Gain from Sale of Affiliate Stock Not Subject to Apportionment by Alabama

By Bruce P. Ely and James E. Long, Jr.[*]

Bruce Ely and James Long discuss the *Tate & Lyle* case, where it was determined that an out-of-state corporation was not subject to Alabama corporate income tax on the gain it realized from selling its one-third stock interest in a European company.

In *Tate & Lyle Ingredients Americas, Inc. v. State Department of Revenue*,[1] the Montgomery County Circuit Court granted the taxpayer's motion for summary judgment, affirming Chief Administrative Law Judge Bill Thompson's comprehensive ruling that the taxpayer's gain from the sale of its one-third interest in a European company could not be apportioned to Alabama. The Alabama Department of Revenue (Department) filed a motion to alter, amend or vacate, which was automatically denied when the Circuit Court chose not to consider it within the prescribed time. The Department recently elected not to appeal to the Alabama Court of Civil Appeals.

Background and Audit History

The taxpayer manufactures, markets, and sells sweeteners and other food products primarily in North America. In 1960, the taxpayer acquired a one-third stock interest in the Amylum Group (Amylum), which manufactures, markets, and sells sweeteners and other food products primarily in Europe. The taxpayer manufactured its products from corn, while Amylum used wheat as its principal raw material. Through a series of acquisitions, a U.K. holding company, Tate & Lyle, PLC (T&L), acquired a controlling interest in the taxpayer and the remaining two-thirds interest in Amylum. In 2005, the taxpayer

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sold its interest in Amylum to T&L, which resulted in the $345 million gain at issue in this case. The taxpayer reported the income to Alabama as nonbusiness income, although it mistakenly included the Amylum gain in its sales factor denominator.

Amylum, unlike the taxpayer, never sold any products or conducted any business in Alabama. The taxpayer and Amylum did purchase finished product from each other infrequently, at fair market value, for resale in their respective markets; however, the taxpayer's sales of Amylum products were less than one percent of its total sales during the year at issue. On audit, the Department determined that the gain should be classified as business income and apportioned to Alabama because the taxpayer and Amylum both sold sweeteners and were owned by the same holding company (T&L).

Administrative Law Division: Taxpayer and Amylum Were Not Unitary or Operationally Related

Following briefing and a lengthy hearing at which Prof. Richard D. Pomp of the University of Connecticut and NYU Law Schools served as the taxpayer's expert witness, the Administrative Law Division disagreed with the Department and held that the taxpayer's gain from the sale of the Amylum stock was not sufficiently connected to the taxpayer's activities *in Alabama*, and thus could not be taxed by Alabama under the U.S. Constitution. This holding was based on two separate determinations: (1) the taxpayer and Amylum were not part of a unitary business being conducted in Alabama, and (2) the taxpayer's ownership of the Amylum stock did not serve an operational function related to its business conducted in Alabama.

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Judge Thompson concluded that the taxpayer and Amylum were not involved in a unitary business, noting that the relationship and transactions between the taxpayer and Amylum were "almost identical to the facts" in *Allied-Signal*, where the absence of a unitary relationship was "a foregone conclusion."[2] The Department's primary basis for its assertion that a unitary relationship existed between the taxpayer and Amylum was the fact that the companies were in the same line of business and shared a common parent company. Acknowledging the Supreme Court's statement in *Container Corp. v. Franchise Tax Board* that there may be "an administrative presumption that corporations engaged in the same line of business are unitary,"[3] Judge Thompson nevertheless concluded that the presumption of a unitary relationship was clearly rebutted in this case.

Absence of Functional Integration, Centralized Management, and Economies of Scale

There was no functional integration between the taxpayer and Amylum because they did not share facilities, employees, or service departments (*e.g.,* legal or accounting), and they independently manufactured, marketed, and sold their products to customers on different continents. Other than the minimal sale of finished product, there were no sales or sharing or raw materials between the taxpayer and Amylum.

