9. *White v. Reynolds Metals Co.*, 558 So. 2d 367, 371 (Ala. Civ. App.), *rev'd*, 558 So. 2d 373 (Ala. 1989), *cert. denied*, 496 U.S. 912 (1990); see also C.C. Torbert, Jr., *Introduction: The Alabama Commission on Tax and Fiscal Policy Reform*, 43 ALA. L. REV. 533 (1992) (describing the general concerns over the tax structure that existed in 1989).

10. See *Reynolds Metals*, 558 So. 2d at 373, 390.

11. 1995 Ala. Acts 403, 564; see also 1996 Ala. Acts 475. The 1996 amendment made very slight changes to subdivision (c)(3) of the statute, which allows the taxpayer to petition the Alabama Department of Revenue to employ an alternative method of apportionment, such as the summation method, in order to arrive at a more equitable determination of capital employed in Alabama. ALA. CODE § 40-14-41(c)(3) (Supp. 1997). The statute prescribes that apportionment be determined according to regulations promulgated by the Department of Revenue. *Id.* This Comment will not focus on this area of the statute.

12. The challenges are in *South Central Bell Tel. Co. v. State*, No. 89-2600-G (Ala. Cir. Ct. Montgomery County Dec. 3, 1996), and *Gladwin Corp. v. Monroe*, No. 96-1065-GR (Ala. Cir. Ct. Montgomery County Aug. 5, 1997). In *South Central Bell*, the circuit court held that, in light of several United States Supreme Court decisions since *White v. Reynolds Metals Co.*, it is clear that a tax imposing burdens on interstate commerce cannot be upheld unless there is some pertinent reason to do so. Consequently, the court ruled that Alabama's foreign franchise tax violates the Commerce Clause of the United States Constitution. *Gladwin*, conditionally certified as a class action, was placed on emergency appeal to the Alabama Supreme Court after Montgomery Circuit Judge Sally Greenhaw ordered all future franchise tax revenues placed in escrow until the final ruling in *South Central Bell*. See Bruce P. Ely, Up-

clarified the foreign franchise tax. Moreover, the amendments provide necessary accommodations to the taxpayer by codifying certain practices existing prior to the enactment of the legislation. Those practices are (1) the exclusion of investments in foreign subsidiaries from a taxpayer's capital base, and (2) the use of Generally Accepted Accounting Principles (GAAP) in the determination of a taxpayer's capital.<sup>13</sup>

This Comment will discuss the codification of these practices and explain their practical effect on foreign taxpayers. Initially, this Comment will briefly address the recent history of the foreign franchise tax and the events triggering the amendments to the law.<sup>14</sup> This Comment will then explore the substance of the legislation and the political motives underlying their enactment, beginning with the foreign subsidiary exclusion,<sup>15</sup> and finally addressing the GAAP provisions.<sup>16</sup>

## II. HISTORY OF THE 1995 LEGISLATIVE AMENDMENTS

In 1989, concern over the franchise tax surfaced due to both the overall shortage in state revenue and a state court's ruling

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date on Franchise Tax Challenges (unpublished manuscript, on file with author) [hereinafter Update].

On January 30, 1998, the Alabama Supreme Court granted a motion filed by Attorney General Bill Pryor and lifted Judge Greenhaw's escrow order, thereby releasing the \$11.1 million in franchise tax payments that had been held since August 5, 1997. *Supreme Court Gives State Temporary Relief in Franchise Tax Case*, THE BIRMINGHAM NEWS / POST-HERALD, Feb. 7, 1998, at 8A; *State Seeking a Speedy High Court Ruling with \$95 million at Stake*, TUSCALOOSA NEWS, Jan. 23, 1998, at 8B (quoting a sworn statement from State Finance Director Jimmy Baker as predicting that continued escrow of the revenue "would be 'so severe as to amount an emergency situation in the State of Alabama with regard to services provided by many agencies and would likely interrupt the provision of services to many deserving and needy citizens.'"). The order was issued under the *Gladwin* case, and placed that case on hold until the Supreme Court made a final ruling in the South Central Bell case. *Id.* (noting that only Justice Butts dissented from the order). This final ruling was issued on March 20, 1998, when the Alabama Supreme Court upheld the franchise tax law without opinion. See *South Central Bell Tel. Co. v. State*, No. 1960591, 1998 WL 122735, at \*1 (Ala. Mar. 20, 1998) (per curiam) (5-4 decision).

13. Bruce P. Ely, *Recent Alabama Developments 6* (unpublished manuscript, on file with author) [hereinafter *Alabama Developments*].

14. See *infra* notes 17-36 and accompanying text.

15. See *infra* notes 37-71 and accompanying text.

16. See *infra* notes 72-176 and accompanying text.

holding the tax unconstitutional.<sup>17</sup> The Business Council of Alabama was motivated enough by this concern to promote legislation addressing tax reform.<sup>18</sup> The possibilities existing after the court's decision were that the franchise tax would either be eliminated altogether as unconstitutional or be changed in a manner adversely affecting domestic corporations. The actions of the Business Council indicate its desire to prevent the latter from occurring. One of the results of the Council's effort was the Legislature's establishment of the Alabama Commission on Tax and Fiscal Policy Reform (the Commission).<sup>19</sup>

The Commission was broadly directed to study the entire state tax structure and to recommend changes at the beginning of the 1991 legislative session.<sup>20</sup> The Commission's report included a recommendation that the franchise tax should be retained, but altered to be based on capital employed in Alabama for all corporations, domestic and foreign.<sup>21</sup>

This recommendation was included as part of legislation drafted by the Commission and was introduced on July 29, 1991, at the end of the 1991 Regular Session.<sup>22</sup> The initial proposal called for a rate of \$.80/1,000.00 (.08%) on capital employed in the state.<sup>23</sup> Thus domestic corporations, while facing a larger tax burden due to the repeal of the domestic franchise tax based on capital stock, would be granted a reduction in the rate. By the time this plan passed through the House, Senate, and Conference Committee during the 1992 Regular Session, the strength of the domestic business lobby was evident in a pro-

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17. See Torbert, *supra* note 9, at 533. This Comment will not address the Constitutional disputes surrounding the franchise tax. For an overview of the constitutional issues, see John Smith T, Comment, *Alabama's Franchise Tax: An Affront to the Equal Protection Clause, Notwithstanding White v. Reynolds Metals Co.*, 43 ALA. L. REV. 111 (1991).

18. Torbert, *supra* note 9, at 533.

19. Torbert, *supra* note 9, at 534. Many other factors also contributed to the creation of the Commission.

20. Torbert, *supra* note 9, at 534.

21. REPORT OF THE ALABAMA COMMISSION ON TAX AND FISCAL POLICY REFORM 15 (1991) [hereinafter REPORT], reprinted in 43 ALA. L. REV. 741, 759-61 (1992). The Commission also recommended that the rate be reduced. *Id.*

22. H.R. 1112, 1st Sess. (Ala. 1991).

23. *Id.*; see also James D. Bryce, *Tax Reform Issues in Alabama*, 43 ALA. L. REV. 541, 561 (1993) (describing the issues addressed by the Alabama Commission on Tax and Fiscal Policy Reform and its recommendations for change).

posed \$.45/\$1,000.00 (.045%) rate.<sup>24</sup> In less than one year of consideration by the Alabama Legislature, the proposed rate change was almost cut in half.

Like many of the Commission's recommendations, however, the proposed franchise tax bills failed in the Legislature.<sup>25</sup> Following their failure, and after the constitutional concerns had subsided,<sup>26</sup> the political ambitions regarding the franchise tax shifted. No longer faced with the possibility of "capital employed" taxation of domestic corporations, the focus shifted to altering the existing structure in a manner favorable to foreign corporations. Also surfacing was a separate movement by banks to enact legislation changing the definition of capital as well as the deductions and exclusions allowed.<sup>27</sup>

These two efforts ultimately yielded separate pieces of legislation, Acts 95-403 and 95-564, both enacted in 1995,<sup>28</sup> and Act 96-475, enacted in 1996.<sup>29</sup> Act 95-403 provided for an exclusion from foreign franchise capital for investments made by banks in their foreign subsidiaries.<sup>30</sup> Act 95-564 made this same exclu-

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24. See H.R. 1st Sess. (Ala. 1992).

