THE SQUANDERED LEGACY: THE ALABAMA DEPARTMENT OF REVENUE'S FAILURE TO IMPLEMENT KEY TAX REFORMS.

In previous articles, we have described Alabama's seminal loophole closing legislation passed at the end of 2001. One key reform was the anti-Geoffrey statute, which disallowed the ability of a business in Alabama to deduct payments to offshore intangible holding companies in Delaware, Nevada, Bermuda and other tax haven states unless those deductions are reasonable or such payments are taxed in the recipient state. The original bill to close the Geoffrey loophole prohibited the deduction of such transfers altogether, with the exceptions being added to the legislation in order to compromise the interests of business with Alabama's school children. The exceptions, however, were never intended to swallow the rule, and the statute was to be implemented immediately and retroactively to January 1, 2001. Unfortunately, the Department of Revenue has yet to enforce the statute by sending a single tax bill to a business for wrongly deducting these Geoffrey payments.

A second loophole closing statute passed in 2001 was to eliminate the ability of offshore businesses to claim that the sale of large capital items located in Alabama, such as a factory,

should be taxed not in our state but in the state where the business is headquartered. This was the so-called Uniroyal loophole. The new legislation would tax these sales in Alabama, whether the selling company was domiciled here or elsewhere. Recently, the Department of Revenue's Tax Judge visited a $17 million tax blooper on our school children, in letting one of the biggest Uniroyal transfers escape taxation even though the taxpayer changed its legal theory to oppose the tax three times.

In considering these two recent developments, let me suggest that we consider whether the Alabama Department of Revenue works for the people as its billing and collection department or is too susceptible to the grip of big business.

A. ANTI-GEOFFREY LEGISLATION: GETTING THE BARN DOOR SHUT.

Alabama's intangible add-back statute passed in 2001 was to close this most abusive tax sheltering device, known as Geoffrey. This loophole is named after Geoffrey the Giraffe, of

Toys-R-Us, based upon a recent South Carolina case. Geoffrey transfers are payments to related offshore holding companies disguised as trademark protection businesses. The offshore company holds a trademark which the Alabama business is using and the Alabama business pays "rent" for the trademark, with the real purpose being to export Alabama income offshore, to avoid Alabama income tax.

Even though the add-back statute was to take effect at January 1, 2001, today, over two years later, multistate businesses continue to transfer taxable income out of Alabama with these intangible transfers, claim the deduction and pay no tax. Some companies may lack knowledge of the new statute, but most simply ignore the tax laws. These Geoffrey transfers have escalated to such an all time high for Alabama that, if you add up all the net income claimed by Alabama multistate businesses, it is a negative number.

The Commissioner of Revenue has taken some positive steps to bring Geoffrey tax abusers to the tax table. He recently wrote a demand letter to many of these companies

requesting that they amend their returns and pay the tax. Some checks came trickling in. However, we are only scratching the surface of the problem. Now, businesses are trying to expand their interpretation of the exceptions to the Geoffrey statute, so that they become loopholes to swallow the rule. Businesses protest that they have a valid business purpose other than avoiding tax, so that the add-back is unreasonable. However, from previous audit experience, I can tell you that I have never found a taxpayer who could justify these intangible payment transfers. The income stripped from Alabama is never used to fund trademark protection services or any other related service. It is merely paid to a shell passive investment company that reports profits equal to thousands of percent while the Alabama operating company reports a loss, and Alabama's school children get no tax revenue.

Now, taxpayers are also arguing that the provision in the statute allowing the deduction if the income paid offshore is taxed in the offshore jurisdiction, applies if any small fraction of that income is taxed. Thus, if there is a million dollar Geoffrey transfer from Alabama to Nevada and a thousand dollars is taxed in Nevada, all million dollars would be deductible. This "pre-

apportionment" construction as opposed to a "post-apportionment" construction, under which only the amount taxed on the receiving end would be deductible in Alabama, as originally contemplated by our 2001 statute, would destroy the anti-Geoffrey statute. The same tax professionals who drafted the compromise legislation are attempting to tell the Department of Revenue, with a straight face, that this is the proper construction of Alabama's anti-Geoffrey statute. Here we go again. Big business is treating Alabama corporate income tax as an optional obligation.

In order to eliminate confusion concerning the Geoffrey statue's enforcement, the Department of Revenue recently authored a regulation interpreting it. In the meantime, in a baffling pro-taxpayer maneuver, the Department seems to have decided not to bill any taxpayers for amounts owed under the anti-Geoffrey statute until the regulation becomes final one day. This will take many months in the future, and would be subject to appeal to the Legislature. Again, our Department of Revenue is afraid to act while schools close and teachers are fired around us.

There are many known taxpayer returns that could generate millions of dollars in lost revenues if the Department would only enforce our anti-Geoffrey statute now. The Commissioner's communication by letter has proved effective. However, it alone is not adequate enforcement and is a disservice to the people of Alabama. The tax assessors in the Department should follow the Commissioner's lead and carry out the Department of Revenue's responsibilities to fully enforce our tax laws.

This is not the time to lose sight our State Legislature's objective in passing the anti-Geoffrey statute: to tax corporations fairly and to collect tax on income generated in Alabama. It's time for taxpayer accountability. The Commissioner's recent collection efforts along with the Department's proposed regulation are steps in the right direction. More importantly, the Department of Revenue should enforce the anti-Geoffrey statute that has been on its books for a year and a half, without waiting for the regulation to become effective. Alternatively, the regulation could be implemented now on an emergency basis. Our school children cannot wait on the lugubrious pace at which Alabama's tax laws are enforced.

B. A $17 MILLION UNIROYAL BLOOPER: THE TAXPAYER IS ALWAYS RIGHT.

As suggested above, the Uniroyal case allowed companies headquartered elsewhere to sell large capital items in Alabama and claim them to be non-business income taxable in the home state and not here. Legislation passed at the end of 2001 reversed this rule, with such income being taxed in Alabama.

While this reform was in the works, Kimberly-Clark, a large pulp paper company, was in litigation with the Department of Revenue over the proper tax treatment of a sale of an Alabama pulp mill and large timberlands. First, Kimberly-Clark claimed the receipts from the sale were business income, resulting in a large tax bill from the State of Alabama. Then, Kimberly-Clark wised up, became aware of the Uniroyal loophole and argued to the Alabama Department of Revenue's Tax Judge, that the receipts were really non-business income and should therefore

only be reported in Texas, where the company is headquartered, with no Alabama income tax being paid. The Judge agreed, even though this was an about face in Kimberly-Clark's position and despite instructions from the Supreme Court of Alabama in a previous Kimberly-Clark case that, "When interpreting a taxation statute, exemptions and deductions must be strictly construed against the taxpayer and in favor of the taxing authority."

The Department of Revenue then accepted Kimberly-Clark's non-business income characterization of the sale, but was able to claim that the entire sale was in Alabama, due to the real estate exception to the Uniroyal loophole. Kimberly-Clark was promptly sent a tax bill for $21 million.

Undaunted, Kimberly-Clark went back to our Tax Judge and said that, even though this is the third position we have taken on this case, we would like to go back and call the sale business income, mostly allocated to Texas where the company is headquartered. Again, the Judge agreed, so that the taxes owed shrank from $21 million to $4 million.

To highlight the absurdity of this decision, Kimberly-Clark's outside auditors classified the sale of these items as being "extraordinary" or non-business, and Kimberly-Clark classified the transaction as business or non-business in various states in order to minimize income taxes. If this blatant tax gaming is not only allowed by our Department of Revenue but encouraged by its Tax Judge, how will we ever be able to tell the people of Alabama that our tax system is fair? Here is a case were bloopers are feeding off bloopers, and still the Administrative Law Judge fails to pull back the curtain to take a peek at economic reality. If independent auditors conclude that the transaction meets the extraordinary income test the Tax Judge should follow suit with his interpretation.

Should a corporation be able to pick and choose how it wants to report income in arriving at the best tax result? Here is another case of a corporation re-arranging the furniture on paper, or in this case trees, to further reduce tax payments to Alabama. The Department of Revenue has appealed this ruling of its Tax Judge in hopes of reaching a favorable decision in Circuit Court. This is a serious problem that exceeds the boundaries of taxation and shouldn't be tolerated.

C. CONCLUSION.

Who is representing the people in the tax assessment and collection process at our Department of Revenue? Should our tax collectors, without compunction or consequence, who pays taxes and who doesn't with no rhyme or reason in the process? When will this process have gone to the extreme? Is that time now?

We encourage the Alabama Department of Revenue to take a good look at itself and to remember that it works for the people and not large multistate businesses. The Department of Revenue is to enforce all tax laws uniformly and not bow to the rich and powerful. Unless this is done, any tax reform efforts requiring a vote of the people will be dead on arrival. No one is going to agree to a tax increase unless the taxes already on the books are being collected from everyone, business and individual, rich and poor.