



# Alabama Tax Developments: 2011 Year in Review

By Christopher R. Grissom, James E. Long, Jr. and William T. Thistle, II

Our final Alabama SALT Bulletin of 2011 summarizes the major legislative, judicial, and administrative developments affecting Alabama taxpayers with respect to income, transaction and property taxes. The Spring 2011 legislative session produced several noteworthy tax bills, including an incentive designed to encourage foreign manufacturers to locate in Alabama, adoption of a double-weighted sales factor coupled with market sourcing for sales of intangibles and services, and the creation of the Alabama Streamlined Sales & Use Tax Commission. The courts decided several cases of importance during the year, including upholding a taxpayer's calculation of its I.R.C. section 199 deduction on a separate company basis while, unfortunately, denying a retailer's sales tax refund attributable to uncollectible private label credit card accounts. The final section of the Bulletin provides a few unofficial predictions regarding legislative tax proposals that we expect to be introduced in the 2012 regular session.

## I. INCOME/FRANCHISE TAXES

**Act 2011-17 – Rejection of Business Privilege Tax (“BPT”) Regulation:** sustained the Legislative Council's unanimous decision to reject the Alabama Department of Revenue's (“ADOR”) controversial regulation that attempted to repeal the statutory BPT deduction for the book value of a taxpayer's investments in the equity of another business entity that's also doing business in Alabama. For more information, please click [here](#).

**Act 2011-551 – The Full Employment Act of 2011:** as promised by Governor Bentley in his State of the State speech, offers a one-time income or financial institution excise tax credit of \$1,000 for each new job created by small businesses (i.e., no more than 50 employees as of January 1, 2011). For more information, please click [here](#).

**Act 2011-648 – The Tariff Credit Act of 2011:** has a limited focus and is designed to encourage foreign manufacturers to locate in Alabama by providing an income tax credit to companies investing in qualifying projects that meet certain minimum requirements. For more information, please click [here](#). The Alabama Education Association (AEA) is supporting and apparently funding a lawsuit recently filed by two teachers against Governor Robert Bentley and the ADOR, challenging the constitutionality of the Tariff Credit Act, along with two other incentive measures. **Gibson v. Bentley**, Case No. CV 2011-900998 (Montgomery County Cir. Ct. Aug. 3, 2011). We are awaiting a ruling from the circuit court on whether the plaintiffs even had standing to file their lawsuit.

**Act 2011-616 – Double-Weighted Sales Factor and Market-Based Sourcing:** amends Alabama's version of the Multistate Tax Compact to double-weight the sales factor in the previously equally-weighted three-factor formula used to apportion business income to Alabama, effective for tax years beginning on or after December 31, 2010. In addition, the bill amends Alabama's apportionment methodology by converting Alabama from a “cost of performance” state to a “market source” state for receipts from certain intangibles or services. The ADOR is in the process of developing interpretive regulations.

*Caveat: Members of our SALT Practice Group are or were involved in several of the cases and items of legislation discussed in this Bulletin.*

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### AUTHORS



**Christopher R. Grissom**  
205.521.8514  
[cgrissom@babbc.com](mailto:cgrissom@babbc.com)



**James E. Long, Jr.**  
205.521.8626  
[jelong@babbc.com](mailto:jelong@babbc.com)



**William T. Thistle, II**  
205.521.8985  
[wthistle@babbc.com](mailto:wthistle@babbc.com)

**Act 2011-709 – Tornado Recovery Tax Incentive Protection Act of 2011:** provides that the wage and employment requirements for Alabama’s capital credit are tolled for two years for otherwise qualifying projects that were damaged by the devastating tornado outbreaks in late April.

**GKN Westland Aerospace, Inc. v. State Department of Revenue,** Admin. Law Div. Dkt. No. BIT. 10-988 (July 25, 2011): In a case of first impression, Chief Administrative Law Judge Bill Thompson held that a corporate taxpayer properly calculated its I.R.C. § 199 domestic production activities deduction (“DPAD”) by applying the taxable income limitation on a separate company basis for Alabama income tax purposes, voiding the 2007 final assessment entered against the taxpayer. Judge Thompson agreed with the taxpayer, holding that ADOR “Reg. 810-3-1.1-.01(4)(a) requires, . . . that for Alabama tax purposes, the Taxpayer’s DPAD, and specifically the income limitation in issue, must be calculated on a separate entity basis. The [taxable income] limitation thus did not apply for Alabama purposes in the subject years because, unlike the Group, which had consolidated losses in those years, the Taxpayer had income as a separate company in those years greater than the allowable DPADs.” The ADOR did not appeal the ruling.

