

810-27-1-.01 Multistate Tax Compact Rule Definitions. (NEW RULE)

(1) *Scope.* These Rules are intended to set forth guidance concerning the application of the apportionment and allocation provisions of Article IV ("Division of Income") of Code of Alabama 1975, §40-27-1 titled "Multistate Tax Compact". The apportionment guidelines set forth in these rules are applicable to any taxpayer having business income, regardless of whether or not it has nonbusiness income, and the allocation rules set forth in these rules are applicable to any taxpayer having nonbusiness income, regardless of whether or not it has business income.

(a) The only exceptions to the allocation and apportionment guidelines contained in these rules are those allowed pursuant to the authority of §40-27-1, Article IV.18 and the rules promulgated there under.

(b) These rules are not intended to modify existing guidelines concerning jurisdictional standards.

(2) *Business and Nonbusiness Income Defined.* "Business income" was originally defined by §40-27-1, Article IV.1.(a). This definition has been superseded by Act 2001-1113 which codified Code of Alabama 1975, §40-27-1.1 and provides that "business income" is income arising from transactions or activity in the taxpayer's trade or business. "Business income" also includes a gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business carried on in Alabama while the stock was owned by the taxpayer.

(a) Nonbusiness income means all income other than business income.

(b) The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or non-business income. Income of any type or class and from any source is business income if it arises from transactions or activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions or activity which are the elements of a particular trade or business. In general all transactions or activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions or activity arising in the regular course of, and will constitute integral parts of, a trade or business.

(3) *Business and Nonbusiness Income: Application of Definitions.* The following are rules for determining whether particular income is business or nonbusiness income.

(a) *Rents and Royalties from real and tangible personal property.* Rental and royalty income from real and tangible property is business income if the property with respect to which the income was received is used in the taxpayer's trade or business, or if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business, or incidental thereto and therefore is includable in the property factor under §40-27-1, Article IV.10 and the rules promulgated there under.

(b) *Gains or losses from sales of assets.* Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business, operationally related to the taxpayer's trade or business carried on in Alabama or operationally related to sources within Alabama, or the property was operationally related to sources outside this state and to the taxpayer's trade or business carried on in Alabama; or gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business carried on in Alabama while the stock was owned by the taxpayer.

(c) *Interest.* Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

(d) *Dividends.* Dividends are business income where the stock, with respect to which the dividends are received, arises out of or was acquired in the regular course of the taxpayer's trade or business operations, or where the purpose of acquiring and holding the stock is related to, or incidental to, such trade or business operations.

(e) *Patent and copyright royalties.* Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring or holding the patent or copyright is related to or incidental to such trade or business operations.

(4) *Proration of Deductions.* In most cases, an allowable deduction of a taxpayer will be applicable to only the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases,

an allowable deduction may be applicable to business income or several items of nonbusiness income. In such cases, the deduction shall be prorated among those items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable. Any allowable deduction that is applicable both to business and nonbusiness income of the taxpayer shall be prorated to each class of income in determining income subject to tax as provided below:

(a) *Interest Expense.* Interest expense shall be prorated to nonbusiness assets by multiplying total interest expense by the ratio of average cost of the nonbusiness assets to the average cost of the total assets. If any assets were acquired with stock of the taxpayer's corporation, the value of such assets to the extent attributed to the taxpayer's stock shall be excluded from the computations.

(b) *Other Expenses.* Other type expenses applicable both to business and nonbusiness income shall be prorated in such a manner as to equitably assign such expenses to business or nonbusiness categories, as appropriate.

(c) *Year to year consistency.* In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(d) *State to state consistency.* If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act or §40-27-1.1, are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

Author: Holly H. Coon

Authority: §§ 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975

History:

810-27-1-.02 Application of Apportionment and Allocation. (NEW RULE)

(1) *Definitions.*

(a) A taxpayer means any corporation, Subchapter K entity, firm, association, governmental unit or agency or other person acting as a business entity in more than one state, but does not include any individual.

(b) "Apportionment" refers to the division of net income between states by the use of a formula containing apportionment factors.

(c) "Allocation" refers to the assignment of nonbusiness income to a particular state.

(d) "Business activity" refers to the transactions or activity occurring in the regular course of a trade or business of a taxpayer or to the acquisition, management, and disposition of property that constitute integral parts of the taxpayer's trade or business operations or to the sale, exchange, or disposition of real property or tangible or intangible personal property or the sale, exchange or disposition of stock of another corporation. Income from business activity includes business and nonbusiness income.

(e) "Employee" means (A) any officer of a corporation, or (B) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if included by an employer as an employee for purposes of the payroll taxes imposed by the Federal Insurance Contributions Act. However, for purposes of determining a taxpayer's payroll factor, a leased employee is an employee of the client (lessee) organization, and not an employee of the employee leasing company.

(f) "Gross Receipts" are the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest and dividends) in a transaction which produced business income, in which the income or loss is recognized (or would be recognized if the taxpayer were required to file a separate entity return) under the Internal Revenue Code. Amounts realized on the sale or exchange of property are not reduced for the cost of goods sold or the basis of property sold. Gross Receipts, even if business income, do not include such items as, for example:

1. repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;

2. the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;

3. proceeds from issuance of the taxpayer's own stock or from sale of treasury stock;
4. damages and other amounts received as the result of litigation;
5. property acquired by an agent on behalf of another;
6. tax refunds and other tax benefit recoveries;
7. pension reversions;
8. contributions to capital (except for sales of securities by securities dealers);
9. income from forgiveness of indebtedness; or
10. amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code

(2) *Application of Article IV.*

(a) *Apportionment.* If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from such trade or business which is derived from sources within this state shall be determined by apportionment in accordance with Code of Alabama 1975, §40-27-1, Articles IV.9 to IV.17.

(b) *Allocation.* Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its nonbusiness income or loss within or without this state in accordance with §40-27-1, Articles IV.4 to IV.8.

(c) *Public utility election.* If a taxpayer has income from business activity as a public utility which is not permitted to allocate and apportion net income pursuant to § 40-27-1, Article IV but derives more than 50 percent of income from business activities otherwise subject to this rule, the taxpayer may elect, with a timely filed original return, to allocate and apportion the entire net income as provided for in § 40-27-1, Article IV. The taxpayer must determine "business income" in accordance with Code of Alabama 1975, §40-27-1.1. If a taxpayer engaged in multistate business does not elect the reporting option available in this subparagraph or is not eligible to make the election then the taxpayer shall use separate (direct) accounting to determine income earned in this state.

(3) *Consistency and Uniformity in Reporting.* Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the manner in which income has been classified as business income or nonbusiness income in returns for prior years, the taxpayer shall disclose in the return for the current year the nature

and extent of the modification.

