

PUBLICATION

Spotlight on Alabama: State and Local Tax Developments in 2008

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There have been several important Alabama legislative, administrative and legal developments that individuals and businesses should note.

Administrative Law and Court Decisions

Sales and Use Tax

1. Independent Agents Establish Nexus for Out-of-State Company: A Mississippi-based taxpayer rented graduation caps and gowns in Alabama but otherwise did not own property or have employees in Alabama. However the taxpayer had a business relationship by which four employees of an unrelated company assisted the taxpayer. These persons (or possibly their employer in Alabama) were paid on a commission basis for measuring students for caps and gowns, providing and collecting order forms and submitting orders to the taxpayer. These persons accounted for approximately 95% of the taxpayer's rentals in Alabama.

The administrative law judge held that, even in the absence of any written agreement, the in-state persons were the agents of the taxpayer and allowed the taxpayer to establish and maintain its Alabama business, thereby creating nexus for the taxpayer with Alabama.

The taxpayer was also deemed to have nexus because of the presence, although temporary, of its caps and gowns in Alabama from time to time. While seemingly the case could have been decided on this basis alone, the decision indicates that the implied agency relationship of the in-state persons also provides the needed nexus. Graduate Supply House, Inc. v. Alabama Department of Revenue, Administrative Law Division, No. S05-751, November 20, 2007.

2. First Use of Vehicles Determines Taxability: Related corporations headquartered in Alabama were not liable for Alabama use tax on used trailers it purchased from non-dealers outside Alabama that were first placed in service and use outside of Alabama. The taxpayers never intended to use the trailers in Alabama. The taxpayers were not liable for Alabama use tax on their subsequent use of the trailers in Alabama. Similarly, the taxpayers were not liable for Alabama use tax on new trailers they purchased from an out-of-state dealer when such trailers were also first used outside of Alabama. Further, the taxpayers were not liable for Alabama use tax on trucks they purchased in Alabama and assigned to terminals outside Alabama even though the taxpayers failed to provide valid drive-out sales tax certificates. Suttles Truck Leasing, Inc. v. Alabama Department of Revenue, Alabama Department of Revenue, Administrative Law Division, No. S. 07-503 and S. 07-504, July 22, 2008.
3. Sales Tax Refunds Not Assignable Under Bad Debt Regulations: Credit companies financed installment sales by various retailers of tangible personal property. The retailers assigned the resulting installment sales contracts to the credit companies. The credit companies paid to the retailers the entire amount financed, including sales tax due. When purchasers defaulted on the installment sales contracts, the credit companies concluded the accounts were uncollectible and petitioned the Alabama Department of Revenue ('ADOR') for refunds of the uncollectible sales taxes, relying on Alabama's 'bad debt' regulation. ADOR refused to make

the refunds and the Alabama Administrative Law Judge affirmed. The Circuit Court of Montgomery County, however, granted partial summary judgment to the credit companies. In overturning the trial court's decision, the Alabama Court of Civil Appeals noted that under the Taxpayer Bill of Rights, strict compliance with tax statutes and regulations dealing with refunds was required. The court then found that under the bad debt regulation, the credit companies were not retailers since they were not selling tangible personal property items and did not remit sales tax revenues. Therefore, were not entitled to the sales tax refunds.

Alabama State Department of Revenue v. Wells Fargo Financial Acceptance Alabama, Inc., Alabama Court of Civil Appeals, No. 2061148, July 18, 2001.

4. **Administrative Appeal Procedures in Alabama Taxpayers' Bill of Rights Equally Applicable To Local Taxing Authorities:** The Tuscaloosa County Special Tax Board (the 'Tax Board') issued an assessment of the sales taxes. The taxpayer filed a petition with the Tax Board, seeking review of the assessment. The Tax Board, however, notified the company that it did not have an administrative appeal process. The taxpayer filed an action against the Tax Board and Tuscaloosa County seeking a judgment declaring that the Tax Board, in issuing a final assessment and in 'reinterpreting' its appeal procedures, violated Alabama statutes and the taxpayer's constitutional due process rights. The court dismissed the taxpayer's action as untimely, and the taxpayer appealed. The Supreme Court of Alabama reversed and remanded, holding that the Local Tax Simplification Act of 1998 required all local taxing authorities to have an administrative appeal process in conformity with the Alabama Taxpayers' Bill of Rights. Further, the Supreme Court held that because the taxpayer filed a notice of appeal to the Circuit Court of Tuscaloosa County within 30 days of the Tax Board's letter denying an appeals process, the taxpayer's notice of appeal was timely under the Taxpayers' Bill of Rights. Pittsburg & Midway Coal Mining Co. v. Tuscaloosa County, Alabama Supreme Court, No. 1060496, May 16, 2008.

Corporate Income Tax

5. **Gain From Sale of Stock in Non-Unitary Affiliate Not Subject to Alabama Corporate Income Tax:** 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, despite the fact that the two companies were in the same general line of business and were owned by the same holding company.