In addition, there was no centralization of management, because the evidence showed that the taxpayer and Amylum had their own independent management teams with no overlap in officers or directors. While the corporations did share a common parent and their upper level managers exchanged information periodically, Judge Thompson characterized those activities as similar to the "occasional oversight" present in *F.W. Woolworth v. New Mexico Taxation and Revenue Department*.[4] Moreover, the mere *potential* to manage and control its subsidiaries by T&L was not dispositive.[5] Rather, the relevant inquiry was whether any actual control was exercised by T&L over its subsidiaries. Given the lack of common directors and the evident lack of participation in the management of either the taxpayer or Amylum, there was no actual control by T&L and no centralization of management between the taxpayer and Amylum.

Finally, there was no proof of economies of scale resulting from the taxpayer's ownership of Amylum. While they both benefited from global purchasing agreements for supplies and equipment entered into by T&L, this fact only proved that the taxpayer and Amylum had a common parent, not that the companies were unitary. The Department analogized T&L's purchasing agreements to Container's role "in obtaining used and new equipment and in filling personnel needs" for its subsidiaries as evidence of economies of scale between the taxpayer and Amylum.[6] However, the Department's analogy was deficient because it omitted several of the critical characteristics that established a unitary relationship in *Container*, such as Container's managerial role in its subsidiaries' affairs, loaning and guaranteeing substantial funds to its subsidiaries, and the uncompensated technical assistance provided by the parent company. None of these factors were present in this case. The taxpayer's "independent management team had nothing to do with operating Amylum, and vice versa. There were no common directors, no sharing of raw materials or employees, and no interaction between the two companies, except the relatively small amount of finished goods purchased from each other at arm's-length."

In the end, Judge Thompson concluded that the lack of centralized management, functional integration, and economies of scale established that "there was no flow of value between the companies as required for the entities to be unitary."

No Short-Term Working Capital or *Corn Products*-Type Income

Judge Thompson also held that the Amylum stock, while owned by the taxpayer, did not serve an operational function relating to its activities within Alabama.[7] The taxpayer's ownership of Amylum for 45 years was clearly not "a short-term investment of working capital." Nor did the so-called "*Corn Products* doctrine" apply to the taxpayer's ownership of Amylum – the companies manufactured products from different raw materials, *i.e.*, corn versus wheat, and thus the taxpayer did not use Amylum as a source of supply for its business activities in Alabama.[8] Judge Thompson also noted that, while the taxpayer may have used the Amylum sale proceeds to expand its business, this factor was irrelevant in determining whether the Amylum stock, *while owned by the taxpayer*, was operationally related to the taxpayer's business *in Alabama*. Thus, the taxpayer's investment in Amylum was found to be not operationally related to its business being conducted in Alabama.

Prof. Pomp opined that the evidence did not establish that the taxpayer and Amylum were either unitary or operationally related. For example, the taxpayer and Amylum did not possess "such interdependencies as to view the two entities as a single business" and the sale of Amylum stock was unrelated to the taxpayer's business in Alabama. Thus, there was not a sufficient connection between the taxpayer's business activities, in Alabama, and its sale of Amylum stock to justify the State of Alabama taxing the gain. Despite the Department's objections to the admissibility of, in their words, the "dynamic" Prof. Pomp's testimony, Judge Thompson nevertheless held that Prof. Pomp's "conclusions correctly apply the constitutional principles enunciated by the Supreme Court to the facts in this case."

Judge Thompson concluded that the taxpayer had satisfied its burden of proving that the income derived from its sale of the Amylum stock "was earned in the course of activities" unrelated to the taxpayer's business in Alabama.[9] There was substantial evidence that the taxpayer and Amylum operated independent and discrete businesses, and that the Amylum stock, while owned by the taxpayer, was not operationally related to the taxpayer's business activities in Alabama. The department was therefore constitutionally barred from subjecting the gain to apportionment.