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Individual and Corporate Tax Division

Authority: §§ 40-2A-7(a)(5), 40-27-1, and 40-18-57, Code of Alabama 1975

History:

810-27-1-.09 Apportionment Formula: Double Weighting the Sales Factor. (NEW RULE)

(1) The provisions of this rule are effective for taxable years beginning on or after December 31, 2010. For previous taxable years, the sales factor was evenly weighted with property factor and payroll factor in calculating a taxpayer's apportionment factor in Alabama.

(2) All business income of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in Code of Alabama 1975 40-27-1, § 40-27-1, Article IV.9, as amended. The elements of the apportionment formula are the property factor, the payroll factor and the sales factor. The apportionment formula gives double-weight to the sales factor and equal weight to both the property and payroll factors. If any factor is not utilized in the production of business income, it shall be eliminated and the denominator reduced accordingly. The taxpayer may request, or the Commissioner may require, the use of a replacement factor in lieu of the eliminated factor where appropriate as provided for in §40-27-1, Article IV.18 and any rules promulgated thereunder.

(a) EXAMPLE: Company A is a multistate entity which does business both within and without of Alabama. Company A shall apportion its income using the apportionment formula as follows:

	<u>Alabama</u>	<u>Everywhere</u>
Property	500,000	600,000
Payroll	1,500,000	2,000,000
Sales	2,500,000	7,000,000

Company A must compute its apportionment formula as follows:

Property	(500,000/600,000)	83.3333%
Payroll	(1,500,000/2,000,000)	75.0000%
Sales	(2,500,000/7,000,000)	71.4286%= (35.7143% X 2)

Sum of Factor Percentages	229.7619%
Divide by Number of Factors Used	<u> </u> ÷ 4
Apportionment Factor Average	
Percentage:	<u>57.4405%</u>

(b) Company B is a multistate entity which does business both within and without of Alabama. Company B has property and sales within Alabama but does not have any payroll within Alabama. Therefore, Company B shall eliminate the payroll factor and reduce the denominator. Company B shall apportion its income by doing the following:

	<u>Alabama</u>	<u>Everywhere</u>
Property	500,000	600,000
Payroll	0	0
Sales	2,500,000	7,000,000

Company B must compute its apportionment formula as follows:

Property	(500,000/ 600,000)	83.3333%
Payroll	(0/0)	00.0000%
Sales	(2,500,000/ 7,000,000)	71.4286%= (35.7143% X 2)

Sum of Factor Percentages	154.7619%
Divide by Number of Factors Used	<u> </u> ÷ 3
Apportionment Factor Average	
Percentage	<u>51.5873%</u>

(3) For taxpayers with a business interest in an unincorporated entity (e.g., partnership, unincorporated joint-venture, limited liability company taxed as a partnership, etc.), the apportionment formula shall include the pro rate share of the unincorporated entity's factor data.

(a) EXAMPLE: Corporation C has a 20 % distributive share of Partnership P's income which is included in Corporation C's apportionable business income. There are no transactions between Corporation Co and Partnership P. Corporation C shall apportion his income as follows:

	<u>Alabama</u>	<u>Everywhere</u>
Property	550,000	600,000
Payroll	1,800,000	2,000,000
Sales	1,500,000	7,000,000

Using the rules for computing the elements of the apportionment formula at the partnership level, Corporation C's 20% share of Partnership P's apportionment factor data is as follows:

	<u>Alabama</u>	<u>Everywhere</u>
Property	20,000	55,000
Payroll	10,000	25,000
Sales	15,000	70,000

Corporation C must compute its apportionment formula as follows:

	<u>Alabama</u>	<u>Everywhere</u>
Property	(550,000 + 20,000) 570,000	(600,000+ 55,000) 655,000
Payroll	(1,800,000 + 10,000) 1,810,000	(2,000,000 + 25,000) 2,025,000
Sales	(1,500,000 + 15,000) 1,515,000	(7,000,000 + 70,000) 7,070,000

Property	(570,000/ 655,000)	87.0229%
Payroll	(1,810,000/ 2,025,000)	89.3827%
Sales	(1,515,000/ 7,070,000)	42.8572% = (21.4286% X 2)
Sum of Factor Percentages		219.2628%

Divide by Number of Factors Used	<u> </u> ÷ 4
Apportionment Factor Average	
Percentage	<u>54.8157%</u>

Author: Holly H. Coon

Authority: §§ 40-2A-7 (a) (5) and 40-18-57, Code of Alabama 1975

History:

810-27-1-.10 Property Factor. (NEW RULE)

(1) **Property Factor: In General.** The property factor of the apportionment formula for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the tax period in the regular course of the trade or business. The term "real and tangible personal property" includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property used in connection with the production of business income but does not include coin or currency. Property used in connection with the production of nonbusiness income shall be excluded from the property factor. Property used both in the regular course of the taxpayer's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent that the property is used in the regular course of the taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case. The property factor shall include the average value of property includable in the factor.

(2) **Property Factor: Property Used for the Production of Business Income.** Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property or equipment under construction during the tax period, (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is no longer held for use in the trade or business.

(a) EXAMPLE: Taxpayer closed its manufacturing plant in State X and held the property for sale. The property remained vacant until its sale one year later. The value of the manufacturing plant is included in the property factor until the plant is sold.

(b) EXAMPLE: Same as above except that the property was rented until the plant was sold. The plant is included in the property factor until the plant is sold.

(c) **EXAMPLE:** Taxpayer closed its manufacturing plant and leased the building under a five-year lease. The plant is included in the property factor until the commencement of the lease.

(d) **EXAMPLE:** The taxpayer operates a chain of retail grocery stores. Taxpayer closed Store A, which was then remodeled into three small retail stores such as a dress shop, dry cleaning, and barber shop, which were leased to unrelated parties. The property is removed from the property factor on the date on which the remodeling of Store A commenced.

(3) Property Factor: Consistency in Reporting.

(a) *Year to year consistency.* In filing an Alabama return, if the taxpayer departs from or modifies the manner of valuing property or of excluding property from or including property in the property factor used in returns for prior years, the taxpayer shall disclose in the Alabama return for the current year the nature and extent of the modification.

(b) *State to state consistency.* If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the valuation of property and in the exclusion of property from or the inclusion of property in the property factor, the taxpayer shall disclose in its return to Alabama the nature and extent of the variance.

(4) Property Factor: Numerator. The numerator of the property factor shall include the average value of the real and tangible personal property owned or rented by the taxpayer and used in Alabama during the tax period in the regular course of the trade or business of the taxpayer. Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination. The value of mobile or movable property such as construction equipment, trucks or leased electronic equipment which are located within and without Alabama during the tax period shall be determined for purposes of the numerator of the factor on the basis of total time within the state during the tax period. An automobile assigned to a traveling employee shall be included in the numerator of the factor of the state to which the employee's compensation is assigned under the payroll factor or in the numerator of the state in which the automobile is licensed.

