

# Alabama Tax Developments: 2010 in Review\*

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

Bruce Ely and James Long, Jr. discuss the major legislative, judicial, and administrative developments affecting Alabama taxpayers during 2010 with respect to income, business privilege, transaction, and property taxes.



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The 2010 regular legislative session produced only a handful of noteworthy tax bills, but included an incentive to hire unemployed workers that was one of Republican Governor-elect Robert Bentley's key platform items. The courts decided several cases of importance during the year, including granting a taxpayer's requested corporate income tax refund due to federal audit changes while, unfortunately, concluding that a taxpayer's sale of unitary operating assets produced nonbusiness income. The final section of this article provides a few predictions regarding legislative tax proposals that we expect to be introduced in what is shaping up to be a contentious 2011 regular session.

## Income/Franchise Taxes

**Act 2010-557 – Reemployment Act of 2010:** provides an income tax deduction for Alabama employers that create jobs for unemployed persons. The income tax deduction equals an amount *up to* 50% of the gross wages paid to each person hired—effectively a 150% deduction for wages paid to qualifying employees. While the income tax deduction is only effective for either tax year 2011 or 2012, the Alabama Department of Revenue (ADOR) will allow employers to choose which year to apply the deduction, as confirmed by helpful Q&A's posted on the ADOR's Web site.

**Act 2010-568:** generally conforms Alabama estimated income tax payment thresholds for both individuals

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and corporations to federal law, IRC §§6654 and 6655, retroactively effective for *all tax years beginning after December 31, 2009*. The authors requested assurances from the Commissioner's Office and the Governor's Office that unsuspecting corporate taxpayers would not be zapped with retroactive penalties for the first quarter. Thankfully, the ADOR issued a revenue procedure (2010-01) providing transitional relief to certain taxpayers that are now required to make estimated payments under the Act, and clarified that estates and trusts are not required to make these payments.

**HealthSouth Corporation et al. v. State Dep't of Revenue**<sup>1</sup>: Presiding Circuit Judge Scott Vowell

granted corporate income tax refunds (plus interest) and the requested net operating loss adjustments resulting from HealthSouth Corporation's and its five subsidiaries' IRS audit changes. In doing so, he affirmed in part and reversed in part the decision of the ADOR's Administrative Law Division (ALD). The ADOR filed a motion for new trial after Judge Vowell granted the Taxpayers' requested refunds and NOL adjustments in September, and that motion was denied on November 24. The Department indicated that it plans to appeal to the Court of Civil Appeals.

**Kimberly-Clark Corp. & Kimberly-Clark Worldwide, Inc. v. State Dep't of Revenue**<sup>2</sup>: The Alabama Supreme Court reversed the decision of the Court of Civil Appeals, remanding the case to the circuit court to reinstate the ADOR's final assessments against the Taxpayers. After nearly two years since the ADOR petitioned for *certiorari* review, the Supreme Court concluded that the sale of a pulp/paper mill and related timberlands by the taxpayers should be classified as nonbusiness income under the "transactional test," the only test that applied in classifying business income during the tax years in question (1996-1998). The Taxpayers have filed a motion with the Montgomery County Circuit Court to remand the case to the ALD to consider their alternative constitutional arguments that were not decided initially by the ALD or subsequent reviewing courts.

**Legislative Council Rejects Controversial ADOR Regulation Disallowing Business Privilege Tax (BPT) Deduction for Alabama Investments**: The ADOR issued

a new BPT form and proposed a controversial regulation that simply deleted the BPT deduction for equity investments in entities doing business in Alabama, for all tax years beginning on or after January 1, 2010. Prop. Ala. Admin. Code r. 810-2-8-.08. The Alabama Legislature's administrative agency oversight committee, known as the Legislative Council, voted unanimously

to reject the proposed regulation for several reasons, including double taxation, the Department's attempt to encroach on the legislative function, and because the proposed regulation directly contravenes the BPT statute.