25. See Torbert, *supra* note 9, at n.6 (citing Peggy Roberts, *Clark Blames Folsom for Tax Plan's Failure*, BIRMINGHAM POST-HERALD, May 20, 1992, at A1; *House Slices Tax Reform Package*, TUSCALOOSA NEWS, Mar. 6, 1992, at 1A). At this point, the Department of Revenue started auditing very aggressively and began using novel theories in reviewing taxpayer compliance.

26. See *Reynolds Metals Co. v. Sizemore*, 558 So. 2d 373 (Ala. 1989), *cert. denied*, 496 U.S. 912 (1990).

27. Alabama Developments, *supra* note 13, at 6.

28. 1995 Ala. Acts 403, 607. Act 95-607 is also known as "The Taxpayer Protection and Technical Correction Act" and was co-authored by Bruce P. Ely of the law firm of Tanner & Guin. The 1995 act was a "new and improved" version of the 1992 Alabama Taxpayer's Bill of Rights, which resulted from a general desire to eliminate many inconsistencies and procedural traps existing in the Alabama tax system in 1992. See 1992 Ala. Acts 186 (codified as amended at ALA. CODE §§ 40-2A-5 to -11 (Supp. 1996)); see also BRUCE P. ELY ET AL., STATE AND LOCAL TAX ISSUES AFFECTING ALABAMA BUSINESSES 245 (1995) [hereinafter TAX ISSUES] (detailing the history of the 1992 act and the parties involved in its creation). The 1995 version added several technical corrections. *Id.* at 246.

29. 1996 Ala. Acts 475; see also *supra* note 11 (discussing the 1996 amendment); Alabama Developments, *supra* note 13, at 6-8 (reviewing changes made in the franchise tax at that time).

30. See 1995 Ala. Acts 403 (codified at ALA. CODE § 40-14-41(d)(3) (Supp. 1997)); see also H.R. 625, 1st Sess. (Ala. 1995) (introducing the bill before the House by Representatives Fuller and Hill); S. Res. 474, 1st Sess. (Ala. 1995) (introducing the bill before the Senate by Senators Bedford, Windom, Barron, and Waggoner); H.R. 625, 1st Sess. (Ala. 1995) (offering the adopted version of the bill creating subsection

sion available to all foreign corporations and clarified the use of Generally Accepted Accounting Principles in calculating capital employed under the franchise tax.<sup>31</sup> Act 96-475 clarified the ability of foreign corporations to petition the Alabama Department of Revenue to utilize a specific method of apportionment in calculating capital employed in Alabama.<sup>32</sup>

The legislation affects two main areas of concern to foreign franchise taxpayers: (1) the foreign subsidiary exclusion, and (2) the use of GAAP for determining capital employed in Alabama. Prior to the amendments, the foreign investment provisions were provided for under state regulation.<sup>33</sup> When the Administrative Law Division rejected the regulation because it lacked a statutory basis, foreign corporations sought a legislative remedy.<sup>34</sup> The issue was fairly settled before the amendments, though some litigation has occurred since their passage.<sup>35</sup> Conversely, the provision providing for the use of GAAP in determining capital has generated litigation both before and after its addition in Act 95-564.<sup>36</sup>

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(d)(2) for the bank foreign subsidiary deduction and moving general deductions to subsection (d)(3)).

31. 1995 Ala. Acts 564 (codified at ALA. CODE § 40-14-41(b)-(d) (Supp. 1997)); see also H.R. 539, 1st Sess. (Ala. 1995) (introducing the bill before the House by Representative Burke); S. Res. 294, 1st Sess. (Ala. 1995) (introducing the bill before the Senate by Senator Windom); H.R. 539, 1st Sess. (Ala. 1995) (stating the adopted version of the bill).

32. 1996 Ala. Acts 475 (codified at ALA. CODE § 40-14-41(c) (Supp. 1997)).

33. See ALA. ADMIN. CODE r. 810-2-3-03 (1995). This is commonly referred to as the "O3" regulation.

34. See *State v. American Fructose-Decatur, Inc.*, No. F. 94-125, 1994 WL 731913, at \*2, \*3 (Ala. Dep't Rev. Dec. 14, 1994).

35. See, e.g., *Hispan Corp. v. State*, No. 2960217, 1997 WL 414873, at \*1 (Ala. Civ. App. July 25, 1997).

36. Before the law was amended by Act 95-564, section 40-14-41(c) provided that GAAP could be used. See ALA. CODE § 40-14-41(c) (1993). This subsection relates to the formula utilized to apportion a foreign taxpayer's capital to Alabama. It becomes relevant only *after* the capital of the corporation has been determined. Subsection (b) defines what is capital for franchise tax purposes. ALA. CODE § 40-14-41(b) (Supp. 1997). Prior to the passage of Act 95-564, Judge Thompson of the Administrative Law Division deferred to GAAP via subsection (c) in order to define certain terms under subsection (b) which the statute left undefined. See, e.g., *Fifteenth Daniel Realty Inv. Co. v. State*, Nos. F. 94-339, -386, -424, -425, 1995 WL 420010, at \*2 (Ala. Dep't Rev. June 28, 1995). Consequently, since GAAP was being used to define terms defining "capital," the provision allowing for its use was moved more rationally to subsection (b). 1995 Ala. Acts 564.

Due to the breadth of GAAP, it is likely that future franchise tax litigation will revolve around these principles. Because of the potential it offers, an inquiry into the history and authoritative hierarchy of GAAP is beneficial. Additionally, an understanding of the litigation relevant to both the foreign subsidiary exclusion and the GAAP provision is important for those who must work with the foreign franchise tax.

### III. THE FOREIGN SUBSIDIARY EXCLUSION

#### A. Act 95-564

In 1995, the Alabama Department of Revenue unsuccessfully attempted to repeal the "O3" regulation,<sup>37</sup> which allowed an exclusion from the capital base of a foreign corporation for any investment made in a foreign subsidiary corporation.<sup>38</sup> The Department based this attempt on the fact that there was no constitutional or statutory basis for the exclusion.<sup>39</sup> The exclusion had simply grown out of the common practice of foreign corpora-

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37. See Ala. Dep't of Rev. r. 3212 (1995).

38. See ALA. ADMIN. CODE r. 810-2-3-.03 (1995). This regulation allows a foreign corporation to deduct any investment it makes in a foreign subsidiary corporation. *Id.* A foreign subsidiary corporation must not be commercially domiciled in Alabama and must do business exclusively outside of Alabama. *Id.* Once these requirements are met, the regulation sets forth six tests to be met in order for a subsidiary investment to qualify for the exclusion. *Id.* The regulation states those tests in subsections (a)-(f) as:

- (a) The franchise tax return of a reporting corporation must contain only unconsolidated operational data.
- (b) The investment in a subsidiary must be included in the balance sheet in all instances. Market value of stock in a subsidiary will not be allowed as a deduction.
- (c) The reporting corporation must own at least 51% of each class of stock to qualify the investment as a [sic] exclusion.
- (d) Loans of advances to a subsidiary corporation are not allowable as an exclusion or deduction.
- (e) To qualify as a exclusion, the investment must be in an operating subsidiary corporation which is regularly engaged in normal and recognized business activities and not merely a dormant or holding corporation.
- (f) The reporting corporation shall submit evidence at the time the return is filed to show that all the above tests have been met.

*Id.*

39. See *State v. American Fructose-Decatur, Inc.*, No. F. 94-125, 1994 WL 731913, at \*2 (Ala. Dep't Rev. Dec. 14, 1994).



tion taxpayers and the Alabama Department of Revenue.<sup>40</sup>

The Department first attempted to withdraw the regulation in 1993, but discontinued its efforts due to the numerous objections of foreign corporations which had come to rely on it over its twenty-two year history.<sup>41</sup> Failing to withdraw the "03" regulation, the Department next denied its use to a foreign taxpayer, who appealed and challenged this action before the Administrative Law Division.<sup>42</sup> Judge Thompson<sup>43</sup> held that the regulation had no statutory basis and that the Department should withdraw it.<sup>44</sup> The Department thereafter issued the withdrawing regulation, again arousing the concerns of foreign franchise taxpayers.<sup>45</sup> Despite the previously noted failure of the withdrawing regulation, the rulings of the Administrative Law Division made it clear that foreign taxpayers had lost a significant exclusion from capital on which they had come to rely. The only option for the continued use of the exclusion was to provide a statutory basis for it.