Author: Holly H. Coon
Authority: Sections 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975
History:

810-27-1-.11 Property Factor: Valuation. (NEW RULE)

(1) *Property Factor: Valuation of Owned Property.*

(a) Property owned by the taxpayer shall be valued at its original cost. As a general rule, "original cost" is deemed to be the basis of the property at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. However, capitalized intangible drilling and development costs shall be included in the property factor whether or not they have been expensed for either federal or state tax purposes. See Code of Alabama 1975, §40-18-6 and the rules promulgated thereunder for basis determination rules.

1. EXAMPLE: The taxpayer acquired a factory building in Alabama at a cost of \$500,000 and, 18 months later, expended \$100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar-year basis. Depreciation deduction in the amount of \$22,000 was claimed with respect to the building on the return for the current taxable year. The value of the building includable in the numerator and denominator of the property factor is \$600,000; the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

2. EXAMPLE: During the current taxable year, Corporation X merges into Corporation Y in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, Corporation X owns a factory which X built five years earlier at a cost of \$1,000,000. X has been depreciating the factory at the rate of two percent per year, and its basis in X's hands at the time of the merger is \$900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y's hands is the same as its basis in X's hands, Y includes the property in Y's property factor at X's original cost, without adjustment for depreciation, i.e. \$1,000,000.

3. EXAMPLE: Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled to use its stock cost as the basis of the X assets under Internal Revenue Code 1954, §334(b)(2) (i.e. stock possessing 80 percent control is purchased and liquidated within two years). Under these circumstances, Y's cost of the assets is the purchase price of the X stock, prorated over the X assets. If the original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

(b) Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.

(c) Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes.

(2) *Property Factor: Valuation of Rented Property.*

(a) *Multiplier and Subrentals.* Property rented by the taxpayer is valued at eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for the property less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See Rule 810-27-1-.18.(3) for special rules when the use of such net annual rental rate produces a negative or clearly inaccurate value or when property is used by the taxpayer at no charge or is rented at a nominal rental rate.) Subrents are not deducted when they constitute business income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

1. EXAMPLE: The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are business income, they are not deducted from rent paid by the taxpayer for the food market.

2. EXAMPLE: The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses on a short-term basis because it anticipates it will need those two floors for future expansion of its multistate business. The rental of all five floors is integral to the operation of the taxpayer's trade or business. Since the subrents are business income, they are not deducted from the rent paid by the taxpayer.

3. EXAMPLE: The taxpayer rents a 20-story office building and uses the lower two stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are nonbusiness income they are to be deducted from the rent paid by the taxpayer.

(b) "Annual rental rate" is the amount paid as rental for property for a 12-month period (i.e., the amount of the annual rent). Where property is rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a period of less than 12 months (due, for example, to a reorganization or change of accounting period), the rent paid for the short tax period shall be annualized. If the rental term is for less than 12 months, the rent shall not be

annualized beyond its term. Rent shall not be annualized because of the uncertain duration when the rental term is on a month-to-month basis.

1. EXAMPLE: Taxpayer A, which ordinarily files its returns based on a calendar year, is merged into Taxpayer B on April 30. The net rent paid under a lease with 5 years remaining is \$2,500 a month. The rent for the tax period January 1 to April 30 is \$10,000. After the rent is annualized the net rent is \$30,000 ($\$2,500 \times 12$).

2. EXAMPLE: Same facts as in Example 1. except that the lease would have terminated on August 31. In this case, the annualized rent is \$20,000 ($\$2,500 \times 8$). (3) "Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:

(ii) Any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

(I) EXAMPLE: A taxpayer, pursuant to the terms of a lease, pays a lessor \$1,000 per month as a base rental and at the end of the year pays the lessor one percent of its gross sales of \$400,000. The annual rent is \$16,000 ($\$12,000$ plus one percent of \$400,000 or \$4,000).

(ii) Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and other items.

(I) EXAMPLE: A taxpayer, pursuant to the terms of a lease, pays the lessor \$12,000 a year rent plus taxes in the amount of \$2,000 and interest on a mortgage in the amount of \$1,000. The annual rent is \$15,000.

(II) EXAMPLE: A taxpayer stores part of its inventory in a public warehouse. The total charge for the year was \$1,000 of which \$700 was for the use of storage space and \$300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is \$700.

(c) *Exclusions.* "Annual rent" does not include:

1. Incidental day-to-day expenses such as hotel or motel accommodations, daily rental of automobiles, etc.; and

2. Royalties based on extraction of natural resources, whether represented by delivery or purchase. For this purpose, a royalty includes any consideration conveyed or credited to a holder of an interest in property which constitutes a sharing of current or future production of natural resources from such property, irrespective of the method of payment or how such consideration may be characterized, whether as a royalty, advance royalty, rental or otherwise.

(d) *Leasehold improvements* shall, for the purposes of the property factor, be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor.

(3) *Factor: Under Completed Contract Method of Accounting.*

(a) Taxpayers using the completed contract method of accounting shall assign the values of property owned and utilized in the performance of such contracts to Alabama in the ratio of gross receipts from contracts completed in Alabama during the tax period to gross receipts from all completed contracts during the tax period. Such property not utilized in the performance of the completed contracts shall be assigned as otherwise provided in this rule.

(b) For property rented and utilized in the performance of completed contracts, such property shall be valued at eight (8) times the rental rate for the completed contract period.

Author: Holly H. Coon
Authority: Sections 40-2A-7(a)(5) and 40-18-5, Code of Alabama 1975
History:

810-27-1-.12 Property Factor: Averaging Property Values. (NEW RULE)

(1) As a general rule, the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and ending of the tax period. However, the Commissioner may require or allow averaging by monthly values if that method of averaging is required to properly reflect the average value of the taxpayer's property for the tax period.

(a) Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or if property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

1. EXAMPLE: The monthly value of the taxpayer's property was as follows:

January	\$2,000	July	\$15,000
February	2,000	August	17,000
March	3,000	September	23,000
April	3,500	October	25,000
May	4,500	November	13,000
June	<u>10,000</u>	December	<u>2,000</u>
	\$25,000		\$95,000
		Total	<u>120,000</u>

The average value of the taxpayer's property includable in the property factor for the income year is determined as follows:

$$\frac{\$120,000}{12} = \$10,000$$

(b) Averaging with respect to rented property is achieved automatically by the method of determining the net annual rental rate of such property as set forth in Rule 810-27-1-.11(b).

Author: Holly H. Coon
Authority: Sections 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975
History:

810-27-1-.13 Payroll Factor: In General (NEW RULE)

(1) The payroll factor of the apportionment formula for each trade or business of the taxpayer shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period.

(2) Definitions. For purposes of Rule 810-27-1-.13, the following terms have the following meanings unless the context requires otherwise.

(a) Employee generally means any person who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. Generally, a person will be presumed to be an employee if such person is included by the taxpayer as an employee for purposes of the payroll taxes imposed by the Federal Insurance Contributions Act. However, for purposes of this rule, a leased employee is an employee of the client (lessee) organization. A leased employee is also treated as an employee of the employee leasing company.