**Composite Return and Qualified Investment Partnership (QIP) Regulations Certified; ADOR**

**Continues to Seek Comments for Possible Revisions**:

The ADOR certified three regulations regarding composite income tax return payment requirements for Subchapter K entities with nonresident members/partners, the exemption for QIPs and the requirements for qualification as a QIP.

**ADOR Repeals Net Operating Loss (NOL)**

**Regulation**: The ADOR repealed Ala. Admin. Code r. 810-3-35.1-.03, "Carryforward of Net Operating Losses for Corporations Apportioning and Allocating Income," effective November 19, 2010. The ADOR's stated reason for repealing the Rule is "due to the fact that it applies to a section of the statute that has been amended; therefore, the [R]ule is no longer accurate." The authors filed comments on behalf of the Council On State Taxation (COST), raising several objections to the ADOR's proposed repeal, including that the ADOR's stated rationale squarely contradicts the Legislature's express intent to "clarify, and not change" Alabama's separate return limitation year rule applicable to consolidated filers.

## Transaction (Sales/Use/Rental) Taxes

**Home Depot USA, Inc. v. State Dept. of Revenue**<sup>3</sup>: Montgomery County Circuit Court Judge William Shashy granted the taxpayer's motion for partial summary judgment, concluding that the taxpayer was entitled to a refund of state and local sales tax attributable to worthless private label credit card accounts,

**Act 2010-568: generally conforms Alabama estimated income tax payment thresholds for both individuals and corporations to federal law, IRC §§6654 and 6655, retroactively effective for all tax years beginning after December 31, 2009.**

and reversing the ALD's decision denying the taxpayer's refund claim. The taxpayer filed a motion for summary judgment regarding the amount of its refund claim, and that motion is still pending before Judge Shashy.

**Nonna Rose Kingsley, LLC, and its Members v. State Dep't of Revenue**<sup>4</sup>: In a ruling of crucial importance to members of LLCs doing business in Alabama, the ALD held that the individual members of a multi-member LLC are not personally liable for withholding (payroll) taxes owed by the LLC, unless they qualify as "responsible persons" under the state's 100% penalty statute. This ruling supersedes a prior, inconsistent ruling issued in 1998 by the ALD. The ADOR has appealed to Jefferson County Circuit Court.

**Warning:** *The ADOR indicates that it will continue to assert personal (joint and several) liability against LLC members for the LLC's taxes until an appellate court rules otherwise or the Alabama LLC Act is amended.*

**Washer & Refrigeration Supply Co. v. PRA Government Services, LLC**: Two Alabama taxpayers have re-filed a very detailed class action suit against the largest private contract auditing firm in Alabama, PRA Government Services, LLC, which conducts business as "Revenue Discovery Systems" or "AlaTax", and its affiliates ("AlaTax"). The complaint alleges several violations by AlaTax or its auditors of the Alabama Taxpayers' Bill of Rights and Uniform Revenue Procedures Act (TBOR). Both tax practitioners and business and professional groups are closely monitoring this case. The complaint was originally filed in Montgomery County, but AlaTax filed a motion to remove the case to federal district court. The district court granted the motion, but then dismissed the case for lack of jurisdiction due to the federal Tax Injunction Act. The taxpayers elected to re-file in Jefferson County Circuit Court. The defendants have filed various motions to dismiss.

**Rental Tax Rule Regarding Incidental Services Amended by ADOR:** The ADOR has amended Rule 810-6-5-.09.01 to provide that the gross proceeds derived by the lessor of tangible personal property for services provided which are incidental to the lease of the property and embodied in the lease agreement are subject to rental tax, *even if* the charge for the service is separately stated. However, if under a separate, optional agreement, the lessor of tangible

personal property performs independent services that are separate, distinct, and not incidental to the leasing of the property, the gross proceeds from those independent services are not considered to be derived from the lease and thus not subject to rental tax. And with respect to delivery or installation services, these charges will be subject to rental tax unless they too are subject to a separate and optional agreement.

## Property Taxes

**Attorney General Opinion No. 2010-094 (Aug. 18, 2010):** concludes that representatives of taxpayers appealing their ad valorem property tax assessments, if the representative is not licensed

by the Alabama Real Estate Appraisers Board, risk criminal charges for providing an estimate of the value of the property at or following the hearing.