The Alabama Department of Revenue treated the gain as apportionable business income and assessed the taxpayer accordingly based on its conclusion that the companies were unitary and operationally related. The determining question was whether there was a flow of value between the companies, as evidenced by functional integration, centralization of management, and economies of scale. Applying those three factors and the statutory functional, transactional or operationally functional tests, the Administrative Law Judge held that the taxpayer and the European company were not involved in a unitary business. Tate & Lyle Ingredients Americas, Inc. v. Alabama Department of Revenue, Alabama Department of Revenue, Administrative Law Division, No. CORP. 07-162, January 15, 2008.

6. **Alabama Add-back Requirement Was Reasonable, Constitutional:** The taxpayer, an in-state manufacturing company, licensed certain trademarks and intellectual property from an affiliated intangible management company ("IMCO"). The Alabama Department of Revenue determined that royalty payments to the IMCO had to be added-back to the taxpayer's income under Alabama's version of an add-back statute, Alabama Code Section 40-18-35(b). A circuit court found for the taxpayer holding that the add-back was unreasonable under the statute's own language.

The Alabama Court of Civil Appeals reversed and held that even though the IMCO had economic substance and bona fide business purposes, the add-back was not unreasonable because it did not result in taxation disproportionate to the taxpayer's presence and operations in Alabama.

The Court of Civil Appeals also held that the income of the IMCO was not "subject to tax" in another state within the meaning of the statutory exception to the add-back requirement. The IMCO's income was taxable in North Carolina, but only to the extent of its four percent apportionment factor there. The court decided that only the portion of the IMCO's income actually apportioned to North Carolina, and not the IMCO's pre-apportionment income, was subject to tax within the meaning of the statute.

Finally, the Court of Civil Appeals held that the add-back statute did not violate either the Commerce Clause or Due Process Clause of the U.S. Constitution because it did not effectively tax out-of-state IMCO's, create a disproportionate Alabama tax, or discriminate in favor of in-state corporations. Surtees v. VFJ Ventures, Inc., Alabama Court of Civil Appeals, No. 2060478, February 8, 2008; aff'd, Alabama Supreme Court, No. 1070718, September 19, 2008.

Alabama Tax Legislation

Business Tax Provisions

7. [Continuation of the Alabama Capital Credit Program, Act 2008-519](#): The Alabama Capital Credit is the major industrial development tool of Alabama in the tax arena. Qualifying new or expanded industrial projects can effectively pay no Alabama income tax for 20 years on income generated by the project. The capital credit legislation would have expired for application to new projects on December 31, 2008. This legislation extends the sunset provision until December 31, 2013.
8. [Captive Real Estate Investment Trusts, Act 2008-543](#): This Act closes a loophole under which a 'captive REIT' might take a dividends paid deduction under the REIT tax rules and a controlling corporation take a dividends received deduction under the corporate income tax rules. A Captive REIT is defined as one whose shares are not publicly traded and are owned or controlled at any time in the last half of the tax year by an association taxable as a corporation which is not itself a REIT or a qualified foreign entity.
9. [Clarification of the 'Add-Back' Statute, Act 2008-543](#): This Act also amended Section 40-18-35(b) which provides that a corporation must add back to its taxable income otherwise deductible interest and intangible expenses paid to a related party. Section 40-18-35(b) provides an exception if the corresponding item of income of the related party is 'subject to tax' based on the related party's income in Alabama or another state. The amendment seeks to clarify that statute by stating that the determination of whether income is subject to tax is to be made after applying the taxing jurisdiction's allocation and apportionment methodology. This amendment is intended to address an argument presented by the taxpayers in *VFJ Ventures*.
10. [Health Insurance Deductions for Small Business, Act 2008-539](#): Under the Small Business Health Insurance Premium Deduction Enhancement Act, qualifying employers and employees will be permitted to deduct from Alabama income tax an additional fifty percent (50%) of the amount paid for health insurance.

A qualified employer is defined as any small business with fewer than twenty-five (25) employees. A qualified employee is defined as any employee of a qualified employer that is an Alabama resident earning wages of \$50,000 or less, and reporting an adjusted gross income of \$75,000 or less (\$150,000 if married filing jointly). The new law is effective as of January 1, 2009.

11. [Decoupling from the Economic Stimulus Act of 2008, Act 2008-549](#): In addition to providing tax rebates to individuals, the federal Economic Stimulus Act of 2008 adopted enhanced Section 179 business expensing benefits for depreciable personal property and included a 50 percent (50%) first year bonus depreciation incentive for qualifying business property.

While Alabama's depreciation rules generally follow the federal rules, this Act specifically excludes these enhanced business deductions from the calculation of Alabama taxable income for any tax year.