(b) Employee Leasing Company means a business that contracts with a client company to supply workers to perform services for the client company. The term "employee leasing company" does not include private employment agencies that provide workers to employers on a temporary help basis or entities such as driver-leasing companies which lease employees to another business to perform a specific service unless the total amount of compensation paid to the employee leasing company during the tax period exceeds 5% of compensation paid everywhere during the tax period. This threshold should be calculated excluding the amount of compensation paid to the employee leasing company.

(c) Independent contractor means any person who performs services for a taxpayer but who is not an employee of the taxpayer, and who is not otherwise subject to the supervision or control of the taxpayer in the performance of the services. In general, a person is treated as an independent contractor with respect to a taxpayer if that person's actions would not represent an employer-employee relationship for federal tax purposes.

(3) The total amount "paid" to employees is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, compensation paid to employees may, at the election of the taxpayer, be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under that method for unemployment compensation purposes. The compensation of any employee on account of activities which are

connected with the production of nonbusiness income shall be excluded from the factor.

(4) Payroll Factor: Denominator. The denominator of the payroll factor is the total compensation paid everywhere during the tax period. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is immune from taxation, for example, Public Law 86-272, is included in the denominator of the payroll factor.

(a) EXAMPLE: A taxpayer has employees in its state of legal domicile (State A) and is taxable in State B. In addition the taxpayer has other employees whose services are performed entirely in State C where the taxpayer is exempt from taxation under the provisions of Public Law 86 272. As to these latter employees, the compensation will be assigned to State C where their services are performed (i.e., included in the denominator but not the numerator of the payroll factor) even though the taxpayer is not taxable in State C.

(5) Payroll Factor: Numerator. The numerator of the payroll factor is the total amount paid in Alabama during the tax period by the taxpayer for compensation in the production of business income. The tests in Code of Alabama 1975, § 40-27-1, Article IV.14 and Rule 810-27-1-.14 should be applied in determining whether compensation is paid in Alabama.

(6) Items Included. Compensation in the payroll factor includes wages, salaries, commissions, and any other form of remuneration paid to employees for personal services rendered.

(7) Treatment of Leased and Temporary Employees.

(a) Leased Employees. Compensation paid for personal services rendered by leased employees is includible in the payroll factor of the taxpayer if the taxpayer is the recipient of the services of the leased employee. Compensation for personal services rendered by leased employees to client companies is also included in the payroll factor of employee leasing companies.

(b) Temporary Employees. Compensation paid for personal services rendered to client companies by employees of temporary help agencies is included in the payroll factor of the temporary agency and is generally excluded from the payroll factor of the client company. If compensation paid to temporary employees is included in the payroll factor of a client company (see subparagraph (2)(b)), such compensation shall be eighty-five percent of the payments during the taxable year by the client company to the temporary help agency or agencies providing the temporary employees. Any adjustment to the payroll factor of a client company shall not affect the payroll factor of the temporary help agency or agencies providing the temporary employees.

(8) **Items Excluded.** For purposes of the payroll factor, compensation excludes payments that are not made by a taxpayer to its employees for personal services rendered. The following items are excluded without limitation:

(a) Payments to or on behalf of employees (including amounts paid for insurance or annuities) for sickness or accident disability, hospitalization, or death.

(b) Payments to or from qualified trusts under 26 U.S.C. § 401(a) (other than employer contributions under qualified cash or deferred arrangements as defined in 26 U.S.C. § 401(k)), payments to or from qualified annuity plans or contracts under 26 U.S.C. § 403, and payments to or from simplified employee pensions under 26 U.S.C. § 408(k).

(c) Employer's payments of employee's FICA taxes.

(d) Tips paid in any medium other than cash, and cash tips which are less than \$20 a month and not reported to the employer pursuant to 26 U.S.C. § 6053(a).

(e) Non-cash payments to employees for services not in the course of the taxpayer's trade or business.

(f) Payments made to independent contractors, retirees, or other persons not properly classified as employees.

(9) **Affiliated Corporations.** In order to prevent distortions in the payroll factor, the Commissioner may require compensation paid to a related member's employee to be included in the payroll factor of a taxpayer regardless of which entity actually paid the compensation or if the related member was reimbursed if there is evidence that a related member's employees provided services to or maintained the property of a taxpayer and the payroll factor is inconsistent with the other components of the apportionment factor. A related member is any person considered a "related member" pursuant to Code of Alabama 1975, § 40-18-1.

(10) **Payroll Consistency.** A taxpayer must use the same rules for determining compensation paid in both the numerator and the denominator of the payroll factor. If a taxpayer changes its method of determining compensation paid, including, but not limited to, its method of accounting of such compensation, from the method used in its return for the prior year, the taxpayer must disclose in the return for the current year the presence of the change, the nature and extent of the change, and the reason for the change. The Commissioner may disregard changes in the current year or in future tax years if they have not been adequately disclosed.

(11) *Payroll Factor: Under the Completed Contract Method of Accounting.* For taxpayers utilizing the completed contract method of accounting, the payroll factor shall include all payroll costs attributed to the contracts completed during the tax period. Payroll costs not directly attributed to the completed contract projects, such as administrative salaries, shall be reported as otherwise provided in this rule.

Author: Holly H. Coon

Authority: §§40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975

History:

810-27-1-.14 Payroll Factor: Compensation Paid in this State. (NEW RULE)

(1) Compensation is paid in Alabama if any one of the following tests, applied consecutively, are met if:

(a) The employee's service is performed entirely within Alabama.

(b) The employee's service is performed both within and outside Alabama, but the service performed outside of Alabama is incidental to the employee's service within Alabama. Service is "incidental" when it is temporary or transitory in nature, or when the service is rendered in connection with an isolated transaction.

(c) The employee's services are performed both within and outside of Alabama, the employee's compensation will be attributed to Alabama if:

1. the employee's base of operations is in Alabama; or

2. there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in Alabama; or

3. the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed but the employee's residence is in Alabama.

(i) The "place from which the service is directed or controlled" is the place from which the power to direct or control is exercised by the taxpayer.

(ii) The "base of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his trade or profession at some other point or points.

(2) The payroll factor should be determined in accordance with Rule 810-27-1-.13.

Author: Holly H. Coon
Authority: §§40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975
History:

810-27-1-.15 Sales Factor. (NEW RULE)

(1) *Sales Factor: In General.*

(a) Code of Alabama 1975, §40-27-1, Article IV.1(g) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under paragraphs (5) through (8) of §40-27-1, Article IV.1(g). Thus, for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, the term "sales" means all gross receipts derived by the taxpayer from transactions or activity in the regular course of the trade or business. The following are rules for determining "sales" in various situations:

1. In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "sales" includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if the taxes are passed on to the buyer or included as part of the selling price of the product.