## Anticipated Tax Legislation in 2011 Regular Session

The 2011 regular session, which begins March 1, promises to be a difficult one, with large deficits projected for both the Education Trust Fund and General Fund budgets, but with a resoundingly Republican majority in both houses. Many of those were elected or re-elected on a "no new taxes" pledge. Governor-elect Bentley stated that he doesn't intend to raise taxes but has also indicated that there may be as much as \$1 billion in uncollected taxes that, if collected, could be used to fill the budget gap. One senior ADOR official describes the budget crisis as a "train wreck." Amidst all the tumult and shouting that we'll likely witness over revenue needs, the authors expect the following tax-related bills to be introduced. We have focused only on bills of statewide application.

**"Alabama Taxpayers' Bill of Rights II":** In 1992, the Alabama Legislature enacted the landmark TBOR, which was patterned in large part after a similar federal law. Since the enactment of the TBOR, its federal counterpart has been amended several times, and numerous judicial, Administrative Law Division and ADOR rulings interpreting the Act have been issued. Also, the annual COST "Scorecard," which gave Alabama a "D" grade this year, has pointed



out several deficiencies or taxpayer inequities that should be remedied. Some of the key provisions that may be included in the TBOR II legislation include extending the period of time a taxpayer can appeal preliminary and final assessments from 30 to 60 days; repeal of the \$50 penalty for late filing of zero returns; revision of the deadline for filing refund claims or amended returns following an IRS audit; and automatic nullification of a preliminary assessment if no action is taken (either to withdraw it or issue a final assessment) within two years.

Additionally, the TBOR II proposal would establish a stand-alone state agency that would hear appeals of final assessments issued by the ADOR (*i.e.*, most state taxes as well as sales, use, rental and lodging taxes levied by ADOR-administered local governments), and possibly appeals of final assessments of certain local taxes issued by some self-administered cities and counties, by transferring the ADOR's Administrative Law Division to this new agency (the Alabama Tax Appeals Commission). This portion of the TBOR II proposal is modeled after the American Bar Association's Model State Tax Tribunal Act. Alabama is now in the distinct minority of states that do not have an independent tax commission or tax court. The Business Council of Alabama, the Alabama Retail Association, the Alabama State Bar and the Alabama Society of CPAs endorsed an earlier version of this proposal. The Council On State Taxation (COST) and the ABA Section of Taxation have also joined the effort.

**Uniformity of Tax Classification of Pass-through Entities:** At the request of the ADOR, a joint task force was formed last year, consisting of representatives of the ADOR, the Alabama State Bar Tax Section, the Alabama Society of CPAs, the Business Council of Alabama, and the Alabama League of Municipalities. The task force is reviewing draft legislation that would harmonize the classification of various pass-through business entities (*e.g.*, LLCs and LPs) for Alabama state and local tax purposes by limiting conformity with the federal "check the box" regulations to only Alabama *income* and *financial institution excise taxes*, while preserving the sales, use and rental tax exclusions for certain related party transactions and the property, business privilege, and sales and use tax exemptions for disregarded entities that exist under Alabama's current classification regime. The proposal would also clarify that members of a multi-member LLC are not personally liable for the LLC's sales, use, payroll and other non-income taxes solely because their LLC is classified as a partnership for federal and Alabama tax purposes, thereby codifying

the recent ruling by the ALD in *Nonna Rose Kingsley, LLC* (discussed above).

**Adoption of Streamlined Sales and Use Tax Compact:** A number of states have banded together to create a set of uniform sales and use tax rules to reduce the difficulties and uncertainties of doing business in multiple jurisdictions, known as the Streamlined Sales and Use Tax Compact or simply "SST". Forty-three states have joined either as full members or (in the case of Alabama and several others) associate members. Most recently, Tennessee and Georgia have joined. We expect there to be a renewed effort next session for Alabama to join the SST Compact because this would not be a "new tax" but merely a compliance effort. Proponents also focus on the reduced costs (and fewer traps) of compliance especially for small businesses. We also are monitoring Congressional efforts with the bipartisan "Main Street Fairness Act," H.R. 5660, which would mandate SST compliance by all states that levy a sales tax and by all vendors with sales into a particular state that exceed a certain dollar threshold.