MeadWestvaco Not Controlling: Taxpayer's Gain Not Apportionable Business Income

The taxpayer's appeal was pending before the Administrative Law Division when these constitutional issues were pending before the U.S. Supreme Court in *MeadWestvaco Corp. v. Illinois Department of Revenue*.[10] After post-hearing briefs were filed by both parties in the instant case, the Department requested, unsuccessfully, that the judge hold the case in abeyance pending the resolution of *MeadWestvaco*. Judge Thompson held that, even if the Supreme Court modified either the operational function test or the unitary-business principle in *MeadWestvaco*, the Department would nevertheless be precluded from apportioning the gain under Alabama's statutory definition of business income. Alabama's definition of "business income" was amended in 2001 to include a transactional, functional, and "operational related" test for business income.[11]

The transactional test focuses on the nature of the particular transaction giving rise to the income and the customary occurrence and consistency of similar transactions. The sale of stock "held for 45 years was an infrequent transaction not in the taxpayer's regular course of business," and thus did not yield business income under the transactional test. The functional test would apply if the taxpayer acquired, managed, or disposed of the Amylum stock as an integral part of its regular business of selling sweeteners and other food products. However, the taxpayer's "purchase, ownership, and/or sale of the Amylum stock had nothing to do with the Taxpayer's business in Alabama or elsewhere," and thus did not constitute business income under the functional test.

Alabama's operationally related definition of business income was apparently a codification of the operational function test espoused by the U.S. Supreme Court in *Allied-Signal*. Because Alabama's operational definition of business income also requires that the ownership of stock must be operationally related to the taxpayer's activities within Alabama, the Judge Thompson held that the gain did not constitute business income for the same reasons that it was not subject to apportionment under the operational function test in *Allied-Signal*.

Circuit Court Affirms ALJ, Dismisses Final Assessment

After its application for rehearing was denied, the Department appealed Judge Thompson's ruling to the Montgomery County Circuit Court.[12] The taxpayer filed a motion for summary judgment, effectively requesting that the court affirm Judge Thompson's ruling. After discovery and oral arguments, these holdings were affirmed by Circuit Judge Johnny Hardwick's order granting the taxpayer's motion for summary judgment.

As mentioned, the Department then filed a motion to alter, amend, or vacate the Circuit Court's order, arguing that certain material facts were in dispute and that the Amylum stock was indeed a unitary asset used in the Taxpayer's business. The Taxpayer responded that the undisputed evidence before the court established that none of the three "essentials" of a unitary relationship existed between the Taxpayer and Amylum, and secondly, that the gain at issue did not constitute business income under Alabama's statutory definition. The Department's motion was denied by operation of law, and the Department elected not to appeal. Thus, the ruling is now final.

Endnotes

* The authors, with Paul H. Frankel and Michael A. Pearl of Morrison & Foerster LLP, New York, represented the taxpayer in this case.

1 *Tate & Lyle Ingredients Americas, Inc. v. State Department of Revenue*, No. CV-2008-900755 (Montgomery Co. Cir. Ct. Aug. 4, 2009).

2 *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 775 (1992).

3 *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 178 (1983).

4 *F.W. Woolworth v. New Mexico Taxation and Revenue Department*, 458 US 354 (1982).

5 *See ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 323 (1982).

6 *See Container*, *supra* note 3, at 179.

7 *Supra* note 2, at 788.

8 *See Corn Products Co. v. Commissioner*, 350 U.S. 46 (1955).

9 *See Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 221 (1980), *quoting Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980).

10 *MeadWestvaco Corp. v. Illinois Department of Revenue*, 128 S.Ct. 1498 (2008).

11 *See* Ala. Code §40-27-1.1.

12 Admin. Law Div. Dkt. No. CORP. 07-162 (Final Order Den. ADOR's Appl. for Reh'g June 23, 2008).