Due to the efforts of the Business Council of Alabama, the Alabama Bankers Association, and several other business groups,<sup>46</sup> the legislature codified and, some commentators believe, expanded the parameters of the exclusion in 1995.<sup>47</sup> The

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40. See *id.* (noting that the "03" regulation was promulgated by the Department sometime prior to 1971). The exclusion was "on the books" for at least 24 years. See Alabama Developments, *supra* note 13, at 6.

41. *American Fructose-Decatur*, 1994 WL 731913, at \*3. Furthermore, the Department discontinued its repeal efforts because a financial impact study required by state law had not been performed. See Alabama Developments, *supra* note 13, at 6; see also ALA. CODE § 41-22-23 (1993) (requiring a financial impact study before a regulation can be repealed).

42. *American Fructose-Decatur*, 1994 WL 731913, at \*1.

43. Bill Thompson is the Chief Administrative Law Judge for the Administrative Law Division of the Alabama Department of Revenue. He is the author of many crucial decisions regarding the franchise tax.

44. *American Fructose-Decatur*, 1994 WL 731913, at \*5. American Fructose was allowed to take the exclusion based on equal protection concerns. *Id.* at \*5. Since all other foreign taxpayers had been allowed to exclude their investments in foreign subsidiaries from capital during the subject years, American Fructose was allowed the same benefit. *Id.* The Administrative Law Division made the same ruling in 1995 when the issue came before it again. See *State v. TRMI Holdings, Inc.*, No. F. 94-177, 1995 WL 47033, at \*1 (Ala. Dep't Rev. Jan. 11, 1995). TRMI, like American Fructose, was allowed the exclusion for prior years based on equal protection concerns. *TRMI Holdings*, 1995 WL 47033, at \*1.

45. See Alabama Developments, *supra* note 13, at 6-7.

46. See Alabama Developments, *supra* note 13, at 6.

47. See ALA. CODE § 40-14-41(d)(2) (Supp. 1997); TAX ISSUES, *supra* note 28, at

revised statute allows for the exclusion of loans from the capital of a subsidiary, whereas the "O3" regulation prohibited such action.<sup>48</sup> This expansion has not been addressed either by the Department of Revenue or by the Administrative Law Division, but it provides a clear and broad window of opportunity for foreign taxpayers because "capital employed" for the year is based on the taxpayer's balance sheet as of December 31.<sup>49</sup> The capital base of a foreign corporation could be significantly reduced, by shortly before December 31, advancing a loan to a foreign subsidiary which in turn repays the taxpayer soon thereafter. The loan could be for the amount of the taxpayer's retained earnings, thereby reducing the base amount to zero. The capital of the corporation would then be based on outstanding capital stock and long and short-term debt as defined by the statute.<sup>50</sup> Capital stock can be reduced by setting par value at a low amount, thus reducing the franchise capital even further.

Foreign taxpayers obtained this avenue of reducing franchise tax liability through political efforts taken in reaction to the Department's efforts to block the road to the foreign subsid-

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212-13 (1995). It is important to have a clear understanding of the differences between ALA. CODE § 40-14-41(b)(4) and § 40-14-41(d). Subsection (b)(4) allows an exclusion from the capital base of a subsidiary corporation for "the amount of bonds, notes, debentures, or other evidences of indebtedness" if they meet certain qualifications. See *supra* note 4 (quoting ALA. CODE § 40-14-41(b)). Subsection (d) allows an exclusion from capital for any qualifying investments made in the capital of other corporations, both domestic and foreign. ALA. CODE § 40-14-41(d) (Supp. 1997). This exclusion will be taken when the taxpayer *makes* an investment in another qualifying corporation; conversely, the (b)(4) exclusion is taken when the taxpayer *receives* qualifying investments from a related corporation. See *id.* § 40-14-41(b)(4), (d).

48. Compare ALA. CODE § 40-14-41(d)(2) (Supp. 1997), with ALA. ADMIN. CODE r. 810-2-3-.03(d) (1994). As a whole, the regulation provided much more detailed requirements with which the taxpayer had to comply. See regulation quoted *supra* note 38. The amended statute states:

[I]n addition to any other applicable exclusions, in the case of any taxpayer, there shall be excluded from the amount of capital as determined in subsection (b) . . . the investment by the taxpayer in the capital of any other corporation that does not pay a franchise tax to the State of Alabama if the taxpayer owns more than 50 percent of the outstanding capital stock of the other corporation, unless the other corporation is dormant and not regularly engaged in one or more business activities.

ALA. CODE § 40-14-41(d)(2) (Supp. 1997).

49. See ALA. CODE § 40-14-41(d)(2) (Supp. 1997).

50. See ALA. CODE § 40-14-41(b) (Supp. 1997); see also *supra* note 4 (discussing judicial interpretations of "capital stock").

iary exclusion altogether.<sup>51</sup> In this regard, the result of the Department's efforts to increase state revenue by eliminating the "O3" regulation ultimately backfired due to the enactment of Act 95-564.

### B. Act 95-403

On the same day that Act 95-564 was signed into law, the Governor also enacted Act 95-403.<sup>52</sup> This act created the same subsidiary investment exclusion that was contained in Act 95-564 but confined it to investments made by foreign banks or bank holding companies.<sup>53</sup> Act 95-403 was the product of the Alabama Bankers Association's political efforts and was separate from the general lobby organized to enact 95-564.<sup>54</sup> By securing this exclusion separately, the Association may have denied foreign banks enjoyment of the full benefit of the exclusion.

Under the amended section 40-14-41(b), defining "capital," the added language is favorable to foreign banks. Notably, the new terms were added by Act 95-564, not Act 95-403, which was the Bankers Association's solo effort.<sup>55</sup> Prior law required banks to include the amount of long-term "bonds, notes, debentures, or other evidences of indebtedness" in the capital calculation.<sup>56</sup> The revised law enables all "banks and other financial institutions" also to exclude "deposit liabilities" in determining their capital.<sup>57</sup> Allowing this exclusion for short-term debt has little practical value because most short-term deposit liabilities will not satisfy the statutory ownership requirements.<sup>58</sup> However, this provision enables banks to exclude long-term deposit liabilities such as bonds, certificates of deposit, and other invest-

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51. See *supra* notes 34-36.

52. See 1995 Ala. Acts, Table 1, 403, 564.

53. See 1995 Ala. Acts 403 (codified as amended at ALA. CODE § 40-14-41(d)(3) (Supp. 1997)).

54. See TAX ISSUES, *supra* note 28, at 208.

55. See 1995 Ala. Acts 403, 564.

56. ALA. CODE § 40-14-41(b)(3) (1993). Both long-term and short-term debt are described in this manner. However, short-term debt must only be included if owed to parties who satisfy certain ownership requirements. See *id.* § 40-14-41(b)(4) (Supp. 1997).

57. *Id.* § 40-14-41(b)(3)-(4).

58. *Id.* § 40-14-41(b)(4).

ments maturing and payable in more than a year.<sup>59</sup> The effect of excluding them from the statutory definition of capital is to limit a bank's franchise tax capital base to: (1) outstanding capital stock and paid-in capital; (2) retained earnings, whether positive or negative; (3) non-qualifying short-term debt; and (4) amounts necessary to adjust certain depreciation costs.<sup>60</sup>

Under the language of the statute, however, foreign banks are precluded from using this advantage along with the foreign subsidiary exclusion.<sup>61</sup> The latter can only be excluded from capital "as determined in subsection (b) as subsection (b) provided prior to the enactment of Act 95-564."<sup>62</sup> Therefore, any bank seeking to exclude its investments in foreign subsidiaries is prevented from excluding its long-term deposit liabilities in determining its capital.<sup>63</sup> The effect could render the bank foreign subsidiary investment exclusion useless because of banks' potentially large long-term deposit liabilities. An investment in

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59. *Id.* § 40-14-41(b)(3).