**Mandatory Unitary Combined Reporting:** would require a group of two or more corporations to file a combined report (income tax return) that includes the income and apportionment factors of all corporations that are members of a "unitary" business—regardless of whether all members have nexus with the state. The last proposal, H.B. 865, would also have simultaneously repealed Alabama's nexus consolidated reporting regime. Both the well-respected COST and the Organization for International Investment submitted letters to the bill's primary sponsor and other key legislators expressing their opposition to H.B. 865. As a result, the bill did not move out of committee. While the powerful Alabama Education Association and its supporters did not introduce this bill during the 2010 Regular Session, we may see this proposal next session.

**Business Privilege Tax Deduction for Equity Investments:** As a result of numerous comments filed in opposition to the proposed BPT regulation discussed above, ADOR officials began informal talks with various business groups regarding an alternative legislative proposal. The most recent legislative proposal includes a deduction for equity investments in *all* entities (to comply with the *AT&T* ruling), but it is coupled with a formulaic add-back of certain liabilities as a result of the deduction. Near the end of the 2010 session, the ADOR indicated that it would not push for an increase to the \$15,000 BPT cap applicable to most taxpayers as part of this process. While this proposal was never

introduced during the 2010 Regular Session, we expect the ADOR to renew its push for a legislative fix in 2011.

**“Gross Income Regulation” Fix:** legislation was discussed during the 2008 and 2009 regular sessions that would have confirmed, but delayed the effect of, the ALD’s controversial ruling in *McNees v. State Dep’t of Revenue*. Readers may recall that the ruling (which the ADOR – to no one’s surprise – did not appeal) invalidated the ADOR’s own entity-level apportionment regulation and held that an Alabama resident-owner of a multistate pass-through entity must include his or her *entire*, unapportioned distributive share of the entity’s income or loss in computing his or her Alabama income. Similar to

proposed ADOR regulations issued after the *McNees* decision that were opposed and eventually withdrawn, the 2009 proposal would have allowed an income tax credit for resident owners of multi-state Subchapter K entities and S corporations for their share of income taxes paid on their behalf via composite returns, withholding, etc. to states other than Alabama.

The ADOR argues that it’s now being whipsawed by taxpayers, with some relying on the Gross Income Regulation to apportion income away from Alabama, and others relying on the *McNees* ruling to import losses incurred in other states. Thus, we expect the ADOR to renew their efforts, likely by proposed legislation.

## ENDNOTES

\* The authors’ firm represents several of the taxpayers or business/professional associations involved in the cases and proposed legislation discussed.

<sup>1</sup> *HealthSouth Corporation et al. v. State Dep’t of Revenue*, No. CV 09-902941 (Jefferson County Cir. Ct. Nov. 24, 2010).

<sup>2</sup> *Kimberly-Clark Corp. & Kimberly-Clark*

*Worldwide, Inc. v. State Dep’t of Revenue*, \_\_ So. 3d \_\_, Case No. 1070925 (Ala. S. Ct. Sept. 17, 2010), *as modified on denial of reh’g & rev’g* No. 2061117 (Ala. Civ. App. Mar. 21, 2008).

<sup>3</sup> *Home Depot USA, Inc. v. State Dep’t of Revenue*, Montgomery County Cir. Ct. CV-2008-1025 (Jan. 4, 2010), *rev’g* Admin. L.

Div. Dkt. No. S. 06-1079 (June 6, 2008).

<sup>4</sup> *Nonna Rose Kingsley, LLC, and its Members v. State Dep’t of Revenue*, Admin. L. Div. Dkt. No. W. 09-1194 (April 15, 2010)(on appeal).

<sup>5</sup> *Washer & Refrigeration Supply Co. v. PRA Government Services, LLC*, Jefferson Co. Cir. Ct. CV 2010-903417 (Sept. 17, 2010).

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