2. In the case of cost plus fixed fee contracts, such as the operation of a government-owned plant for a fee, "sales" includes the entire reimbursed cost plus the fee.

3. In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency or the performance of equipment service contracts or research and development contracts, "sales" includes the gross receipts from the performance of such services, including fees, commissions, and similar items.

4. In the case of a taxpayer engaged in renting real or tangible property, "sales" includes the gross receipts from the rental, lease, or licensing the use of the property.

5. In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.

6. If a taxpayer derives receipts from the sale of equipment used in its business, those receipts constitute sales. For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor.

(b) *Exceptions.* In some cases certain gross receipts should be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to Alabama the income of the taxpayer's trade or business. See Rule 810-27-1-.18(4).

(c) *Year to year consistency.* In filing returns with Alabama, if the taxpayer departs from or modifies the basis for excluding or including gross receipts in the sales factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(2) *Sales Factor: Denominator.* The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions or activity in the regular course of its trade or business except receipts excluded under Rule 810-27-1-.18(4).

(3) *Sales Factor: Numerator.* The numerator of the sales factor shall include gross receipts from sales attributable to Alabama and derived by the taxpayer from transactions or activity in the regular course of its trade or business. All interest income, service charge, carrying charges, or time-price differential charges incidental to such gross receipts shall be included regardless of (1) the place where the accounting records are maintained or (2) the location of the contract or other evidence of indebtedness.

(4) *Sales Factor: Under the Completed Contract Method of Accounting.* For taxpayers utilizing the completed contract method of reporting income, the receipts from such contracts completed during the tax period shall be included in the sales factor. Other receipts not directly attributable to the completed contracts shall be included in the sales factor as otherwise provided in this rule.

Author: Holly H. Coon

Authority: Sections 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975

History:

810-27-1-.16 Sales Factor: Tangible Personal Property. (NEW RULE)

(1) *Sales Factor: Sales of Tangible Personal Property in this State.*

(a) Gross receipts from sales of tangible personal property (except sales to the United States Government are in this state; see subparagraph (b)) are in this state:

1. if the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or

2. if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser.

(b) Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

1. **EXAMPLE:** The taxpayer, with inventory in State A, sold \$100,000 of its products to a purchaser having branch stores in several states, including this state. The order for the purchase was placed by the purchaser's central purchasing department located in State B. \$25,000 of the purchase order was shipped directly to purchaser's branch store in this state. The branch store in this state is the purchaser within this state with respect to \$25,000 of the taxpayer's sales.

(c) Property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

1. **EXAMPLE:** The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of the taxpayer's products shipped to the purchaser's warehouse in this state constitute property delivered or shipped to a purchaser within this state.

(d) The term "purchaser within this state" shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

1. **EXAMPLE:** A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to purchaser's instructions. The sale by the taxpayer is in this state.

(e) When property being shipped by a seller from the state of origin to a consignee in another state is diverted while *en route* to a purchaser in this state, the sales are in this state.

1. EXAMPLE: The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While *en route*, the produce is diverted to the purchaser's place of business in this state in which state the taxpayer is subject to tax. The sale by the taxpayer is attributed to this state.

(f) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

1. EXAMPLE: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this state. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since the taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to this state, the state from which the merchandise was shipped.

(g) If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

1. If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.

2. If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state.

(i) EXAMPLE: The taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer is not taxable in State A. Upon direction of the taxpayer, the merchandise was shipped directly to the purchaser by the manufacturer in State B. If the taxpayer is taxable in State B, the sale is in State B. If the taxpayer is not taxable in State B, the sale is in this state.

(2) *Sales Factor: Sales of Tangible Personal Property to United States Government in this State.*

(a) Gross receipts from sales of tangible personal property to the United States Government are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. For the purposes of this rule, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States Government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

1. EXAMPLE: A taxpayer contracts with General Services Administration to deliver X number of trucks which were paid for by the United States Government. The sale is a sale to the United States Government.

2. EXAMPLE: The taxpayer, as a subcontractor to a prime contractor with the National Aeronautics and Space Administration, contracts to build a component of a rocket for \$1,000,000. The sale by the subcontractor to the prime contractor is not a sale to the United States Government.

(b) When the United States Government is the purchaser of property which remains in the possession of the taxpayer in this state for further processing under another contract, or for other reasons, "shipment" is deemed to be made at the time of acceptance by the United States Government.

Author: Holly H. Coon
Authority: Sections 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975
History:

810-27-1-.17 Sales Factor: Sourcing Sales Derived from Services Rendered to Individual and Unrelated Business Customers. (NEW RULE)

(1) Effective for tax years beginning after December 31, 2010, Code of Alabama 1975, §40-27-1, Article IV.17 has been amended to state that sales other than sales of tangible personal property pursuant to §40-27-1, Article IV.16, are to be sourced to this state if the taxpayer's market for the sale is in this state. For previous tax years, §40-27-1, Article IV.17 sourced these sales to this state if the "income producing activity" was performed in this state based on "cost of performance". This rule sets forth the Alabama Department of Revenue's policy regarding the sourcing of sales derived from services rendered to individual and unrelated business customers.

(2) The taxpayer's market for a sale is in this state if and to the extent the service is delivered to a location in this state. This rule interprets when and to what extent a service will be considered delivered to a location in this state under certain situations.

(a) **In the case where the taxpayer's customer is an individual, the taxpayer shall source receipts from the sale of a service consistent with this subparagraph.**

1. In the case where a taxpayer's customer is an individual and the service provided is a direct personal service, the sale shall be sourced to the state where the customer received the direct personal service. "Direct personal services" are services that are delivered or rendered in person by or on behalf of the service provider to the customer. This type of service requires the service provider and the customer be together at one location. Direct personal services include, but are not limited to, salon services, medical and dental services including examinations and surgeries, dance lessons and other similar services.

(i) Example: Hair Cutting Corp, located in Alabama and other states, provides hair grooming services for individuals. Receipts from hair grooming services performed at Hair Cutting Corp locations in Alabama shall be sourced to this state. Receipts from hair grooming services performed at Hair Cutting Corp locations outside of Alabama shall be sourced to the state in which the services were performed.

2. Services delivered to customers which are individuals with an Alabama billing address that are not direct personal services should be sourced to this state.

(i) Example: A brokerage firm provides brokerage services to individuals located both inside and outside of Alabama. The firm's brokerage service receipts are sourced to this state if the customer's billing address is in this state.

3. In the case where the sourcing methodology specified by subparagraphs 1. or 2. is: (1) difficult to administer or (2) fails to reasonably reflect the taxpayers market in this state, the taxpayer may utilize, or the Department may require, the use of other criteria and methodologies that will reasonably approximate the taxpayer's market in this state. If an alternate approach is utilized, the taxpayer must conspicuously note on the return that an alternate approach was utilized for sourcing its sales. If the taxpayer fails to make such a conspicuous disclosure on the return, it will be deemed the taxpayers consent to the sourcing as detailed in subparagraph 1. or 2. above as applicable. Although not required, it is highly recommended that in addition to the conspicuous notation required above, the taxpayer attach to each tax return a detailed explanation of why it was unreasonable to utilize the methodology specified by subparagraph 1. or 2. and an explanation of the methodology used.