**Temporary Modification of Gross Income Regulation for 2011:** Under prior ADOR regulations, income earned by a pass-through entity in another state was apportioned to and taxable by that state—assuming it levied an individual income tax. If it did not (e.g., Florida, Texas or Tennessee), then the income escaped taxation by Alabama, but the Alabama resident owner was entitled to a deduction for federal income taxes paid on his or her entire, pre-apportioned distributive share of income due to a provision of the Alabama Constitution. For all tax years beginning after December 31, 2010, the ADOR proposed to amend three regulations, including its so-called “gross income regulation,” which provided for this result. The proposed regulations became final on September 7, 2011, but with two ADOR amendments. First, they added a sunset provision that limits the regulation to the 2011 tax year and will allow the compromise legislation that died on the last day of the 2011 legislative session to be reintroduced (and likely passed) next session. Secondly, the ADOR included a provision that prevents any amendments to these regulations from applying to certain asset sales for which negotiations began in 2010 but that closed in 2011.

## II. TRANSACTION (SALES/USE/RENTAL) TAXES

**Act 2011-709 – Tornado Recovery Tax Incentive Protection Act of 2011:** provides that any tax abatement that was granted pursuant to the Tax Incentives Reform Act of 1992 (“TIRA”) shall not be forfeited solely because of delays caused by repairs to or replacement of property damaged in the devastating tornado outbreaks this April. This expansion of TIRA is effective for any property acquired or transactions entered into before December 31, 2012.

**Act 2011-563 – Streamlined Sales Tax Commission:** establishes the Alabama Streamlined Sales and Use Tax Commission to develop, implement, and administer the programs necessary for Alabama to come into compliance

with the Streamlined Sales and Use Tax Agreement, in the event that federal legislation implementing the agreement, or similar principles, becomes law. For more information, including details of the Commission’s preliminary report and recommendations, please click [here](#).

**Logan’s Roadhouse, Inc. v. State Dep’t of Revenue,** \_\_\_ So. 3d \_\_\_, Dkt. No. 2090753 (Ala. Civ. App. May 13, 2011): The Alabama Court of Civil Appeals held that a taxpayer is not liable for Alabama use tax on the wholesale cost of complimentary peanuts that it buys and provides to its customers, affirming the decision of the Jefferson County Circuit Court (that had reversed the decision of the Administrative Law Division). The Court of Civil Appeals agreed with the Circuit Court’s reasoning, holding “all that is required for purposes of classifying a bulk sale to a retailer, such as the taxpayer’s purchases of quantities of peanuts, as a nontaxable ‘wholesale sale’ is that a subsequent retail ‘resale’ of tangible personal property occur; there is no statutory requirement for purposes of classifying a sale as a retail sale that a separate price be overtly stated and paid. To treat the taxpayer, a restaurant operator, as liable for use tax based upon its purchase of peanuts in bulk for its customers to consume as a part of their lunch and dinner meals, as the ADOR suggests be done in this case, would disregard the evidence presented at trial indicating that the taxpayer charges its customers for the average incremental cost of peanuts they aggregately consume.” The ADOR’s application for rehearing was overruled by the Court of Civil Appeals.

**Magee v. The Home Depot USA, Inc.,** \_\_\_ So. 3d \_\_\_, Dkt. No. 2100715 (Nov. 4, 2011) (on appeal): The Alabama Court of Civil Appeals held that the taxpayer was not entitled to a sales tax refund under the ADOR’s bad debt regulation for certain uncollectible private label credit card accounts, thereby reversing the decision of the Montgomery County Circuit Court that granted the taxpayer’s refund claim. The Court held that the bad debt regulation did not apply when a third party finance company, instead of the retailer, administered the credit card program and charged off the worthless accounts. The taxpayer has filed a petition for *certiorari* with the Alabama Supreme Court.

**Box Family Restaurants, LLC v. State Department of Revenue,** Admin. Law Div. Dkt. No. S. 11-375 (Prelim. Order on Taxpayer’s Appl. for Reh’g June 28, 2011): Chief Administrative Law Judge Bill Thompson recently affirmed his ruling that the individual members of a multi-member LLC are not personally liable for withholding (payroll) or sales taxes owed by the LLC, unless they qualify as “responsible persons” under the state’s 100% penalty statute. That issue is critically important to investors in LLCs that operate in Alabama. For more information, please click [here](#).