60. ALA. CODE § 40-14-41(b) (Supp. 1997). Subsection (b)(5) attempts to restore depreciable or amortizable property accounts "to original cost less depreciation or amortization computed on the basis of the useful life of the property to the taxpayer." *Id.* § 40-14-41(b)(5). This is targeted at preventing the taxpayer from reducing capital by taking unreasonably rapid or excessive depreciation deductions. *Id.* § 40-14-41(b)(5).

61. In the foreign franchise tax computation, the term "exclusion" can cause some confusion. Subsection (b) defines capital, expressly excluding both short and long-term deposit liabilities of banks. *Id.* § 40-14-41(b)(3)-(4) (Supp. 1997). These are excluded by a bank at the outset. Subsection (d) defines deductions and exclusions, allowing banks a specific exclusion for any investments made in foreign subsidiaries. *Id.* § 40-14-41(d)(3). This exclusion is taken after the corporation has determined its capital under subsection (b) but before apportionment. ALA. CODE § 40-14-41(d)(3) (Supp. 1997). Only the allowable deductions are taken after apportionment of the capital to Alabama. *Id.* § 40-14-41(d)(4). Under the language of the statute, though, a bank is not allowed to take both exclusions. *See id.*

62. *Id.* § 40-14-41(d)(3). This subsection states:

In addition to any other applicable exclusions, in the case of any bank or bank holding company, there shall be excluded from the amount of capital as determined in subsection (b) as subsection (b) provided prior to the enactment of Act 95-564, the investment by the bank or bank holding company in the capital of any other corporation that does not pay a franchise tax to the State of Alabama if the bank or bank holding company owns more than 50 percent of the outstanding capital stock of the other corporation, unless the other corporation is dormant and not regularly engaged in one or more business activities.

*Id.* (emphasis added).

63. *See id.*

the capital of a foreign corporation subsidiary might have to be substantial to justify the use of a pre-Act 95-564 determination of capital. Conversely, if the bank has substantial foreign subsidiary investments, the foreign subsidiary exclusion might prove more useful. Act 95-403<sup>64</sup> forces this analysis and requires foreign banks to carefully consider the franchise tax consequences of their investments.

If the Alabama Bankers Association had never pursued Act 95-403, foreign banks would be in a better position. These banks would be able to enjoy both the more favorable capital definition and the foreign subsidiary exclusion, both of which were enacted as part of Act 95-564.<sup>65</sup> The requirements for claiming the subsidiary investment exclusion are the same under both provisions;<sup>66</sup> however, the general exclusion, presumably available to all foreign corporate taxpayers, including banks, contains no restriction requiring the use of a pre-Act 95-564 capital determination.<sup>67</sup>

As a political representative of domestic banks, the Bankers Association's intent is unclear. Larger domestic banks such as SouthTrust Corp., Compass Bancshares, Inc., and Regions Financial Corp. must incorporate under national banking laws.<sup>68</sup> Because they are not incorporated under the laws of Alabama, these banks are subject to the foreign franchise tax.<sup>69</sup> With the recent increase in these banks' investments outside of Alabama,<sup>70</sup> the use of the foreign investment exclusion becomes

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64. 1995 Ala. Acts 403 (codified at ALA. CODE § 40-14-41(d)(3) (Supp. 1997)).

65. 1995 Ala. Acts 564 (codified at ALA. CODE § 40-14-41(b)-(d) (Supp. 1997)).

66. Compare 1995 Ala. Acts 403 (codified at ALA. CODE § 40-14-41(d)(3) (Supp. 1997)) with 1995 Ala. Acts 564 (codified at ALA. CODE § 40-14-41(b)-(d) (Supp. 1997)). Both amendments require that: (1) the corporation own more than 50% of the capital stock of the subsidiary, (2) the foreign subsidiary does not pay the Alabama franchise tax, and (3) the foreign subsidiary is not dormant but is actually conducting business. *Id.*

67. ALA. CODE § 40-14-41(d)(2) (Supp. 1997). In 1996, the Code Commissioner added an exception at the beginning of section 40-14-41(d)(2), the bank foreign subsidiary exclusion, that prevents banks from falling under Section 40-14-41(d)(2), which is the general exclusion. *Id.* This addition minimizes the embarrassment to the Bankers Association for its ineffective political efforts.

68. National Bank Act, 12 U.S.C. § 21 (1994) (requiring articles to be filed with the Comptroller of the Currency).

69. ALA. CODE § 40-14-41 (Supp. 1997).

70. *Alabama's Top Banks Continue Buying Spree*, THE GADSDEN TIMES, Dec. 18, 1997, at B1 (noting that by early 1998 SouthTrust will have more banking offices in

very important in reducing franchise tax liability. Thus, it is probable that the Bankers Association's separate lobby to secure the exclusion for domestic banks resulted from these foreign investments. Regardless, under the clear language of the amended franchise tax, foreign banks, including those Alabama banks organized according to federal law, are prevented from enjoying the same benefits as other foreign taxpayers.<sup>71</sup>

#### IV. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

##### A. Introduction to GAAP

The foreign franchise tax, as amended by Act 95-564, requires that a foreign corporation's capital employed be "determined in accordance with Generally Accepted Accounting Principles."<sup>72</sup> GAAP encompass various accounting rules and procedures which companies must follow in preparing their financial statements.<sup>73</sup> These rules, often very technical, are set by the Financial Accounting Standards Board (FASB), which was established in 1973 in order to produce GAAP.<sup>74</sup> FASB is not part of the public sector; rather, it is a creation of the private sector whose origins date back to the Securities and Exchange Act of 1934.<sup>75</sup>

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Florida than in Alabama). Compass, SouthTrust, and Regions announced 28 acquisitions from July, 1995, to July, 1996, ranking them first, third, and fourth nationwide. See Rick Brooks, *For Bank Acquisitions, The Action is in Alabama*, WALL ST. J., Aug. 21, 1996, at S2. Additionally, Colonial BancGroup, Inc., of Montgomery rounded out the top five, giving Alabama four of the five most active banks. *Id.* Of the 28 deals announced, 25 were acquisitions for banks located outside of Alabama, primarily in Florida, Georgia, and Texas. *Id.* See generally *Compass Bancshares to Buy Bank*, WALL ST. J., June 21, 1994, at C24 (noting that Compass had agreed to acquire Southwest Bankers, Inc. and its subsidiary located in Texas); *SouthTrust Corp.: Concern Agrees to Purchase Bankers First in Stock Pact*, WALL ST. J., Nov. 1, 1995, at B4 (noting that SouthTrust had agreed to purchase Bankers First, Georgia's biggest thrift at the time).

71. ALA. CODE § 40-14-41 (Supp. 1997).

72. *Id.* § 40-14-41(b).

73. VINCENT J. LOVE, UNDERSTANDING AND USING FINANCIAL DATA: AN ERNST & YOUNG GUIDE FOR ATTORNEYS 4-5 (1992).

74. *Id.*

75. ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 6-7 (1994).

That Act created the Securities and Exchange Commission (SEC)<sup>76</sup> and authorized it "to prescribe the form and content of financial statements" issued by companies required to register under the Act.<sup>77</sup> Several years later, in 1938, the SEC voted to rely on the private sector to create the standards, reserving for itself an oversight function.<sup>78</sup> This self-regulation began with the Committee on Accounting Procedure, which was re-organized twenty years later as the Accounting Principles Board.<sup>79</sup>

Neither the federal government nor the corporate world was satisfied with the performance of these bodies, and they ultimately mounted enough pressure to create FASB.<sup>80</sup> At its creation, this body was viewed as the last chance the corporate sector had "to avoid government control of accounting."<sup>81</sup> Due to this possibility and the high level of criticism, a more detailed effort was utilized in radically changing the system that existed in 1972 and in creating FASB.<sup>82</sup>

FASB is composed of seven members, each serving five year terms as full-time salaried employees.<sup>83</sup> The Board issues Statements of Financial Accounting Standards which promul-

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76. Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78(d) (1993).

77. VAN RIPER, *supra* note 75, at 6.

78. VAN RIPER, *supra* note 75, at 7.

79. LOVE, *supra* note 73, at 4.

80. LOVE, *supra* note 73, at 4.

81. VAN RIPER, *supra* note 75, at 10 (quoting *The Accountant's Last Chance*, BUS. WK., Mar. 31, 1978).

82. VAN RIPER, *supra* note 75, at 11. In 1971, when the level of criticism of the existing system had peaked, Marshall Armstrong, the president of the American Institute of Certified Public Accountants at the time, convened a conference to consider ways to alleviate the criticism. VAN RIPER, *supra* note 75, at 8. The study group on the establishment of accounting principles was led by Francis M. Wheat and eventually became known as the "Wheat Committee." VAN RIPER, *supra* note 75, at 8. After a year of intense study, including a public hearing, the Wheat Committee published its recommendations in a March 1972 report. VAN RIPER, *supra* note 75, at 9 (citing AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS (1972)). The Wheat Committee proposed the creation of FASB as a separate entity, unrelated to any professional group. VAN RIPER, *supra* note 75, at 9. Up until that time, both the Committee on Accounting Procedures and the Accounting Principles Board were arms of the American Institute of Accountants. VAN RIPER, *supra* note 75, at 7. FASB, on the other hand, was recommended as a separate entity composed of full-time, salaried members. VAN RIPER, *supra* note 75, at 9.

83. VAN RIPER, *supra* note 75, at 9.

gate its interpretation of specific issues.<sup>84</sup> These remain valid until amended or superseded and are recognized by the accounting profession as the most authoritative GAAP opinions.<sup>85</sup>

As the perceived threat of government regulation in 1973 and the corporate criticism present at that time have dwindled, a core issue has surfaced which exposes the ultimate debate regarding standards. FASB must consistently balance the issuer's desire for broad, flexible standards with the auditor's quest for specific, certain ones.<sup>86</sup> As FASB's third chairman noted in 1988: "In general, the issuers [of financial reports] want few standards, or only very broad standards, with plenty of room for the exercise of judgment in their application; auditors are inclined to want more standards, and more specific ones."<sup>87</sup>

The same statement could be used in describing the incorporation of GAAP into Alabama's foreign franchise tax, with foreign corporations playing the role of "issuers" and the state the role of "auditors." Those foreign taxpayers hope to use GAAP, with its many rules and FASB interpretations, as a flexible device in determining capital employed under the terms of the law. Conversely, the state hopes to use these same varied and detailed provisions as a rigid mechanism for making certain the same determination. Rulings revealing the use of GAAP terms and FASB interpretations by both sides were issued prior to the amendments of the law and have continued after those changes were enacted. An understanding of the result of these rulings is important to all who work with the foreign franchise tax.

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84. LOVE, *supra* note 73, at 4-5.

85. LOVE, *supra* note 73, at 4-5. Additionally, similar opinions issued by both the Committee on Accounting Procedures and the Accounting Principles Board are given the same authoritative value until amended or superseded by a FASB statement. LOVE, *supra* note 73, at 4-5.

86. VAN RIPER, *supra* note 75, at 11.

87. VAN RIPER, *supra* note 75, at 11 (quoting Dennis R. Beresford, *The Economic and Social Consequences of Financial Accounting Standards*, address to the Financial Executives Institute Conference (Nov. 1, 1988)).



*B. Rulings Involving GAAP*

Prior to the enactment of Act 95-564, section 40-14-41(c) provided for the use of GAAP. This subsection addresses the apportionment process to be used in computing capital employed in Alabama.<sup>88</sup> In recent years, Judge Thompson began using this reference to GAAP in defining terms left undefined by the statute.<sup>89</sup> Ultimately, the use of GAAP became crucial in determining capital under the statute. Consequently, the consensus was that the law would be more coherent if the reference to GAAP was placed in section 40-14-41(b), the subsection defining "capital."<sup>90</sup> This necessary accommodation was fulfilled by Act 95-564.<sup>91</sup>

GAAP principles have been utilized recently to establish six new rules. Those rules are: (1) loans that are callable by the creditor on the violation of certain loan provisions by the taxpayer are long-term debt if the taxpayer intends to refinance the debt;<sup>92</sup> (2) non-interest bearing promissory notes issued to a taxpayer by its parent corporation which are not intended to be repaid should not be included as capital;<sup>93</sup> (3) surplus held for the payment of dividends remains capital until the dividends are actually paid;<sup>94</sup> (4) open-ended demand notes payable to a sister corporation do not have to be included in a foreign taxpayer's capital;<sup>95</sup> (5) foreign corporate general partners in a partnership operating in Alabama may be required to include their pro-rata shares of the partnership's long-term capital debt in their capital bases;<sup>96</sup> and (6) certain financing leases are not included in cap-

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88. See ALA. CODE § 40-14-41(c) (Supp. 1997); see also *supra* note 11.

89. See, e.g., *Fifteenth Daniel Realty Inv. Co. v. State*, Nos. F. 94-339, -386, -424, -425, 1995 WL 420010, at \*2 (Ala. Dep't Rev. June 28, 1995).

90. See *Fifteenth Daniel Realty*, 1995 WL 420010, at \*2.

91. *Id.*

92. *QMS, Inc. v. State*, No. F. 96-170, 1996 WL 640454, at \*1-\*2 (Ala. Dep't Rev. Sept. 17, 1996).

93. *Fifteenth Daniel Realty*, 1995 WL 420010, at \*1-\*2.

94. *State v. Taxpayer*, No. F. 94-103, 1994 WL 150130, at \*1 (Ala. Dep't Rev. Apr. 19, 1994).

95. *MCI Telecomm. Corp. v. State*, No. F. 95-301, 1996 WL 93670, at \*2-\*3 (Ala. Dep't Rev. Jan. 11, 1996).

96. *Flournoy Dev. Co. v. State*, Nos. F. 95-481, -482, 1997 WL 101681, at \*2 (Ala. Dep't Rev. Jan. 21, 1997); *American Television & Communication Corp. v. State*, No. F. 95-258, 1995 WL 521626, at \*1 (Ala. Dep't Rev. Aug. 29, 1995); cf.

ital as long-term debt.<sup>97</sup> The cases from which these rules arose are discussed hereafter.

The issue in *QMS, Inc. v. State* was whether long-term debt, initially due and payable by the taxpayer in more than one year, was converted to short-term debt because the lenders acquired the authority to call the debt on demand.<sup>98</sup> The loans that QMS took contained covenants which, if breached, would result in a default.<sup>99</sup> Upon default, the creditor obtained the option of calling the notes on demand.<sup>100</sup> QMS breached the loan covenants and then excluded the debt from capital as short-term debt.<sup>101</sup> The Department audited QMS and argued that the debt was long-term and includable under section 40-14-41(b)(3).<sup>102</sup>

QMS argued that FASB Publication 78 (No. 78) controlled, requiring the loans to be booked as short-term debt and excluded from the franchise tax base.<sup>103</sup> FASB No. 78 states that long-term obligations that are callable by the creditor because of a debtor's violation of a loan agreement are short-term debt.<sup>104</sup> However, it also provides that short-term obligations that are expected to be refinanced on a long-term basis are to be classified according to FASB Publication 6 (No. 6).<sup>105</sup> FASB No. 6 excludes from current liabilities all short-term obligations that the debtor intends to refinance on a long-term basis.<sup>106</sup> QMS conceded in its brief that it intended to and ultimately did refinance the loans.<sup>107</sup> Consequently, Judge Thompson held that the loans had to be included as capital because of the intent to refinance the loans on a long-term basis.<sup>108</sup>

Though the *QMS* case provides a rule affecting a very nar-

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*Macol Corp. v. State*, No. 97-401-R (Ala. Cir. Ct. Montgomery County Sept. 29, 1997) (holding that 1995 amendment to section 40-14-41(b) overruled *American Television*).

97. *Mead Coated Bd., Inc. v. State*, 701 So. 2d 10, 12-13 (Ala. Civ. App. 1997).

98. *QMS, Inc. v. State*, No. F. 96-170, 1996 WL 640454, at \*1 (Ala. Dep't Rev. Sept. 17, 1996).

99. *QMS*, 1996 WL 640454, at \*1.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. See *QMS*, 1996 WL 640454, at \*1 (quoting FASB No. 78).

105. *Id.* at \*2.

106. See *id.* (citing FASB No. 6).

107. *Id.* (citing QMS Memorandum of Law).