Individual Taxes

12. [Deduction for Contributions to College Tuition Programs, Act 2008-377](#): Contributions to either the Alabama Prepaid College tuition Program or the Alabama College Education Savings Program made in 2008 or later are now deductible for Alabama income tax purposes.
13. [Exclusion of Federal Tax Rebates, Act 2008-549](#): This Act provides for the exclusion from Alabama taxable income of federal tax rebates received pursuant to the Economic Stimulus Act of 2008. The amount of the rebates are also excluded from any and all calculations of the Alabama deduction for federal income taxes paid.

Withholding Tax – Sales or Transfers of Real Estate, Act 2008-504

14. [Generally](#): Effective August 1, 2008, this Act adds new Section 40-18-86 to the Alabama Code which requires in the case of a sale or transfer of real property and related tangible personal property located in Alabama by a nonresident of Alabama, the buyer or transferee shall be required to withhold and remit a withholding tax equal to three percent (3%) of the purchase price for individual buyers and four percent (4%) of purchase price for corporate, partnership or unincorporated association buyers. The withholding is limited to the amount of the net proceeds of the sale. The legislation has some apparent flaws. For example, it does not mention limited liability companies. Also it is not clear why the identity of the buyer, as opposed to the seller, determines the appropriate withholding rate.
15. [Penalty for Buyer](#): Failure to withhold and pay over the tax results in personal liability for the tax for the buyer.
16. [Residence](#): Withholding is not applicable to residents or deemed residents of Alabama. A resident seller can, but is not required to, and a deemed resident seller must, supply the buyer with an Affidavit of Residence. The ADOR has drafted a form for this purpose. The buyer's good faith reliance on the seller's Affidavit of Residence eliminates any potential liability for the buyer. Buyers should routinely ask for an affidavit from any seller.

While the statute does not define a resident, information supplied by the Department of Revenue has defined residence in the following terms:

Residents of Alabama. Individuals and business entities domiciled in Alabama. Business entities will be considered domiciled in Alabama if the entity is organized under Alabama law or if the entity has its principal place of business in Alabama.

Nonresidents of Alabama. The ADOR states that the term 'Nonresident of Alabama' includes individuals, trusts, partnerships, corporations, and unincorporated organizations. For purposes of Alabama Code Section 40-18-86 (the Act), the following persons are Nonresidents of Alabama and are, therefore, subject to the withholding tax requirements:

1. Individual – Any individual having his or her principal residence outside Alabama at the time of closing, unless he or she otherwise meets the requirements of Section 40-18-86(a)(1) through (4) to be deemed a resident.

2. Business Entities and Estates – Any business entity (corporation, partnership, LLC, LLP, trust) or estate whose principal place of business is located outside Alabama, unless it meets the statutory test for a 'deemed resident' (or, presumably, if it is an entity organized under Alabama law).

Furthermore, no withholding is required if the seller is a "deemed resident," which is defined in Section 40-18-86 as a seller meeting the following requirements:

The seller or transferor has filed Alabama income tax returns or appropriate extensions for the two tax years immediately preceding the sale;

The seller or transferor is in business in Alabama and will continue substantially the same business in Alabama after the sale or the seller or transferor has real property remaining in Alabama at the time of closing of equal or greater value than the withholding tax liability as measured by the 100% property tax assessment of such remaining property;

The seller or transferor will report the sale on an Alabama income tax return for the current year and file the return by the due date (or extended due date); and

The seller or transferor is registered to do business in Alabama if the seller is a corporation or a limited partnership. (Note: Presumably this applies to LLCs and LLPs as well.)

17. Statutory Exemptions: The Act specifically exempts the following transactions from withholding:

- Principal Residence. Sales of principal residences within the meaning of Section 121 of the Code;
- Foreclosures. Transfers to a mortgagee in foreclosure or in lieu of foreclosure with no additional consideration;
- Government Entities. Transfers by agencies or authorities of the United States, the State of Alabama, FannieMae, FreddieMac and Ginnie Mae; and
- Composite Returns. Transfers by a partnership or S corporation which certifies to the buyer that it will file a composite tax return on behalf of all nonresident partners, members or shareholders and remit the appropriate tax.

18. Limitation For Amount of Gain: If the seller determines that the amount to be withheld will result in excess withholding on any gain to be recognized from the sale, the seller may provide the buyer with an affidavit signed under oath swearing to the amount of gain to be recognized on the sale. In such a case the withholding rate is applied only to the amount of the gain rather than the purchase price. As a corollary to this statutory limitation, the ADOR has stated that transfers by tax-exempt organizations and transfers in which gain is realized but not recognized, e.g. 1031 exchanges, are exempt from the withholding requirement.

19. Disregarded Entities: Though not addressed in the statute, the Department has indicated that if a seller is a disregarded entity for Alabama income tax purposes, it will be disregarded for withholding tax purposes as well. Therefore, the residency tests will apply at the owner level.