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

**City of Birmingham v. Orbitz, Inc. et al.,** CV 09-3607 (Jefferson Co. Cir. Ct. Mar. 24, 2011) (on appeal): Presiding Judge Scott Vowell issued a final order in the ongoing battle between

nine Alabama municipalities and Orbitz, Inc., and 15 other online travel service companies (OTCs), holding that Alabama's lodgings tax did not apply to the OTCs' compensation for their online travel services and ruling against the municipalities. Judge Vowell concluded that "[t]he plain language of the statute and the plaintiffs' ordinances compel the Court to the conclusion that the defendants . . . are not engaged in the business of renting or furnishing any room or rooms," again citing the ADOR regulation. "These defendants are not hoteliers. These defendants do not operate a hotel . . . They provide a service to the public for which they are compensated by their customers. The compensation is not subject to the lodging tax." The municipalities appealed to the Alabama Supreme Court. We expect a ruling soon.

**Washer & Refrigeration Supply Co. v. PRA Government Services, LLC**, Jefferson Co. Cir. Ct. CV 2010-903417 (Oct. 19, 2011): Two Alabama taxpayers filed a very detailed class action suit against the largest private auditing firm in Alabama, PRA Government Services, LLC, which does business as "Revenue Discovery Systems" or "AlaTax," and its affiliates, requesting damages for prior assessments, as well as declaratory and injunctive relief. The complaint alleges multiple violations by AlaTax or its auditors of the Alabama Taxpayers' Bill of Rights ("TBOR"). The Circuit Court ruled in favor of the taxpayer-plaintiffs recently and allowed the case to proceed to the class certification phase. For more information, please click [here](#).

### III. AD VALOREM PROPERTY TAXES

**Dunn v. Sequa Corp.**, \_\_\_ So. 3d \_\_\_, Dkt. No.2100299 (Ala. Civ. App. Jun. 24, 2011): The Alabama Court of Civil Appeals awarded a refund of property taxes that Sequa Corp. erroneously paid on abated property in 2007, 2008, and 2009. In May 2005, the Industrial Development Board of the City of Hueytown and Sequa entered into a tax abatement agreement under which Sequa was granted an abatement of certain noneducational property taxes. In 2007 and 2008, Sequa did not reference its tax abatements on its personal property tax returns and overpaid its taxes. The Court held that while a taxpayer is generally required to notify the tax assessor of an exemption, an exception to that general rule exists when the taxpayer's failure was a mistake or error. The Court granted Sequa's refund petition because nothing in the record indicated that Sequa intentionally chose to reject the tax exemptions to which it was entitled by virtue of the tax abatement agreement and TIRA.

**Sustainable Forests, LLC v. Ala. Dep't of Revenue**, \_\_\_ So. 3d \_\_\_, Dkt. No. 2091149 (Ala. Civ. App. June 10, 2011), cert. denied Case No. 1101088 (Ala. S. Ct. Sept. 30, 2011): The Alabama Court of Civil Appeals held that the recording of deeds evidencing the transfer of property from the owner of three single-member limited liability companies to the LLCs did not fall within any of the exceptions provided under Ala. Code § 40-22-1 and was therefore subject to recordation tax. The taxpayer claimed that a refund of recordation tax paid on the transaction was due because an LLC is a disregarded entity for tax purposes and therefore the deeds did not actually convey property or any interest in property for purposes of the recordation tax. See Ala. Code § 10-12-8(b). However, the

Alabama Supreme Court held in *Hawkins v. Pure Oil Co.*, 232 Ala 660, 169 So. 307 (1936), that the purpose of the recordation tax is not the perfection of title to real estate, but the perfection of the record of the transaction, and the tax is exacted for the privilege of recording the evidence of the transaction. Because the tax is imposed on the recording of the document and not on the underlying transaction, it must be paid unless a specific exemption applies; thus, the taxpayer was not entitled to a refund.

**Ala. Att'y Gen. Op. No. 2011-065** (May 25, 2011): Similar to prior opinions, the Attorney General advised that residential real property owned by an LLC is never entitled to a homestead exemption in the name of the LLC. An individual occupant of the subject property, however, may be entitled to the homestead exemption if their occupancy arises from a valid, arm's-length executory sales agreement between the individual occupant and the LLC. When the individual occupant is also an officer or member of the owner/LLC, the AG cautioned that the details of the underlying sales transaction should receive careful scrutiny. Accordingly, special attention must be paid to the reasonableness of the sales price, the length of the contract term, and any other factors that appear to depart from a true arm's-length real estate transaction.