108. *Id.*

row set of facts, it teaches a valuable lesson about the use of GAAP. The entire dispute in *QMS* revolved around GAAP interpretations. FASB No. 78 seemingly offered irrefutable support for the taxpayer's argument. Because of the fatal admissions in its brief, it is likely that *QMS* did not anticipate the use of FASB No. 6. The use of GAAP, which is a set of financial standards, requires thorough research and analysis when applied to tax law. The principles and rulings are numerous, providing both the state and taxpayers the opportunity to find favorable authority. This breadth was apparent in *QMS*, where the taxpayer ultimately provided the strongest evidence used to rule against it.<sup>109</sup>

In *Fifteenth Daniel Realty Inv. Co. v. State*,<sup>110</sup> the primary issue was whether certain notes issued to the taxpayers by their parent corporation should be included as capital under section 40-14-41(b)(2).<sup>111</sup> The taxpayers were all wholly-owned subsidiaries of Daniel Realty Corporation and were all formed to be general partners in specific real estate limited partnerships.<sup>112</sup> In order to satisfy state regulations, Daniel Realty issued each subsidiary a promissory note;<sup>113</sup> the notes bore no interest and were not intended to be repaid.<sup>114</sup>

The Department argued that the taxpayer's netting of the notes was barred under *State v. Arch of Alabama, Inc.*, and that the taxpayer should be required to include the amounts as surplus.<sup>115</sup> The Administrative Law Division, though, saw the issue not as whether an improper deduction from capital occurred but whether the notes must be included as capital in the first

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109. *QMS*, 1996 WL 640454, at \*2 (quoting *QMS Memorandum of Law*).

110. F. 94-339, -386, -424, -425, 1995 WL 420010, at \*1 (Ala. Dep't. Rev. June 28, 1995).

111. *Fifteenth Daniel Realty*, 1995 WL 420010, at \*1.

112. *Id.*

113. *Id.* (noting that the promissory notes were issued in order to satisfy the net worth requirements of Revenue Procedure 72-13).

114. *Id.*

115. *Id.* at \*2. Upon receipt of the note, the taxpayers debited accounts receivable and credited their paid-in capital accounts. *Id.* at \*1. Thus, the Department argued that the taxpayers improperly reduced their capital by improperly deducting an intercompany receivable. *Fifteenth Daniel Realty*, 1995 WL 420010, at \*1-2; *State v. Arch of Ala., Inc.*, No. F. 90-173 (Ala. Dep't Rev. July 22, 1994). At the time of this ruling, section 40-14-41(b)(2) required that "surplus and undivided profits" be included as capital. See *Fifteenth Daniel Realty*, 1995 WL 420010, at \*2.

place.<sup>116</sup> The notes did not represent indebtedness of the taxpayer; rather, they were merely promissory notes saying that the parent corporation owed the taxpayer money.<sup>117</sup> Consequently, the only argument for their inclusion into capital was as "surplus and undivided profits."<sup>118</sup> Since the statute did not define surplus, GAAP was used to determine its meaning.<sup>119</sup> The taxpayers used FASB Emerging Issues Task Force, Issue No. 85-1, as authority that the notes should not be included as surplus.<sup>120</sup> This authority did not provide for the inclusion of promissory notes issued by a corporate parent to a subsidiary as surplus.<sup>121</sup> Hence, Judge Thompson held that promissory notes issued by a parent corporation to its subsidiaries are not part of a foreign corporation's capital.<sup>122</sup>

The sole authoritative basis supporting this ruling was the FASB interpretative ruling.<sup>123</sup> While "surplus and undivided profits" was replaced with "retained earnings" by Act 95-564,<sup>124</sup> the *Fifteenth Daniel Realty* ruling is still important for the rule it established. The foreign franchise taxpayer should not focus on the deductibility of promissory notes issued to it by its parent. Rather, the taxpayer should look to the initial capital determination and decide whether inclusion of the notes is warranted.<sup>125</sup>

GAAP was used previously in 1994 to establish that surplus held for the payment of dividends remains capital until the dividends are actually paid.<sup>126</sup> The hearing involved the declaration of dividends made by the taxpayer in 1990 and 1991.<sup>127</sup> The taxpayer did not include the amounts required to pay these

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116. *Fifteenth Daniel Realty*, 1995 WL 420010, at \*2.

117. *Id.* at \*1.

118. *Id.*

119. *Id.*; see also *supra* notes 90-91 and accompanying text.

120. *Fifteenth Daniel Realty*, 1995 WL 420010, at \*2.

121. *Id.*

122. *Id.*

123. *Id.*

124. 1995 Ala. Acts 564. This is merely a change in terminology as the two phrases represent the same thing.

125. See *supra* note 4 (defining capital under ALA. CODE § 40-14-41(b) (Supp. 1997)).

126. *State v. Taxpayer*, No. F. 94-103, 1994 WL 150130, at \*1 (Ala. Dep't Rev. Apr. 19, 1994).

127. *Taxpayer*, 1994 WL 150130, at \*1.

dividends in their capital calculation.<sup>128</sup> Rather, the taxpayer excluded it as money held for the payment of dividends under section 40-14-41(b)(2).<sup>129</sup> Under that subsection, the taxpayer must include "any amounts designated for the payment of dividends until the amounts are definitely and irrevocably placed to the credit of stockholders subject to withdrawal on demand."<sup>130</sup>

Since the law did not specify when a dividend is irrevocably placed to the credit of shareholders subject to withdrawal, the court referred to GAAP and adopted the pertinent section, 44.11, to define when this event occurred.<sup>131</sup> Under that section, a dividend is subject to withdrawal on demand after the date of record and the date of payment.<sup>132</sup> Because the taxpayer had only declared a dividend, it was thus required under the ruling to include the amounts in capital.<sup>133</sup>

The important rule established in this case requires a foreign franchise taxpayer to clear two hurdles before excluding from capital money held for a declared dividend. First, the taxpayer must identify its stockholders and notify them of the distribution. Second, it must actually disburse the payment of the dividend.<sup>134</sup> Furthermore, the timing of these events is important for the exclusion to be properly taken. If the dividend amount is substantial, a foreign taxpayer is well served to consider this rule in determining the timing of its dividend distribution. By complying with the rule, a taxpayer can significantly reduce its Alabama franchise tax liability.<sup>135</sup>

GAAP has also been used as supporting authority to allow a foreign taxpayer to exclude from capital the amount of demand notes owed to a sister corporation.<sup>136</sup> Since 1989, open-account advances and demand notes to a subsidiary taxpayer from a

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128. *Id.* The Taxpayer's Board of Directors declared a dividend of \$90,000,000 on Dec. 31, 1990, and \$100,000,000 on Dec. 31, 1991. *Id.*

129. *Id.*

130. ALA. CODE § 40-14-41(b)(2) (1993 & Supp. 1997).

131. *Taxpayer*, 1994 WL 150130, at \*1.

132. *Id.*

133. *Id.*

134. *Id.*

135. Because the taxpayer did not satisfy the requirements of the rule, it was assessed an additional \$16,916.81 plus interest for the years in issue. *Id.*

136. *MCI Telecomm. Corp. v. State*, No. F. 95-301, 1996 WL 93670, at \*2 (Ala. Dep't Rev. Jan. 11, 1996).

corporate grandparent have been excluded from the taxpayer's capital base.<sup>137</sup> In *MCI Telecomm. Corp. v. State*, the taxpayer challenged the inclusion as capital of demand notes representing debt owed by the taxpayer to its sister corporations.<sup>138</sup> The Administrative Law Division held in favor of the taxpayer for three reasons. Initially, the court cited its decisions in *Norandal USA, Inc. v. State* and *State v. Magnolia Methane Corp.* as excluding from long-term debt any note that is payable on demand.<sup>139</sup> More importantly, the court referred to FASB No. 78, which requires demand notes to be included as current liabilities not assets.<sup>140</sup> Finally, the court referred to GAAP in holding that debt incurred by the taxpayer in the ordinary course of its busi-

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137. *E.g.*, *Norandal USA, Inc. v. State*, 545 So. 2d 792 (Ala. Civ. App. 1989). In *Norandal*, the court held that open-account advances made by a corporate grandparent to the taxpayer were excluded from the taxpayer's capital because the notes were payable on demand to the grandparent, which did not directly own more than fifty percent of the taxpayer's capital stock. *Norandal*, 545 So. 2d at 793. ALA. CODE § 40-14-41(b)(4) specifies when short-term demand notes are includable in the capital base; section 40-14-41(b)(4)(ii), in defining *corporate* ownership of the taxpayer's outstanding capital stock, does not place the restriction of "direct[] or indirect[]" ownership as does section 40-14-41(b)(4)(i), which defines *individual* ownership of the same. ALA. CODE § 40-14-41(b)(4) (Supp. 1997). Therefore, the open-account advances from the taxpayer's grandparent were not includable in capital as short-term debt. *Norandal*, 545 So. 2d at 793.

This created an accessible means of reducing franchise tax liability for many foreign corporations. By creating another corporation to act as the "parent" corporation, the "grandparent" (the true parent corporation) could make advances to subsidiaries who would not have to include the amounts as capital. The "parent" needed to be nothing more than the articles of incorporation. This scheme was utilized in *State v. Magnolia Methane, Inc.*, where the court held that demand notes were indistinguishable from open-account advances for franchise tax purposes because both were payable on demand. *See* 676 So. 2d 341, 342 (Ala. Civ. App. 1996) (providing unanimous affirmation of *Norandal* holding). Therefore, both are short-term debts under the franchise tax statute. *See* ALA. CODE § 40-14-41(b)(4) (Supp. 1997).

138. *MCI Telecomm.*, 1996 WL 93670, at \*1. The taxpayer was a subsidiary of MCI Telecomm., Inc., and a sister corporation of both MCI International, Inc., and MCI Financial Management, Inc. *Id.* The taxpayer was also part-owner of a partnership, Satellite Business Systems, to which it also owed money. *Id.*

139. *Id.* at \*2. The Department argued that the demand notes were long-term debt because the taxpayer did not have sufficient assets on hand to pay the debt. *Id.* The Department made the same fruitless argument in *Magnolia Methane*. *State v. Magnolia Methane, Inc.*, 676 So. 2d 341, 341-42 (Ala. Civ. App. 1996).

140. *MCI Telecomm.*, 1996 WL 93670, at \*3 ("The current liability classification is also intended to include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period.") (quoting FASB No. 78 which amended Accounting Principles Board 43).

ness operations is excluded from capital.<sup>141</sup>

*MCI Telecommunications* has important practical implications. First, foreign taxpayers should not include in capital any demand notes or accounts payable that were obtained during its regular operating cycle. Furthermore, foreign taxpayers do not have to include loans from sister corporations if those advances are made payable on demand, even if the intended term is greater than one year. For that matter, no loan made payable on demand and issued to the taxpayer is includable in capital unless the ownership requirements of the statute are satisfied.<sup>142</sup> The key in this situation is not to specify the term of the loan but to make the loan payable on demand. This allows the taxpayer and its related corporations greater freedom in making intercompany loans without incurring a larger franchise tax liability.

Several recent administrative rulings and one circuit court opinion have addressed the issue of whether a foreign corporation, as general partner in a partnership operating in Alabama, must attribute the long-term debt of that partnership to its capital employed in Alabama.<sup>143</sup> The corporation may be required to include in its capital base that portion of partnership long-term debt that is equal to the corporation's ownership interest in the partnership.<sup>144</sup>

In *Flournoy Development Co. v. State*, the taxpayer was a foreign general partner in several real estate development limited partnerships operating in Alabama.<sup>145</sup> These partnerships obtained nonrecourse, long-term financing for their projects that

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141. *Id.*

142. ALA. CODE § 40-14-41(b)(4) (Supp. 1997).

143. *E.g.*, *American Television & Communications Corp. v. State*, No. F. 95-258, 1995 WL 521626, at \*1 (Ala. Dep't Rev. Aug. 29, 1995); *Flournoy Dev. Co. v. State*, Nos. F. 95-481, F. 95-482, 1997 WL 101681, at \*2 (Ala. Dep't Rev. Jan. 21, 1997); *Macol Corp. v. State*, No. 97-401-R (Ala. Cir. Ct. Montgomery County Sept. 29, 1997).

144. *American Television*, 1995 WL 521626, at \*1. The court stated, "if the entire long-term debt was allocated to each general partner 100 percent, the same capital would be subjected to multiple taxation in Alabama." *Id.* at \*2. Therefore, the debt should be prorated to the taxpayer's Alabama capital base in accordance with the taxpayer's ownership percentage. *Id.* at \*1. The court utilized general principles of partnership law in reaching its verdict. *Id.*

145. *Flournoy Dev.*, 1997 WL 101681, at \*1.

were secured solely by partnership properties.<sup>146</sup> The taxpayer excluded this debt from its Alabama capital, and that action forced the state to adjust the returns to include the debt.<sup>147</sup> In fact, the nonrecourse debt was not the responsibility of the taxpayer, and as such, the taxpayer was not liable for the debt.<sup>148</sup> Judge Thompson found this distinction irrelevant, holding that the taxable event is capital employed in Alabama, regardless of who is liable for it.<sup>149</sup> Since the capital represented by the partnership long-term debt was being employed in Alabama, Flournoy Development was required to include the amount of the debt in its capital base on a pro rata basis.<sup>150</sup>

In *Macol Corp. v. State*, the taxpayer was a majority general partner in a Montgomery investment partnership.<sup>151</sup> As in *Flournoy*, the partnership incurred nonrecourse, long-term debt secured by partnership property which it failed to include in its capital base, thereby triggering an audit.<sup>152</sup> The taxpayer, though, attacked the rule from a new angle, arguing that it was not required by GAAP to record the debt on its financial statements, and therefore, the debt should not be attributed to its capital base.<sup>153</sup> Based on FASB Statement No. 5, the taxpayer argued that it was not required to disclose the debt in its financial records because the likelihood of its having to pay the debt was too remote.<sup>154</sup>

The Administrative Law Division agreed that GAAP did not require the taxpayer to disclose the debt, but that "[t]he substance of the underlying transaction must control, not how it is recorded on a corporation's books."<sup>155</sup> Since the substance of the partnership debt constituted capital employed in Alabama,

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146. *Id.*

147. *Id.*

148. *Id.* at \*2.

149. *Id.*

150. *Flournoy Dev.*, 1997 WL 101681, at \*2.

151. *Macol Corp. v. State*, No. F. 96-266, 1997 WL 101667, at \*1 (Ala. Dep't Rev. Jan. 29, 1997).

152. *Macol*, 1997 WL 101667, at \*1; see also *supra* note 146 and accompanying text.

153. *Macol*, 1997 WL 101667.

154. *Id.* at \*2.

155. *Id.* (quoting *Pechiney Corp. v. State*, No. F. 96-106 (Ala. Dep't Rev. Jan. 1, 1997)).



Macol was required to include its portion of the debt in its Alabama capital base.<sup>156</sup> However, on appeal to the Montgomery County Circuit Court, the taxpayer won using the same argument.<sup>157</sup> The court held that since the 1995 amendments require foreign taxpayers to use GAAP there is no longer any need to use the law of partnership in determining franchise tax liability.<sup>158</sup> Macol presented testimony from its accountant that the exclusion of nonrecourse debt from its investment partnership was proper under GAAP.<sup>159</sup> By showing the court that it complied with the financial accounting standards of GAAP, Macol showed that it complied with the state franchise tax.<sup>160</sup>

Finally, the Alabama Court of Civil Appeals recently held that GAAP does not require a lease to be included in a foreign taxpayer's capital as long-term debt.<sup>161</sup> The Mead Corporation owned and operated a paperboard facility in Phenix City.<sup>162</sup> In 1988, in order to finance construction of a new paper machine, Mead entered into an inducement agreement with the Phenix City Industrial Development Board in which the Board issued bonds to finance the construction.<sup>163</sup> Mead formed MCBI, a wholly-owned subsidiary, to purchase the bonds with capital contributed by Mead.<sup>164</sup> The bond revenue was used to construct the paper machine, which the Board then leased to MCBI.<sup>165</sup> The lease payments, of course, were sufficient to allow the board to pay principal and interest on the bonds.<sup>166</sup>

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156. *Id.* at \*3.

157. *Macol Corp. v. State*, No. 97-401-R (Ala. Cir. Ct. Montgomery County Sept. 29, 1997).

158. *Id.*

159. *Id.*

160. *Id.*

161. *Mead Coated Board, Inc. v. State*, 701 So. 2d 10, 12 (Ala. Civ. App. 1997).

162. *Mead*, 701 So. 2d at 11.

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.* This scheme has two primary advantages for the taxpayer, one now precluded by federal law, and the other provided for under Alabama law. First, the obligations of state and local governments are exempt from federal tax. See I.R.C. § 103 (1997). Therefore, the interest on state bonds is generally considerably less than on private debt because the state bonds do not have to accommodate federal tax. In the industrial inducement scenario, this allows the taxpayer to borrow funds at a lower rate of interest, which creates a lower lease price. The lease price is set at the amount of principal and interest the state owes, which is the cost of the

The Revenue Department included the lease in MCBI's capital base as long-term debt, resulting in the taxpayer's appeal to the Montgomery Circuit Court, which held for the state.<sup>167</sup> On appeal, both the Revenue Department and the taxpayer conceded that under GAAP the lease and the bonds offset each other; consequently, they did not have to be reported in the taxpayer's financial statements.<sup>168</sup> Also, both sides' experts testified that this balance sheet treatment was in conformance with GAAP.<sup>169</sup> The Revenue Department, though, considered the lease a capital lease to be included as a long-term "evidence of indebtedness" under the statute.<sup>170</sup> Because GAAP "extinguished" the debt for financial reporting purposes, the court of appeals held that it could not be evidence of indebtedness.<sup>171</sup> Therefore, MCBI did not have to include it in its franchise tax capital base.

The *Mead* decision marks the first time a court outside of the Administrative Division has addressed the franchise tax since the GAAP revision of Act 95-564.<sup>172</sup> The Court of Civil Appeals' verdict hinged on a GAAP analysis, with the court quoting an Accounting Principles Board's statement on the basics of GAAP.<sup>173</sup> Without the use of GAAP, the lease would

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industrial development. Federal law now prevents states from issuing the bonds for this purpose. Another advantage is that the taxpayer never takes title to the property during the lease period, which will last until the principal and interest liability of the state is extinguished, thereby allowing the taxpayer to avoid property taxes. Also, by allowing the tax-exempt state or local authority to construct the building, the corporation can avoid the sales and use taxes on construction materials, thereby reducing the total cost of production. Currently, though, there is no need to engage in such a scheme in order to avoid these taxes in Alabama. The corporation can now file for an abatement of such taxes with the local industrial authority. See ALA. CODE §§ 40-9B-1 to -7 (1993 & Supp. 1997).

167. *Mead*, 701 So. 2d at 11.

168. *Id.* The bonds were an asset, and the lease was a liability, both equaling the same total amount, thereby canceling out the need to report them.

169. *Id.* at 11-12.

170. *Id.* at 12; see also *supra* note 5 (quoting ALA. CODE § 40-14-41(b)(3) (Supp. 1997)).

171. *Id.* at 12.

172. The Court of Civil Appeals deferred to GAAP prior to the amendments of 95-564. See *West Point Pepperel, Inc. v. State*, 624 So. 2d 579 (Ala. Civ. App. 1992) (holding that reserve accounts for the payment of taxes were not included in franchise tax capital as long-term liabilities). The court gave more weight to GAAP in *Mead*, but its use of GAAP three years before such a statutory requirement certainly illustrates the necessity of the amendments to the law. See *Mead*, 701 So. 2d at 10.

173. *Mead*, 701 So. 2d at 12 (quoting AMERICAN INSTITUTE OF CERTIFIED PUBLIC

likely have been included in the taxpayer's capital.

Furthermore, the case illustrates the effect of GAAP's emphasis on financial form in a court's interpretation of the franchise tax statute. "Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time."<sup>174</sup> Since there was no accounting principle requiring MCBI to include the lease as capital, the court ruled for the taxpayer.<sup>175</sup> In the future, there is a possibility for a form over substance conflict caused by the use of GAAP where the form of the accounting rules will not always follow the substance of the law.<sup>176</sup>

## V. CONCLUSION

The Alabama foreign franchise tax is a unique method of exacting a fee for the privilege of doing business in Alabama. Facially, its structure appears unfair, imposing a much larger burden on the foreign taxpayer as compared to a domestic corporation. Both the United States Supreme Court and the Alabama Supreme Court, though, have clearly expressed their view that the tax is constitutional.<sup>177</sup> Because it has thus far survived constitutional judicial challenges, the political realm has become the primary arena in attempt to change the tax.

Politically, the current structure of the franchise tax does not allow for much change. Domestic taxpayers are content with the existing system, which allows them to easily avoid a large assessment and merely pay the statutory minimum. Conse-

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ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD STATEMENT NO. 4 (1970)). Recall that the Accounting Principles Board preceded the current Financial Accounting Standards Board, to which the franchise tax statute refers. See *supra* notes 77-90 and accompanying text; see also ALA. CODE § 40-14-41(b) (Supp. 1997).

174. *Mead*, 701 So. 2d at 12 (quoting AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD STATEMENT NO. 4 (1970)).

175. *Id.*

176. For a thorough discussion of the propriety of using financial accounting standards to guide tax accounting, see Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, AM. J. TAX POL'Y. (forthcoming 1998).

177. See *White v. Reynolds Metals Co.*, 558 So. 2d 373 (Ala. 1989), *cert. denied*, 496 U.S. 912 (1990); *South Central Bell Tel. Co. v. State*, No. 1960591, 1998 WL 122735, at \*1 (Ala. Mar. 20, 1998) (per curiam) (5-4 decision).

quently, these corporations have every incentive to resist a change in the system, which inevitably will require them to share more of the burden. Foreign taxpayers, on the other hand, are eager to change the tax as it currently requires thorough planning in order to reduce the burden. However, the revenue generated by the franchise tax, the bulk of which comes from the foreign portion, is substantial.<sup>178</sup> Any effort to dramatically alter the tax must recognize that the state will not accept a reduction in revenue.<sup>179</sup>

Faced with this realization, foreign taxpayers obtained slight changes to the law in the 1995 amendments. These changes made necessary accommodations to the law, codifying practices existing prior to the legislation. The foreign subsidiary exclusion, now codified reinstating prior regulatory practice, provides an important means of reducing a corporation's capital, and thereby its tax liability. The separate political efforts used in securing this exclusion for banks are indicative of its importance to the foreign taxpayer.

Additionally, the use of GAAP in computing capital supplies a well of potential authority to support arguments both for and against the inclusion of certain items as capital. It is GAAP that will be very important in refining the foreign franchise tax law in the future. Because of its many rules and interpretations, GAAP creates the potential for arguments over more specific

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178. Through December 1997, franchise tax revenue for the year increased by over 100% from 1996. See generally *Gross Tax Collections*, ALA. TAX REPORTER, Jan.-Dec. 1997 (reporting the monthly collections and comparing them to collections during 1996).

For fiscal year 1998, the tax is expected to yield \$95.5 million in total income for the state. *State Seeking a Speedy High Court Ruling with \$94.5 Million at Stake*, THE TUSCALOOSA NEWS, Jan. 23, 1998, at 8B. \$73.5 million is expected to go to the General Fund, \$15.6 million to the Alabama Department of Human Resources, and \$6.4 million to various county programs. *Id.*

179. The legislature is considering, though, a bill that would give certain companies a twenty-year abatement of franchise taxes. Any company that builds a facility costing \$350 million and creating 2000 jobs or costing \$1 billion and creating at least 1500 jobs would qualify. *James Supports Incentives Bill*, THE BIRMINGHAM NEWS, Sept. 5, 1997, at C1.

The state is also currently offering a twenty-year franchise tax exemption as bait in an effort to sell two Reynolds Metals plants. *Governor Oks Tax Break for Reynolds Plant Buyer*, THE BIRMINGHAM NEWS, Feb. 21, 1998, at 11A. Valid for six months, the offer is conditioned upon the buyer keeping at least half of the plants' current employees. *Id.*

and defined issues. Issues that seem resolved can possibly be reversed by applying the pertinent GAAP provisions. Consequently, those who work with the foreign franchise tax will benefit most in the future from a thorough understanding of GAAP.

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