(b) In the case where the taxpayer's customer is a business enterprise which is not affiliated with the taxpayer, the taxpayer shall source receipts from the sale of a service consistent with this subparagraph.

1. A business enterprise is affiliated with the taxpayer if it is a related member pursuant to Code of Alabama 1975, §40-18-1(29). "Business enterprise" includes any person other than an individual.

2. To the extent a service is provided to an unrelated business enterprise and the service being provided has a substantial connection to a specific geographic location, the income shall be sourced to Alabama if the geographic location is in this state. If the service receipts have a substantial connection to geographic locations in more than one state, the sales shall be reasonably sourced between those states.

(i) Example: Cleaning Company Inc. has a contract to provide cleaning services to Company B, an unrelated business enterprise. The contract specifies that cleaning services are to be provided to Company B's locations in Alabama and other states. Cleaning Company Inc. should source a portion of the total service receipts to Alabama based on the amount of services performed at Company B's locations in Alabama to the total amount of services performed at the other Company B locations.

(ii) Example: Hard Hat Inc. contracts with Company D, a multistate company commercially domiciled outside of Alabama, to design and build a building in Alabama. Hard Hat Inc. will source service receipts from this project to this state.

(iii) Example: Training Service Inc. contracts with Company A, an unrelated multistate business enterprise, to provide training services to Company A's employees located in Alabama and three other states. The training services are related to a specific geographic location, therefore they shall be sourced to the location where Company A's

employees received the training and not the location of Company A's commercial domicile. Training Service Inc. sources receipts from its contract with Company A by reasonably assigning those receipts between Alabama and other states using a formula based on the number of training hours provided to Company A locations in Alabama to the total number of training hours provided to all Company A locations.

3. To the extent a service is provided to an unrelated business enterprise and the service being provided does not have a substantial connection to a specific geographic location, sales from services delivered to unrelated business enterprises, commercially domiciled in Alabama, should be sourced to Alabama. A business enterprise is commercially domiciled in Alabama if its principal place of business is in Alabama. If the "Principal place of business" or the nerve center of the business is unknown or it is cost prohibitive to determine, the taxpayer should source the sale to the "Principal Address" of the entity as noted on the public records of the corporations section of the Alabama Secretary of State or the equivalent in the taxpayer's state of domicile.

(i) Example: CPA firm provides tax preparation services to Company A that is commercially domiciled in Alabama. Company A also operates business establishments in four other states. The CPA firm should source these sales solely to Alabama.

4. In the case where the sourcing methodology specified by subparagraphs 2. or 3. is: (1) difficult to administer or (2) fails to reasonably reflect the taxpayers market in this state, the taxpayer may utilize, or the Department may require, the use of other criteria and methodologies that will reasonably approximate the taxpayer's market in this state. If an alternate approach is utilized, the taxpayer must conspicuously note on the return that an alternate approach was utilized for sourcing its sales. If the taxpayer fails to make such a conspicuous disclosure on the return, it will be deemed the taxpayers consent to the sourcing as detailed in subparagraph 2. or 3. above as applicable. Although not required, it is highly recommended that in addition to the conspicuous notation required above, the taxpayer attach to each tax return a detailed explanation of why it was unreasonable to utilize the methodology specified by subparagraph 2. or 3. and an explanation of the methodology used.

(i) Example: Computer Fix It Company has a contract with Company C to provide on-site computer repair services to Company C's customers. Company C is an unrelated business enterprise which sells computers to customers in Alabama and many other states. Computer Fix It Company should assign a portion of the total service receipts to Alabama based on the portion of repair services performed for Company B's

customers in Alabama as compared to the total portion of repair services performed for all of Company B's customers.

(c) The delivery of a tangible medium representing the output of a service does not control the sourcing of receipts from the underlying service.

1. Example: Law Firm Inc. prepares a bond opinion for refinancing the corporate debts of Corporation A, a multi-state corporation commercially domiciled in Alabama. Law Firm Inc. mails the opinion to an office of Corporation A in Delaware. The receipts from this service will be assigned to Alabama despite the property deed having been mailed to a Delaware address unless the taxpayer shows that it is unreasonable to source the receipts to the commercial domicile of its customer pursuant to (b)4. above.

(d) Whenever a taxpayer is subjected to different sourcing methodologies regarding intangibles or services, by the Department of Revenue and one or more other state taxing authorities, the taxpayer may petition for, and the Department of Revenue shall participate in, and encourage the other state taxing authorities to participate in, non-binding mediation in accordance with the mediation rules promulgated by the Multistate Tax Commission from time to time, regardless of whether all the state taxing authorities are members of the Multistate Tax Compact.

Author: Holly H. Coon

Authority: Sections 40-2A-7(a)(5) and 40-27-1, Article IV(17.), Code of Alabama 1975

History:

810-27-1-.18 Special Rules. (NEW RULE)

(1) *Special Rules: In General.* Code of Alabama 1975, §40-27-1, Article IV.18 provides that, if the allocation and apportionment provisions of §40-27-1, Article IV do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(e) A taxpayer may petition for an alternative allocation and apportionment method pursuant to provisions of §40 27 1, Article IV.18 by written communication with the Department Secretary. The petition should be submitted at least six months before the due date of the first return within which the taxpayer seeks to use the alternative methodology. A petition attached to an original or amended return will not be considered a valid petition pursuant. Should the Department process an original or amended return which uses an unapproved alternative methodology such action should not be construed as the Department's acceptance of the taxpayer's proposed alternative method.

(2) *Special Rules: Adoption of Multistate Tax Commission Special Industry Rules.* In the case of certain industries, the general provisions of §40-27-1, Article IV and the rules promulgated thereunder in respect to the apportionment formula do not set forth appropriate procedures for determining the apportionment factors. This rule hereby adopts Model Apportionment "Special Rules" that relate to such industries and have been adopted by the Multistate Tax Commission.

(3) *Special Rules: Property Factor.* The following special rules are established in respect to the property factor of the apportionment formula:

(a) If the subrents taken into account in determining the net annual rental rate under §40-27-1, Article IV.11 or any rules promulgated thereunder produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by the Commissioner or requested by the taxpayer.

1. In no case, however, shall the value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for the property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property. **EXAMPLE:** The taxpayer rents a 10-story building at an annual rental rate of \$1,000,000. Taxpayer occupies two stories and sublets eight stories for \$1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or \$200,000.

(b) If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for the property shall be determined on the basis of a reasonable market rental rate for the property.