### IV. ANTICIPATED TAX LEGISLATION IN 2012 REGULAR SESSION

The 2012 regular session, which begins February 7, is expected to focus on several important tax and economic development proposals, as well as immigration reform and, of course, the state budgets. The session promises to be a difficult one for the General Fund budget, with a projected deficit of at least \$400 million (22.6% of the total budget), as well as the Education Trust Fund that may also fall below revenue projections. Governor Bentley recently stated that he is considering a proposal to un earmark tax revenues dedicated to the Education Trust Fund in order to help make up for the General Fund budget shortfall. The recent Jefferson County bankruptcy filing will also draw the attention of the Legislature and the Governor. Amidst this backdrop, we expect the following tax-related bills to be introduced or re-introduced. We focus here only on bills of statewide application.

**"Alabama Taxpayers' Bill of Rights II" / Alabama Tax Appeals Commission Act:** H.B. 427 would have created an independent tax tribunal, known as the Alabama Tax Appeals Commission ("ATAC"), by abolishing the current Administrative Law Division and transferring both the personnel (including its only Administrative Law Judge) to a newly-formed state agency under the executive branch. This bill also contains several important changes and updates to the Alabama Taxpayers' Bill of Rights Act of 1992 ("TBOR"), such as extending the time period for filing an appeal or petition for review from 30 to 60 days and eliminating the \$50 failure-to-file penalty for any individual income taxpayer that is owed a refund on the delinquent return and otherwise requiring a 30-day notice from the ADOR.

Since the enactment of the TBOR, its federal counterpart has been amended several times, and numerous Administrative Law Division and ADOR rulings interpreting the Act have

been issued. For example, the bill conforms state law to the more pro-taxpayer federal law in the area of “innocent spouse” relief. Also, the bi-annual Council On State Taxation (“COST”) “Due Process Scorecard” gave Alabama a “D” grade, pointing out several deficiencies or taxpayer inequities that should be remedied.

HB 427 was passed unanimously by the House last session and received a favorable vote from the Senate Judiciary Committee before stalling in the Senate logjam during the last few days of the session. The Alabama State Bar and the 29-member Business Associations’ Tax Coalition were strong advocates for the bill. Special thanks are due to immediate past State Bar President Alyce Spruell of Tuscaloosa, new President / Legislative Mediator Jim Pratt of Birmingham, and of course, the lead sponsors, Rep. Paul DeMarco (R-Homewood) and Sen. Ben Brooks (R-Mobile). Messrs. DeMarco and Brooks have already indicated that they plan to reintroduce HB 427, with agreed amendments, early next session.

**Jobs Creation and Retention Act:** This bill (H.B. 478/S.B. 373) would allow companies that undertake certain qualifying projects, similar to those listed in TIRA, to also qualify to receive “withholding incentives.” If passed, new businesses would be entitled to retain up to 90% of the state income taxes withheld from the wages of its eligible employees and existing businesses could retain up to 75%. The incentives are designed to encourage the retention of existing jobs and create new jobs by increasing development and growth of industry within the state. Several competitor states offer these. The State Industrial Development Authority, the Governor, the Alabama Development Office, and the ADOR would determine whether a project qualifies for the withholding incentives. In a recent press conference, Governor Bentley touted the bill as “another incentives option we can use to give greater flexibility to bring companies and keep companies in the State.”

**Alabama Data Processing Center Economic Incentive Enhancement Act of 2011:** In order to encourage data centers to locate in Alabama, this bill (H.B. 485/S.B. 223) would extend the time period for TIRA abatements of certain noneducational sales, use, and property taxes from the current ten-year maximum to as long as 30 years, depending on the total capital investment; and would also allow abatements for recurring capital investment in a data center project during the abatement period. This bill would also reduce the employment threshold to a minimum of 20 new jobs.

**Gross Income Regulation Compromise:** As mentioned above, H.B. 548 would amend the definition of “gross income” and override the inconsistent ADOR regulation—that was temporarily modified by the ADOR for the 2011 tax year—so that resident individuals who are owners of partnerships, LLCs, or Alabama S corporations must include their entire pro rata share of income from the pass-through entity, regardless of where the income is earned. Resident owners of these pass-through entities would receive an income tax credit for certain taxes paid by the entity to other states or foreign countries on behalf of the individual owner because the other state imposes an income tax withholding obligation or an entity-level tax on the pass-through entity.

### **Uniform Tax Classification of Pass-through Entities:**

At the request of the ADOR, this legislation 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 intercompany 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*, now pending in Jefferson County Circuit Court. One of the authors of this Bulletin is a member of the Entity Harmonization Task Force, which includes representatives of the State Bar Tax Section, the Alabama Society of CPAs, the ADOR, the Business Council of Alabama, and the Alabama League of Municipalities.

**Mandatory Unitary Combined Reporting:** Similar to the proposals introduced in the 2008 and 2009 regular sessions, this bill would authorize the Commissioner of Revenue to impose mandatory unitary combined reporting “when an Alabama taxpayer is part of a unitary business consisting of multiple business entities.” For more information, please click [here](#).

### **Business Privilege Tax (“BPT”) Deduction for Equity Investments:**

As a result of numerous comments filed in opposition to the proposed BPT regulation that was rejected by the Legislative Council and sustained by Act 2011-17, 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 or 2011 regular session, we expect the ADOR to renew its push for a legislative fix in 2012. We expect the legislation will also allow taxpayers to e-file their BPT returns or it would simply merge the BPT return with the income tax return.

*If you have any questions regarding the contents of this Bulletin, feel free to contact any of the Alabama members of our [SALT Practice Group](#). Their contact information is listed in the right hand column on page 5.*

## BRUCE ELY NAMED AS ONE OF THE TOP 10 SALT LAWYERS

Congratulations to Bruce Ely, a partner in the Birmingham Office, who is considered one of the best tax lawyers by his peers and adversaries and was just voted one of the "Top 10 Tax Lawyers" in the United States by *State Tax Notes*.



**Bruce P. Ely**  
205.521.8366  
[bely@babbc.com](mailto:bely@babbc.com)

## BRADLEY ARANT BOULT CUMMINGS LLP OFFICE LOCATIONS:

**ALABAMA**  
One Federal Place  
1819 Fifth Avenue North  
Birmingham, AL 35203-2119  
205.521.8000

200 Clinton Avenue West, Suite 900  
Huntsville, AL 35801-4900  
256.517.5100

Alabama Center for Commerce  
401 Adams Avenue, Suite 780  
Montgomery, AL 36104  
334.956.7700

**WASHINGTON, DC**  
1615 L Street, N.W.  
Suite 1350  
Washington, DC 20036  
202.393.7150

**MISSISSIPPI**  
188 E. Capitol Street, Suite 400  
Jackson, MS 39201  
601.948.8000

**NORTH CAROLINA**  
100 North Tryon Street, Suite 2690  
Charlotte, NC 28202  
704.332.8842

**TENNESSEE**  
1600 Division Street, Suite 700  
Nashville, TN 37203  
615.244.2582

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Bruce P. Ely, Chair  
(205) 521-8366  
[bely@babbc.com](mailto:bely@babbc.com)

Brett R. Carter, Vice-Chair  
(615) 252-2383  
[bcarter@babbc.com](mailto:bcarter@babbc.com)

Joseph W. Gibbs  
(615) 252-2317  
[jgibbs@babbc.com](mailto:jgibbs@babbc.com)

W. Stanley Gregory  
(334) 956-7604  
[sgregory@babbc.com](mailto:sgregory@babbc.com)

Christopher R. Grissom  
(205) 521-8514  
[cgrissom@babbc.com](mailto:cgrissom@babbc.com)

K. Wood Herren  
(205) 521-8505  
[wherren@babbc.com](mailto:wherren@babbc.com)

Emil Hirsch  
(202) 719-8211  
[ehirsch@babbc.com](mailto:ehirsch@babbc.com)

James E. Long, Jr.  
(205) 521-8626  
[jelong@babbc.com](mailto:jelong@babbc.com)

Scott E. Ludwig  
256.517.5149  
[sludwig@babbc.com](mailto:sludwig@babbc.com)

Patricia Head Moskal  
(615) 252-2369  
[pmoskal@babbc.com](mailto:pmoskal@babbc.com)

Brian S. Shelton  
(615) 252-2313  
[bshelton@babbc.com](mailto:bshelton@babbc.com)

William T. Thistle, II  
(205) 521-8985  
[wthistle@babbc.com](mailto:wthistle@babbc.com)

Robert D. Thorington  
(334) 956-7609  
[rthorington@babbc.com](mailto:rthorington@babbc.com)

Robert C. Walthall  
(205) 521-8308  
[rwalthall@babbc.com](mailto:rwalthall@babbc.com)

Stephen M. Wilson  
(601) 592-9957  
[swilson@babbc.com](mailto:swilson@babbc.com)