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Alabama's Pulp Fiction: Paper Company's Sale of Paper Assets Constituted Non-Business Income

The Alabama Supreme Court held that the sale of an Alabama paper mill and timberlands by a company in the business of the manufacture and sale of tissue and paper-related products constituted non-business income allocable to Alabama. *In re: Kimberly-Clark Corporation and Kimberly-Clark Worldwide, Inc. v. Alabama Dep't of Rev.*, CV-03-994 and CV-03-2157 (Feb. 26, 2010).

Background

Kimberly-Clark Corporation (Kimberly-Clark), domiciled in Texas, sold paper and paper products throughout the world. Kimberly-Clark sold a paper mill and timberlands in Alabama (the Coosa Properties) that it had acquired more than 30 years earlier. The 1997 disposition was a response to a Kimberly-Clark strategy adopted in the 1990s to reduce (but *not* eliminate) its dependence on internal pulp production.

Kimberly-Clark transferred the Coosa Properties to a separate legal entity responsible for acquiring, managing and selling timberland. As part of this strategy, Kimberly-Clark sold two pulp and paper mills in the early 1990s followed by the Coosa Properties disposition in March 1997. By 2002, Kimberly-Clark owned 12 pulp mills, had acquired 5 mills between 1999 and 2002, and sold 4 mills before 1999. Kimberly-Clark also engaged in several sales of non-pulp-related entities during the years at issue, such as trucking, graphic arts and medical products.

Kimberly-Clark originally took the position that the gain from the sale of the Coosa Properties constituted apportionable business income on its Alabama tax return. However, Kimberly-Clark excluded the receipts from the sale of the Coosa Properties from the Alabama sales factor, claiming it constituted receipts from an "incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business." AL Admin. Code R. 810-27-1-4.18(3)(a). The Alabama Department of Revenue (the Department) rejected the sales factor exclusion and Kimberly-Clark protested.

In its petition for review, Kimberly-Clark argued that either the receipts from the sale of the Coosa Properties should be excluded from its Alabama sales factor or, in the alternative, the gain should be classified as non-business income allocable to Texas. An administrative law judge held that the gain was business income (but included the receipts in the sales factor); an Alabama Circuit Court held that the gain was non-business income allocable to Alabama (not Texas); and the Alabama Court of Civil Appeals reversed and held that the gain was business income (but remanded as to whether the receipts are includible in the sales factor). The Department petitioned the Alabama Supreme Court to determine whether the gain constituted business or non-business income.

The Alabama Supreme Court Decision

The Alabama Supreme Court held that the gain should be treated as non-business income allocable to Alabama. In reaching its decision, the Court applied the transactional test (but not the functional test) to determine whether the gain constituted business income: earnings arising from transactions and activity in the regular course of the taxpayer's trade or business. The Court had limited the definition of business

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income to include only the transactional test, but not the functional test. *Ex parte Uniroyal Tire Co.*, 779 So. 2d 227, 236 (Ala. 2000).¹

The phrase “regular course of the taxpayer’s trade or business” was interpreted by the Court to refer to an ongoing business concern. The Court concluded that the sale of the Coosa Properties was “extraordinary” and a “premier example of [Kimberly-Clark’s] shift in corporate strategy that entailed the liquidation of long-held major corporate assets.”

Sutherland Observation: The Alabama Supreme Court did not place any significant weight on the fact that Kimberly-Clark continued to own, maintain and dispose of pulp properties. Nor did the Court place much weight on the fact that Kimberly-Clark engaged in several similar, albeit smaller, land transfer transactions. Rather, the Court distinguished the Coosa Properties transaction as extraordinary because it was larger than other Kimberly-Clark transactions.

Conclusion

The Alabama Supreme Court’s holding that Kimberly-Clark’s sale of property previously used in its business creates opportunities for taxpayers to allocate income outside of Alabama. Taxpayers engaging in large transactions should consider refund opportunities related to allocating gains from sales of non-Alabama property outside of Alabama. The analysis adopted by the Court—treating larger transactions as distinguishable from other transactions—presents a more narrow definition of business income than is applied by some other states.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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¹ The *Kimberly-Clark* Court ruled that Alabama did not adopt the functional test to determine business income: income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations. In 2001, the Alabama Legislature enacted Ala. Code Sec. 40-27-1.1 to further define “business income” and explicitly override the Alabama Supreme Court’s decision in *Uniroyal Tire Co. v. Alabama Department of Revenue*. For tax years beginning after December 31, 2001, business income includes “income from tangible or intangible property if the acquisition, management, or disposition of the property constitute integral parts of the taxpayer’s trade or business operations.” (emphasis supplied). The original UDITPA definition of business income uses the word “and” rather than “or,” which is the grammatical basis for courts’ holding that the definition contains only a transactional test, because the “disposition,” as well as the acquisition and management of the property, must be part of the taxpayer’s regular trade or business operations.

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