(4) *Special Rules: Sales Factor.* The following special rules are established in respect to the sales factor of the apportionment formula:

(a) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless their exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include in or exclude from the sales factor gross receipts from transactions such as the sale of office furniture, business automobiles, etc.

(b) Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under §40-27-1, Article IV.17-.18 or any rules promulgated thereunder, such gains or losses shall be treated as provided in this subparagraph. This subparagraph does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subparagraph, each treasury function will be considered separately.

1. For purposes of subparagraph (b), a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the

taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

2. For purposes of subparagraph (b), a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

3. Overall net gain refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

Author: Holly H. Coon
Authority: Sections 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975
History:

810-27-1-.19 Public Law 86-272 Exemption from Income Tax. **(NEW RULE)**

(1) **Scope**

(a) Public Law 86-272, 15 U.S.C. 381-384, (hereafter "P.L. 86-272") restricts a state from imposing a net income tax on income derived within its borders from interstate commerce if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property, which orders are to be sent outside the state for acceptance or rejection, and, if accepted, are filled by shipment or delivery from a point outside the state. The term "net income tax" includes a franchise tax measured by net income. If any sales are made into a state which is precluded by P.L. 86-272 from taxing the income of the seller, such sales remain subject to throwback to the appropriate state which does have jurisdiction to impose its net income tax upon the income derived from those sales.

(b) **Signatory State** is a state which has signed the Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272, as amended, from time to time.

(c) It is the policy of Alabama hereto to impose its net income tax, subject to Alabama and Federal legislative limitations, to the fullest extent constitutionally permissible. Interpretation of the solicitation of orders standard in P.L. 86-272 requires a determination of the fair meaning of that term in the first instance. The United States Supreme Court has recently established a standard for interpreting the term "solicitation" and this rule has been revised to conform to such standard. *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S., 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992). In those cases where there may be reasonable differences of opinion between Alabama and a Signatory State as to whether the disputed activity exceeds what is protected by P.L. 86-272, Alabama will apply the principle that the preemption of state taxation that is required by P.L. 86-272 will be limited to those activities that fall within the "clear and manifest purpose of Congress." See *Department of Revenue of Oregon v. ACF Industries, Inc., et al.*, U.S., 114 S.Ct. 843, 127 L. Ed.2d 165 (1994); *Cipollone v. Liggett Group, Inc.*, 505 U.S., 112 S.Ct. 2608, 120 L. Ed.2d 407, 422 (1992); *Heublein, Inc. v. South Carolina Tax Com.*, 409 U.S. 275, 281-282 (1972).

(d) The following rule reflects Alabama's practice with regard to:

1. Whether a particular factual circumstance is considered under P.L. 86-272 or permitted under this rule as either protected or not protected from taxation by reason of P.L. 86-272 under Secs. 40-18-31 or 40-27-1, Article IV.2; and

2. The jurisdictional standards which will apply to sales made in another state for purposes of applying a throwback rule with respect to such sales under Sec. 40-27-1, Article IV.16 (b).

(2) **Nature of Property Being Sold**

(a) Only the solicitation to sell personal property is afforded immunity under P.L. 86-272; therefore, the leasing, renting, licensing or other disposition of tangible personal property, or transactions involving intangibles, such as franchises, patents, copyrights, trademark, service marks and the like, or any other type of property are not protected activities under P.L. 86-272.

(b) The sale or delivery and the solicitation for the sale or delivery of any type of service that is not either (i) ancillary to solicitation or (ii) otherwise set forth as a protected activity under the subsection (5)(b) below is also not protected under Public Law 86-272 or this rule.

(3) **Solicitation of Orders and Activities Ancillary to Solicitation.**

(a) For the in-state activity to be a protected activity under P.L. 86-272, it must be limited solely to solicitation (except for *de minimis* activities described in paragraph (4) and those activities conducted by independent contractors described in paragraph (6) below).

(b) Solicitation means:

1. Speech or conduct that explicitly or implicitly invites an order; and
2. Activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order.

(c) Ancillary activities are those activities that serve no independent business function for the seller apart from their connection to the solicitation of orders. Activities that a seller would engage in apart from soliciting orders shall not be considered as ancillary to the solicitation of orders. The mere assignment of activities to sales personnel does not, merely by such assignment, make such activities ancillary to solicitation of orders. Additionally, activities that seek to promote sales are not ancillary, because P.L. 86-272 does not protect activity that facilitates sales; it only protects ancillary activities that facilitate the request for an order. The conducting of activities not falling within the foregoing definition of solicitation will cause the company to lose its protection from a net income tax afforded by P.L. 86-272, unless the disqualifying activities, taken together, are either *de minimis* or are otherwise permitted under this rule.

(4) ***De Minimis* Activities**

(a) *De minimis* activities are those that, when taken together, establish only a trivial connection with the taxing State. An activity conducted within a taxing State on a

regular or systematic basis or pursuant to a company policy (whether such policy is in writing or not) shall normally not be considered trivial. Whether or not an activity consists of a trivial or non-trivial connection with the State is to be measured on both a qualitative and quantitative basis. If such activity either qualitatively or quantitatively creates a non-trivial connection with the taxing State, then such activity exceeds the protection of P.L. 86-272. Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing State is not determinative of whether a *de minimis* level of activity exists. The relative economic importance of the disqualifying in-state activities, as compared to the protected activities, does not determine whether the conduct of the disqualifying activities within the taxing State is inconsistent with the limited protection afforded by P.L. 86-272.

(5) Specific Listing of Unprotected and Protected Activities

(a) Unprotected Activities. The following in-state activities (assuming they are not of a *de minimis* level) are not considered as either solicitation of orders or ancillary thereto or otherwise protected under P.L. 86-272 and will cause otherwise protected sales to lose their protection under P.L. 86-272:

1. Making repairs or providing maintenance or service to the property sold or to be sold.
2. Collecting current or delinquent accounts, whether directly or by third parties, through assignment or otherwise.
3. Investigating credit worthiness.
4. Installation or supervision of installation at or after shipment or delivery.
5. Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation.
6. Providing any kind of technical assistance or service including, but not limited to, engineering assistance or design service, when one of the purposes thereof is other than the facilitation of solicitation of orders.
7. Investigating, handling, or otherwise assisting in revolving customer complaints, other than the mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.
8. Approving or accepting orders.
9. Repossessing property.
10. Securing deposits on sales.

11. Picking up or replacing damaged or returned property.
12. Hiring, training, or supervising personnel, other than personnel involved only in solicitation.
13. Using agency stock checks or any other instrument or process by which sales are made within the state during the tax year.
14. Maintaining a sample or display room in excess of two weeks (14 days) at any one location within the state during the tax year.
15. Carrying samples for sale, exchange or distribution in any manner for consideration or other value.
16. Owning, leasing, using or maintaining any of the following facilities or property in-state:
 - (i) Repair shop.
 - (ii) Parts department.
 - (iii) Any kind of office other than an in-home office as described as permitted under subparagraph (5)(a)18 and (5)(b)2.
 - (iv) Warehouse.
 - (v) Meeting place for directors, officers, or employees when done on a regular or systematic basis during the tax year.
 - (vi) Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.
 - (vii) Telephone answering service that is publicly attributed to the company or to employees or agent(s) of the company in their representative status.
 - (viii) Mobile stores, *i.e.*, vehicles with drivers who are sales personnel making sales from the vehicles.
 - (ix) Real property or fixtures to real property of any kind.
17. Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale.
18. Maintaining, by any employee or other representative, an office or place of business of any kind.

