



Volume 12 Number 11

November 2005

State Tax Return

Alabama Nexus: Out-Of-State Lessor Not Subject To Corporate Income Tax

GUEST AUTHOR

Bruce P. Ely
Bradley, Arant, Rose & White LLP
Birmingham, Alabama
(205) 521-8000

Chen Meng Lam
Law Clerk
Columbus
(614) 469-3939

Bruce P. Ely is Chairman of the SALT Practice Group of the multistate law firm of Bradley Arant Rose & White LLP and is resident in its Birmingham office. He is a Fellow of the American College of Tax Counsel, has been listed for over 10 years in *Best Lawyers in America*, and is a member of the Editorial Advisory Boards for BNA/Tax Management, RIA's *Business Entities Journal* and CCH's *State Income Tax Alert*. He can be reached at (205) 521-8366 or bely@bradleyarant.com

An out-of-state lessor of railroad cars will not be subject to Alabama corporate income tax if the only connection with the state is the use of the railcars within the state by an unrelated lessee and over which the lessor has no control, according to the Administrative Law Division. *Union Tank Car Co. v. Alabama*, No. 04-247, 2005 Ala. Tax LEXIS 3 (Ala. Dep't of Revenue Jan. 11, 2005).

Factual Background

Union Tank Car Company ("Taxpayer") is a Delaware corporation, headquartered in Chicago, Illinois, that manufactures and leases railroad cars to customers throughout the United States. During the tax years at issue, 1994 through 1998, the Taxpayer manufactured the railcars in Illinois and Texas, and executed all its leasing agreements in Illinois. Upon the execution of a lease, the lessee arranged for a railroad to pick up the railcar from the Taxpayer's manufacturing facility and hauled the railcar to a location designated by the lessee. The leases were for a fixed monthly amount, paid to the Taxpayer in Chicago. The Taxpayer had no control over where the leased railcars were used and none of its regional sales offices or repair and service centers were located in Alabama. The Taxpayer conducted no business, had no employees, and owned no property in Alabama. The Taxpayer, however, had one Alabama-based lease customer and also some other lessees which used its railcars in interstate commerce in Alabama.

The Audit and The Commissioner's Position

Prior to this case, the Alabama Department of Revenue's Administrative Law Division had held that the Taxpayer was not subject to Alabama franchise tax on the basis that it was not doing business in Alabama.¹ Presumably based on this previous franchise tax ruling, the Taxpayer subsequently stopped filing Alabama corporate income tax returns as well. Upon audit, the Department, however, determined that the Taxpayer was liable for Alabama corporate income tax for 1994 through 1998 on the basis that the Taxpayer conducted its leasing business in Alabama and derived income (the alternative prong under Alabama's income tax nexus statute) from the lessees' use of its railcars located in Alabama. The Taxpayer then appealed to the Administrative Law Division. At issue on appeal was (1) whether Taxpayer was "doing business in Alabama or deriving income from sources within Alabama," and thus subject to the Alabama corporate income tax pursuant to Ala. Code § 40-18-2(3); and (2) even if so, whether Alabama is constitutionally prohibited from taxing the Taxpayer by the Due Process and/or Commerce Clauses of the United States Constitution.

Mere Use of Railcars By Lessees in Alabama Did Not Give Rise to Sufficient Connection Between Lessor and State

The Chief Administrative Law Judge ("ALJ") held that the Taxpayer was not subject to Alabama corporate income tax because it was not doing business in Alabama or deriving income from sources in Alabama. The ALJ reasoned that because the lease contracts were executed in Illinois, the railcars were picked up and returned by the lessees in Illinois, and the lease payments were made to the Taxpayer in Illinois, the Taxpayer was considered to be doing business and earning income in Illinois. Moreover, according to the ALJ, the amount of the lease payments were fixed, and did not depend on how frequently or where the lessee used the railcars. The fact that the lessees used the railcars in Alabama was therefore irrelevant since the Taxpayer lacked control over them. Accordingly, the ALJ held that the Taxpayer lacked sufficient connection with Alabama and was not subject to Alabama corporate income tax.

In arriving at his conclusion, the ALJ also relied upon cases from other courts that have similarly held that the mere use of leased property by the lessee in the state does not subject the out-of-state lessor to income tax in that state. *Kentucky Tax Comm. V. American Refrigerator Transit Co.*, 294 S.W.2d 554, 555 (1956) (holding that the taxpayer was not subject to Kentucky income tax because the source of its leasing income was the leasing contracts negotiated and executed in Missouri); *First Nat'l Leasing and Fin. Corp. v. Indiana Dep't of State Revenue*, 598 N.E.2d 640, 645 (1992) (finding that the activities related to the purpose of the lease, the use and possession of the equipment were conducted by the lessee and that the mere ownership of equipment located in Indiana was remote and incidental to the lease transaction from which its income is derived).

¹ *Alabama v. Union Tank Car Co.*, F. 90-154 (Ala. Dep't of Revenue Mar. 19, 1992) (finding that Taxpayer's only connection with Alabama was that "its leased rail cars occasionally traveled through Alabama in interstate commerce while under the control of the lessees").

In addition, the ALJ noted that if Alabama income tax were to be imposed based on the lessees' use of the railcars, as the Department had argued, there would be practical concerns because it would be difficult for the lessor to monitor how much the lessees used the railcars on their tracks or know where the leased railcars were being used. The Department's position thus could not be accepted. Importantly, the ALJ also made clear that it was deciding the case purely on statutory, not constitutional, grounds. The ALJ explained that since it had determined that Taxpayer was not subject to Alabama income tax under Ala. Code § 40-18-2(3), it need not address the next issue of whether Alabama was constitutionally prohibited from taxing the Taxpayer by the Due Process and/or Commerce Clauses.

According to our "Guest Author," Bruce Ely, the Department has since appealed the case to the Montgomery County Circuit Court. However, the ruling has not been issued by that court yet. Ely believes that the ALJ's ruling is correct and should be upheld.

Conclusion

In conclusion, the ALJ set forth the standard in determining when a lessor of movable equipment would be subject to Alabama income tax: (1) if a leasing business is located in Alabama and leases property in Alabama, all the lease proceeds would be subject to Alabama income tax, regardless of where the leased property was used; but (2) if an out-of-state leasing business whose only contact with Alabama is the use of leased property by lessees in Alabama, the business would not be liable for Alabama income tax. ■



This article is reprinted from the *State Tax Return*, a Jones Day monthly newsletter reporting on recent developments in state and local tax. Requests for a subscription to the *State Tax Return* or permission to reproduce this publication, in whole or in part, or comments and suggestions should be sent to Christine Rhodes (614/281-3911 or crhodes@jonesday.com) in Jones Day's Columbus Office, P.O. Box 165017, Columbus, Ohio 43216-5017.

©Jones Day 2005. All Rights Reserved. No portion of the article may be reproduced or used without express permission. Because of its generality, the information contained herein should not be construed as legal advice on any specific facts and circumstances. The contents are intended for general information purposes only.