(i) Other than an in-home office located within the residence of the employee or representative that (1) is not publicly attributed to the company or to the employee or representative of the company in an employee or representative capacity, and (2) so long as the use of such office is limited to soliciting and receiving orders outside the state for acceptance or rejection by the company ; or for such other activities that are protected under Public Law 86-272 or under subsection (6)(b) of this rule.

(ii) A telephone listing or other public listing within the state for the company or for an employee or representative of the company in such capacity or other indications through advertising or business literature that the company or its employee or representative can be contacted at a specific address within the state shall normally be determined as the company maintaining within Alabama an office or place of business attributable to the company to its employee or representative in a representative capacity . However, the normal distribution and use of business cards and stationery identifying the employee's or representative's name, address, telephone and fax numbers and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.

(iii) The maintenance of any office or other place of business in Alabama that does not strictly qualify as an "in-home" office as described above shall, by itself, cause the loss of protection under this rule.

(iv) For the purpose of this subsection it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining such in-home office.

19. Selling or otherwise transferring intangible personal property which is neither an isolated or transient event nor intrinsic in the related tangible personal property sold or transferred within the state.

20. Conducting any activity not listed in subparagraph (5) (b) below which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

(b) Protected Activities. The following in-state activities will not cause the loss of protection for otherwise protected sales:

1. Soliciting orders for sales by any type of advertising.
2. Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place

of business in the state other than an "in-home" office as described in subsection (5)(a)18 above.

3. Carrying samples and promotional materials only for display or distribution without charge or other consideration.

4. Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration.

5. Providing automobiles to sales personnel for their use in conducting protected activities.

6. Passing orders, inquiries and complaints on to the home office.

7. Missionary sales activities; i.e., the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of retailers to buy the manufacturer's goods from the manufacturer's wholesale customers would be protected if such solicitation activities are otherwise immune.

8. Coordinating shipment or delivery without payment or other consideration and providing information relating thereto either prior or subsequent to the placement of an order.

9. Checking of customers' inventories without a charge therefor (for reorder, but not for other purposes such as quality control.)

10. Maintaining a sample or display room for two weeks (14 days) or less at any one location within the state during the tax year.

11. Recruiting, training or evaluating sales personnel, including occasionally using homes, hotels or similar places for meetings with sales personnel.

12. Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

13. Owning, leasing, using or maintaining personal property for use in the employee or representative's "in-home" office or automobile that is solely limited to the conducting of protected activities. Therefore, the use of personal property such as a cellular telephone, facsimile machine, duplicating equipment, personal computer and computer software that is limited to the carrying on of protected solicitation and activity entirely ancillary to such solicitation or permitted by this rule under subparagraph (5)(b) shall not, by itself, remove the protection under this rule.

(6) Independent Contractors

(a) P.L. 86-272 provides protection to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the company or its employees or other representatives. Independent contractors may engage in the following limited activities in the state without the company's loss of immunity:

1. Soliciting sales.
2. Making sales.
3. Maintaining an office.

(b) Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as those provided under P.L. 86-2722 and this rule.

(c) Maintenance of a stock of goods in the state by the independent contractor under consignment or any other type of arrangement with the company, except for purposes of display and solicitation, shall remove the protection.

(7) Application of Destination State Law In Case of Conflict

(a) When it appears that Alabama and another Signatory State, due to the use of a throwback rule, have included or will include the same receipts from a sale in their respective sales factor numerators, at the written request of the company mailed to both states, Alabama may confer in good faith with the other state to determine which state should be assigned said receipts. Such conference may identify what law, rule or written guideline, if any, has been adopted in the state of destination with respect to the issue. The state of destination shall be that location at which the purchaser or its designee actually receives the property, regardless of f.o.b. point or other conditions of sale.

(b) In determining which state is to receive the assignment of the receipts at issue, preference may be given to any clearly applicable law, rule or written guideline that has been adopted in state of destination. However, except in the case of the definition of what constitutes "tangible personal property", Alabama is not required by this rule to follow any other state's law, rule or written guideline should Alabama determine that to do so (i) would conflict with its own laws, rules, or written guidelines and (ii) would not clearly reflect the income-producing activity of the company within Alabama.

(c) Notwithstanding any provision set forth in this rule to the contrary, as between Alabama and any other Signatory State, Alabama will apply the definition of "tangible personal property" that exists in the state of destination to determine the

application of P.L. 86-272 and issues of throwback, if any. Should the state of destination not have any applicable definition of such term so that it could be reasonably determined whether the property at issue constitutes "tangible personal property", then Alabama will treat such property in any manner that would clearly reflect the income-producing activity of the company within Alabama.

(8) Miscellaneous Practices

(a) **Application of Rule to Foreign Commerce.** Alabama will apply the provisions of Public Law 86-272 and of this rule to business activities conducted in foreign commerce. Therefore, whether business activities are conducted by (i) a foreign or domestic company selling tangible personal property into a country outside of the United States from a point within Alabama or by (ii) either company selling such property into Alabama from a point outside of the United States, the principles under this rule apply equally to determine whether the sales transactions are protected and the company immune from taxation in either Alabama or in the foreign country, as the case might be, and whether, if applicable, Alabama will apply its throwback provisions.

(b) **Application to Corporation Incorporated in Alabama or to person resident or domiciled in Alabama.** The protection afforded by P.L. 86-272 and the provisions of this rule, except for purposes of applying a throwback rule, do not apply to any corporation incorporated within Alabama or to any person who is a resident of or domiciled in Alabama

(c) **Registration or Qualification to Do Business.** A company that registers or otherwise formally qualifies to do business within Alabama does not, by that fact alone, lose its protection under P.L. 86-272. Where, separate from or ancillary to such registration or qualification, the company receives and seeks to use or protect any additional benefit or protection from Alabama through activity not otherwise protected under P.L. 86-272 or this rule, such protection shall be removed.

(d) **Loss of Protection for conducting unprotected activity during part of tax year.** The protection afforded under P.L. 86-272 and the provisions of this rule shall be determined on a tax year by tax year basis. Therefore, if at any time during a tax year the company conducts activities that are not protected under P.L. 86-272 or this rule, no sales in Alabama or income earned by the company attributed to Alabama during any part of said tax year shall be protected from taxation under said Public Law or this rule.

Author: Holly H. Coon
Authority: Sections 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975
History: