IN THE COURT OF CIVIL APPEALS FOR THE STATE OF ALABAMA

Appellate Court No. 2060478

G. THOMAS SURTEES,
in his official capacity as Commissioner
of the Alabama Department of Revenue, and the
STATE OF ALABAMA DEPARTMENT OF REVENUE,

Respondents-Appellants,

v.

VFJ VENTURES, INC.
(f/k/a VF JEANSWEAR, INC.),

Plaintiff-Appellee.

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BRIEF OF THE *AMICUS CURIAE* MULTISTATE TAX COMMISSION IN SUPPORT OF RESPONDENTS-APPELLANTS G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS COMMISSIONER OF THE ALABAMA DEPARTMENT OF REVENUE, AND THE STATE OF ALABAMA DEPARTMENT OF REVENUE

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On appeal from the decision of the Honorable Tracy S. McCooey, Circuit Judge, Circuit Court of Montgomery County, Alabama, dated January 24, 2007.

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Submitted by:

Bruce J. Fort, Esq.
Counsel for *Amicus Curiae*
Multistate Tax Commission
444 N. Capitol Street, NW
Suite 425
Washington, D.C. 20001-1538
(202) 624-8699
N.M. Bar Number 960

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I. INTERESTS OF *AMICUS CURIAE*

This brief is submitted by *amicus curiae* Multistate Tax Commission ("the Commission") in support of the Respondents-Appellants G. Thomas Surtees and the State of Alabama Department of Revenue. The Commission files this brief out of concern that the decision below, if affirmed by this Court, would seriously undermine recent legislative efforts in Alabama and many other states to eliminate a tax-planning device intended to allow multi-state corporations to pay tax on less than their fair share of income earned in those states.

Nineteen states and the District of Columbia have now adopted what are referred to as "add-back" statutes as an integral part of their corporate income tax systems. These statutes prohibit a taxpayer from claiming a deduction for "intangible expenses" paid to a related entity, effectively preventing the tax minimization technique at issue in this case.[1] All of

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[1] Those 20 jurisdictions are: Alabama: Ala. Code Sec. 40-18-35(b), effective 2001; Arkansas, Ark. Code Sec. 26-51-423(g)(1), effective 2004; Connecticut, Conn. Gen. Stat. Sec. 12-218(c), effective 1999; District of Columbia: Code Sec. 47-1803.02, effective 2004; Georgia, Code Sec. 48-7-28.3, effective 2006; Illinois, 35 ILCS 5/203(a)(2), effective 2005; Indiana, Code Sec. 6-3-2-20, effective

those statutes also provide for certain exceptions to the requirement to "add-back" expenses in various circumstances. The focus of the case below was an exception to the "add-back" requirement "if the corporation establishes that the adjustments are unreasonable." Ala. Code Sec. 4-18-35(b)(2)(effective 2001). Six states, in addition to Alabama, provide a similar exception.[2] The Commission respectfully suggests that the lower court has construed that exception so broadly in this case that the decision would undermine the very purpose of the statute were it to be upheld on appeal.

2006; Kentucky, KRS Sec. 141.205, effective 2005; Maryland, Md. Code Sec. 10-3061, effective 2004; Massachusetts, Mass. Gen. Laws, Ch. 63, Sec. 31 I, J, K, effective 2002; Michigan, MCL Sec. 208.9, effective 1975; Mississippi, Miss. Code Sec. 27-7-17, effective 2001; New Jersey, NJ Sec. 54:10A-4(k)-4.4, effective 2002; New York, NY Law Sec. 208(9)(o), effective 2003; North Carolina, N.C. Gen. Stat. Sec. 105-130.7A(c), effective 2001; Ohio, Ohio Rev. Code 5733.042, effective 1999; Oregon, O.A.R. Sec. 150-314.295, effective 2005; South Carolina, S.C. Code 12-6-1130, effective 2005; Tennessee, Tenn. Code Sec. 67-4-2006(b), effective 2004; and Virginia, VA Code Sec. 58.1-402(B). Although there are other tax statutes, state and federal, which disallow deductions in various circumstances, an "add-back statute" for the purposes of this brief means a statute disallowing intangible expenses as listed above.

[2] Those six states are Connecticut, Illinois, Indiana, Massachusetts, New Jersey and Ohio.

The Commission is the administrative agency for the Multistate Tax Compact ("Compact"), which became effective in 1967. (See RIA State & Local Taxes: All States Tax Guide ¶ 701 *et seq.* (2005).) Article IV of the Compact incorporates the Uniform Division of Income for Tax Purposes Act ("UDITPA") almost word for word. Forty-seven states and the District of Columbia are now members of the Commission. Alabama enacted the Compact in 1967 as founding member.[3] Acts 1967, No. 395, p. 982, Sec. 1. The substantive provisions of Article IV of the Compact have been incorporated in Alabama Code 1975, Section 40-27-1.

Acting through its member states, the Commission develops model uniform laws and regulations pertaining to common issues in state taxation where the Commission

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[3] In addition to Alabama, the full members are the states of Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington, and the District of Columbia. The sovereignty members are the states of Georgia, Kentucky, Louisiana, Maryland, New Jersey West Virginia and Wyoming. The associate members are the states of Arizona, Connecticut, Florida, Georgia, Illinois, Iowa, Indiana, Maryland, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

believes that uniformity will benefit the states and the taxpaying community.[4] The Commission also files briefs as a friend of the court in certain cases where, as here, the Commission believes that the proper interpretation and application of common statutory tax systems is of vital importance to its member states and the taxpaying community.

Because this is the first appeal of a case involving the application of an add-back statute, the Commission has a strong interest in ensuring that the proper framework is established for this Court's decision as it may well influence future determinations in many other states.

II. SUMMARY OF ARGUMENT

Add-back statutes, including Alabama's, are not intended merely to prevent deductions based on sham transactions, as the states already had such authority under common law. Instead, these statutes are intended to prevent distortions of the amount of income *reported*

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[4] In 2006, the Commission adopted a model add-back statute:http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Add-Back%20-%20FINAL%20version.pdf

to the states for tax purposes compared to the amount of income actually *earned* in those states.

One technique commonly used by multi-state corporations that results in a distorted underreporting of income is to transfer the legal ownership of a valuable intangible asset from the operating company to a related entity operating in a state which does not impose a tax on such income. The transfer of legal ownership to the assets forms the basis for an inter-company expense deduction where none existed before. The transfer of ownership is and resulting deduction is defended, often after the fact, with evidence of some purported business purpose other than reducing state taxes. This was the technique used in this case to eliminate more than half of the income VFJ Ventures, Inc. reported to Alabama in 2001. The lower court interpreted the "unreasonable" exception as nullifying the add-back requirement whenever the taxpayer could demonstrate that the expense payments to a related entity had some plausible non-tax business purpose. The Commission argues that this construction would nullify the purpose of add-back statutes, which is to prevent

distortion of income even where the taxpayer establishes a non-tax business purpose for the transaction in question.

The lower court also erred in suggesting that the add-back statute should be limited to sham transactions under the theory that any variation from federal income standards would result in taxation of income earned outside of Alabama. The Alabama legislature has chosen to "de-conform" to federal tax policy in numerous areas, including the disallowance of certain expenses paid to a related party. Nineteen other jurisdictions have made the same policy choice. There is simply no basis from which to conclude, as the lower court did, that these states have thus somehow taxed income earned beyond their borders.

The lower court erred in substituting its own judgment of what constitutes sound tax and fiscal policy for that of the Alabama Legislature as expressed in Ala. Code § 4-18-35(b).

III. ARGUMENT

ADD-BACK STATUTES ARE DESIGNED TO ENSURE THAT THE AMOUNT OF INCOME EARNED IN EACH STATE IS FAIRLY REPORTED FOR TAX PURPOSES.

A. Add-Back Statutes Are Intended to Have Application Beyond Merely Preventing Sham Transactions.

The lower court's interpretation of Alabama's add-back statute and the "unreasonable" exception in § 40-18-35(b)(2), Code of Ala. 1975 (as amended 2001), failed to understand what the legislation was intended to accomplish. The lower court first determined that the Delaware holding companies[5] involved in this case were not "sham or shell corporations," and because there were "several business purposes for their creation and continued viability... VFJ had a business purpose for making the royalty payments." (Clerk's Designation of Record on Appeal ("C") 634). The lower court then concluded that requiring an add-back of royalty payments which had a valid business purpose was not what the

[5] Delaware is one of a handful of states which does not impose an income tax on intangible income. Because the early cases addressed to this tax-planning technique involved Delaware companies, the phrase "Delaware intangible holding company" is used herein to refer to a company primarily receiving income from intangible assets in any state which does not impose an income tax on that particular stream of revenue.

Alabama Legislature intended, even if "the transactions may have been motivated by tax considerations." (C. 639). As a result, the lower court's decision, if followed by this Court, would incorrectly limit the statute's application to intangible expense payments made to "sham or shell corporations" regardless of any tax consequences which might result from those payments.

Add-back statutes, however, are not merely designed to thwart "sham" or fraudulent transactions intended to create entirely fictitious expenses, as the lower court held. (C. 638). Alabama and the 19 other jurisdictions which have adopted add-back statutes already had such authority under the common law, and by virtue of following federal taxable income determinations, which permit a deduction only for "the ordinary or necessary expenses paid or incurred during a taxable year in carrying on any trade or business." 26 U.S.C.A. Sec. 162(a). A transaction lacking all economic substance and (non-tax) business purpose cannot be said to create an "ordinary or necessary expense." *Neontology Associates, P.A. v. Commissioner of Revenue,* 299 F.3d 221 (3rd Cir. 2002); *Muhich v. Commissioner of Revenue,*

283 F.3d 860 (7th. Cir. 2001). See also, *Coltec Industries v. Commissioner,* 454 F.3d 1340 (Fed. Cir. 2006); *Black and Decker Corp. v. United States,* 436 F.3d 431 (4th. Cir. 2006).

The lower court's analysis of the purpose of the add-back statute, if followed by this Court, would return Alabama to the position it was in prior to having adopted the statute. One problem which the Alabama Legislature was presumably trying to avoid when it adopted the add-back statute was the need to adjudicate the legitimacy of intangible expense deductions under the sham transaction doctrine on a case-by-case basis through fact-intensive, expensive and ultimately unpredictable litigation. The level of proof necessary to establish a sham transaction is significant. The state must demonstrate that the taxpayer had no business motives other than obtaining tax benefits and that the transaction had no economic substance because there was no reasonable expectation of a profit. The test has both objective and subjective components. *Rice's Toyota World, Inc. v. Commissioner,* 752 F.2d 89, 91 (4th Cir.1985).

The second and related consequence of limiting the state's recourse to the sham transaction doctrine is that corporate taxpayers could potentially reduce their taxable income by millions of dollars by stationing a handful of employees—perhaps even one employee--in a Delaware intangible holding company, thus creating an argument, however tenuous, that the transactions had economic substance in fact. The lower court's interpretation would thus defeat the Legislature's goal of ensuring that income generated in Alabama is fairly apportioned based on the economic reality of where and how that income is earned.

The lower court's conclusion that denial of a deduction would be "unreasonable" where the Delaware holding companies had business purpose and economic substance is especially problematic since these same criteria—business purpose and economic substance—form part of the basis for allowing an exception to add-back in Section (b)(3) of the Alabama statute, but only for payments to related companies which are *not* primarily engaged in licensing intangible property. §40-18-35(b)(3), *Code of Ala.* 1975. The "business purpose and

economic substance" exception in (b)(3) for companies *other than* entities who primarily license intangible property would be rendered meaningless if all companies were allowed to claim the same exception under section (b)(2) of the statute. The lower court does not appear to have recognized that its interpretation of the "unreasonable" exception in (b)(2) would create a conflict with the test in (b)(3). A statute should be construed, if possible, to give effect to each section so that no section is rendered superfluous. *State v. Amerada Hess Corp.*, 788 So.2d 179, 183-4 (Ala. Civ. App. 2000). Where business purpose and economic substance are the criteria for allowing deductions for payments to companies other than those primarily engaged in licensing, those factors cannot be the criteria for allowing a deduction for payments made to companies like Lee and Wrangler who *are* primarily engaged in licensing intangible property.

The lower court's narrow focus on whether a claimed business expense would past muster under the sham transaction doctrine appears to have precluded consideration of the possibility that the Alabama

Legislature meant to address broader issues, including proper determination of the tax base for corporations doing business in Alabama. Tax liability is a product of many aspects of the taxing system, including federal base income determinations, accounting systems, apportionment formulas and the size of the tax base. No one factor can be viewed in isolation. As a consequence of its focus on a single aspect of Alabama's taxing system, the lower court erroneously concluded that any variation from federal taxable income standards would necessarily result in taxation of extra-territorial income. The lower court wrote:

> Because add-back in VFJ's circumstances effectively denies it a deduction for a necessary cost of doing business in Alabama, thereby resulting in a calculation of taxable income that includes income fairly attributable to other states, add-back is unreasonable and thus not required for VFJ.
>
> (C. 638).

In reality, virtually all states' tax bases vary from federal income standards in some particulars, including disallowance of deductions and exemptions. W. Hellerstein, *State Taxation*, ¶ 7.03 (3rd. Ed. 1998)("The measure of every state corporate income tax differs to

at least some extent from the federal corporate income tax base.") When states make these choices, it does not mean that they have taxed income "fairly attributable to other states." (C. 638, 639). It does mean that the states have made different policy conclusions on how taxable income should be determined. In particular, the Alabama Legislature and the legislatures of twenty other jurisdictions have determined, as a general rule, that payments to a related party for the use of intangible property do not warrant a deduction for the purposes of calculating taxable income.

In order to explain why the denial of this deduction did not cause Alabama to tax income earned in other states, it is necessary to briefly discuss some of the basic principles of how the income of a multi-state taxpayer is determined and then subjected to taxation in the states where that taxpayer operates.

1. States May Choose Not to Conform to Federal Taxable Income Standards.

While virtually all states use federal taxable income as a starting point for determining state taxable income, state legislatures commonly make adjustments to

federal standards. *2006 Multistate Corporate Tax Guide*, J.C. Healy & M. Schadewald, Part 3, PP. I-175 through I-391 (CCH Inc., 2006). The adjustments (non-conformities) may include differing treatment of domestic and foreign-source dividends, net operating losses, modified accelerated depreciation, bonus depreciation, depletion allowances, passive loses and credits, deductibility for federal taxes taxes, and state and local bonds. *Id.* Alabama has chosen not to conform to federal income and expense standards in many different areas in addition to the intangible expense add-back statute, including the treatment of domestic dividends and net operating losses. Ala. Code Sec. 40-18-35(a). These non-conformities may represent adjustments necessary to accurately reflect a taxpayer's profitability at the state, versus the federal, level, as is the case with add-back statutes. The non-conformities may also arise from different policy choices, *e.g.*, whether to allow bonus depreciation under Internal Revenue Code ("IRC") § 167(k), thus reducing current tax revenues in the hope of fostering new investment in plants and machinery.

The states are entitled to enact these provisions because they enjoy broad latitude in determining the means by which intra-state income earnings are computed and taxed. *Moorman Manufacturing v. Bair,* 437 U.S. 267 (1978). A decision equating non-conformity to federal deductions with extra-territorial taxation would severely restrict the sovereign right of the State of Alabama to choose its own tax structure within the parameters of the U.S. Constitution.

2. Determining the Size of the Tax Base. The second component of state income taxation is the determination of the size of the tax base. Many large corporate enterprises do business in the form of multiple tiers of commonly-owned corporations. Alabama is among the majority of states which permit the individual members of commonly-owned, unitary enterprises to file "separate entity" returns. Under the "separate entity" reporting system, taxpayers are required to determine their base income following state modifications to federal taxable income standards, using arms-length accounting principles to determine the correct "transfer price" for inter-company transactions.

In that regard, it should be noted that under the IRC, a transfer of assets (e.g., a trade mark representing the value of an entity's goodwill) to another member of the consolidated group in exchange for the stock of such corporation does not trigger recognition of a taxable gain or loss on the transfer. IRC § 351(a). Thus, a taxpayer can move the legal ownership of income-generating assets from entities operating in states which impose an income tax to a related entity nominally located in a state which does not impose an income tax, without having to incur federal or state capital gains tax. When that happens, the stage is set for the company located in the "tax-haven" state to charge a fee for the operating company's use of that asset in the taxing states, reducing the latter's reported net income by the amount of that fee.

3. Dividing the Tax Base Among the States. In the case of taxpayers with operations in multiple jurisdictions, a further adjustment must be made to ensure that each state only taxes income earned within its borders. States have long used "formulary" apportionment systems to determine where a multi-

jurisdictional taxpayer earns its income, because the alternative of using transactional accounting would lead to inevitable disagreement over how much profit or loss should be assigned to a particular business location, e.g., a factory or store in a particular state. *See Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113, 121 (1920)(citing "the impossibility of allocating specifically the profits earned by processes conduced within [a state's] borders."); *Butler Brothers v. McColgan,* 315 U.S. 501 (1942). W. Hellerstein, *State Taxation,* ¶ 8:07[1] (3rd Ed., 1998). Virtually all states pattern their apportionment formulas on the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which divides a taxpayer's "business" income among competing jurisdictions based on the combined average percentages of the taxpayer's property, payroll and sales located within a particular taxing jurisdiction.[6] The UDITPA "three-factor formula", which Alabama follows (§40-27-1, *Code of Ala.* 1975), has been

[6] Income which is completely unrelated to the taxpayer's business, e.g., income from passive investments, is generally allocated to the taxpayer's commercial domicile. Ala. Code 1975, Section 40-27-1 ("Compact").

described by the United States Supreme Court as the "benchmark" for fairly determining how much income is earned in a particular jurisdiction. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983).

The lower court failed to consider the whole of Alabama's taxing system in reaching its conclusion that denial of any federally-allowed deduction would be unreasonable. The decision of the Alabama Legislature to de-conform from federal deduction amounts does not affect the cost of doing business "in Alabama", as the lower court found (C. 638), because taxable income is determined based on the taxpayer's income and expenses generated everywhere, not just in Alabama. The taxpayer's income is only then divided among the states using the formulary apportionment principles of UDITPA. The lower court made no suggestion that the taxpayer's Alabama apportionment percentage did not fairly reflect the amount of business the taxpayer conducted in Alabama. Rather, the lower court appears to have substituted its own judgment of the taxpayer's profit derived from its multi-state activities for that of the legislature.

B. Add-Back Statutes, When Properly Construed, Are An Effective and Necessary Means To Prevent Income Earned in One State From Being "Shifted" to Another For Income Tax Reporting Purposes.

The very common tax minimization technique at issue in this case involves creating a deduction to be claimed on a taxpayer's "separate entity" return filed in Alabama and other states. The deduction is created by transferring the legal ownership of the taxpayer's trademarks and trade names, from the operating company (the taxpayer) to a Delaware holding company in a tax-free exchange pursuant to IRC 351(a). Once the legal ownership of the intangible asset has been transferred, the operating company has a legal justification for paying a royalty in order to continue using the intangible asset in its business. The operating company thus saddles itself with a significant expense, which in turn reduces its reported taxable income. The intangible holding company, having paid nothing for this valuable asset, and with almost no operating expenses of its own, reports phenomenal profits, but is located in a state which does not tax that income, and arguably is not subject to tax anywhere else.

Faced with significant revenue losses from the utilization of these intangible holding companies, state tax administrators have mounted a variety of legal challenges, with mixed success. One strategy employed by the states was to attack these transactions as lacking economic substance and business purpose, justifying the denial of the claimed deduction under the sham transaction doctrine. The problem with that strategy is that taxpayers desiring to shelter hundreds of millions of dollars in income can easily imbue their transactions with some arguable business purpose and economic substance by establishing a small office in Delaware tasked with performing some minor but necessary business functions formerly carried out by the operating company, such as trademark registration. It does not follow, of course, that the hundreds of millions of dollars paid to that holding company could be said to have been "earned" in Delaware in any meaningful economic sense. In addition, corporations might easily document some non-tax "business reasons" for creating the holding companies, putting trial courts in the

difficult position of measuring the sincerity of a memorandum or corporate resolution.[7]

One of the earliest reported intangible holding company cases, *Aaron Rents, Inc. v. Collins,* Fulton County (Georgia) Sup. Ct. No. D-96025 CCH GA-TAXRPTR Para. 200-242 (6/27/94), illustrates the difficulties states have faced when challenging such transactions. There, the state of Georgia attempted to disallow a royalty payment to a wholly-owned Delaware subsidiary

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[7] An example of this practice can be seen in the New Mexico administrative decision *In the Matter of the Protest of Wal-Mart Stores Inc.,* No. 06-07, CCH NM TAXRPTR Para. 401-130 (5/1/06). The factual findings of the hearing officer in that decision include a discussion of a memorandum from the head of Wal-Mart's tax department to Wal-Mart's corporate controller:

"18. In October 1990, Mr. Orr sent a memorandum to Mr. Walker summarizing the concept of a Delaware holding company (also known as a passive investment company, or 'PIC') and some of the benefits it would provide to Wal-Mart. Ex. 2.

19. Mr. Orr explained that a PIC 'is a corporate structure that enables a company to shelter significant amounts of income from state taxes' and that a retailer 'which derives a significant amount of its income from non-unitary states, *can reduce its state income tax liability between 25-40%.*' (emphasis in the original). Ex. 2.

20. Mr. Orr stated that appropriate business reasons would have to be developed for the transaction, although '[a] company does not need ironclad reasons, just plausible ones.' Ex. 2."

for use of the trade name Aaron Rents, on the theory that the subsidiary, Aaron Investments, "was not a corporation which should be recognized for tax purposes." The royalty payments at issue were wired from Aaron Rents to Aaron Investments and wired right back to the same bank account two days later. The district court recited a list of business purposes for the establishment of Aaron Investments which appear to have been drawn from a Board of Director's resolution, noted that the Delaware holding company carried on activities in its own name and maintained a separate office, declared that the tax benefits from the arrangement were "incidental", and then ruled against the state.

More recently, the Supreme Judicial Court of Massachusetts upheld the application of the sham transaction doctrine to deny a deduction for trade mark royalties in one case involving a Delaware holding company, but shortly thereafter denied the application of the sham transaction doctrine in a case which arguably involved similar factual circumstances. *Compare: Syms Corporation v. Commissioner of Revenue*,

765 N.E. 2d 758 (Mass. 2002) and *Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E. 2d 504 (Mass. 2002). Georgia and Massachusetts have since adopted add-back statutes. Mass. Ch. 63, Sec. 31I, J, K (2002); Ga. Code Sec. 48-7-28.3 (2006).

In the late 1990's, many state legislatures began to consider add-back statutes as the most practical way to resolve the central problem presented by Delaware holding companies.[8] Since income earned in the taxing states was being shifted out of those states through the creation of an artificial deduction, the best way to remedy that problem was to simply deny the deduction in the case of intangible holding companies, putting the income back into the apportioned tax base of operating companies. Alabama, Mississippi and North Carolina were

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[8] A second legal approach to the problem has been to assert the state's taxing jurisdiction ("nexus") over the holding companies, even though those companies have no physical presence beyond Delaware's borders. See, e.g., *Geoffrey Inc. v. South Carolina*, 437 S.E. 2d 13 (S.C. 1993), *cert. den.*, 510 U.S. 992 (1994); *Kmart Corporation v. Taxation and Revenue Department, 139 N.M. 172, 131 P.3d 22 (2005); A & F Trademark, Inc. v. Tolson,* 605 *S.E.*2d 187, 193-96 (N.C. App. 2004). The nexus approach raises concerns with properly apportioning the holding companies' income under UDITPA.

among the first states to adopt add-back statutes in 2001.

The add-back statutes are designed to prevent deductions which distort the economic reality of where and how income is earned, even where—*especially where*—the transactions creating those deductions are clothed with enough business purpose and economic substance to make resort to sham transaction theory impractical.

C. The "Unreasonable" Exception to Alabama's Add-Back Statute Should Be Interpreted to Prevent Taxation of Income Earned Outside Alabama's Borders

In 2003, the Alabama Department of Revenue promulgated a regulation which adopted a standard for applying the "unreasonable" language:

> The adjustment required in (1) above will be considered "unreasonable" if: [] the taxpayer establishes that, based on the entirety of the taxpayer's particular facts and circumstances, the adjustments have increased the taxpayer's Alabama income tax liability to an amount that bears no fair relation to the taxpayer's Alabama presence.

Ala. Admin. Code R. 810-3-35-.02(3)(h).

The Commission believes that this regulation, although not in effect in the tax year at issue in this appeal, is an appropriate interpretation of the "unreasonable" exception, as it captures the intent of

the statute to avoid under-reporting or over-reporting of income earned in the state.

Obviously, if the deduction does represent a payment for real economic activity taking place outside of the state, it would be unreasonable not to allow that deduction if its denial would so completely distort Alabama income as to result in extra-territorial taxation. Because Alabama uses the UDITPA three-factor apportionment formula, there is a strong presumption that the formula would fairly apportion income generated within the state. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 192 (1983); *Compare*: *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931)(single-factor formula applied to particular taxpayer produced tax liability "out of all appropriate proportion" to activities in the state.")

Interestingly, the lower court seemed to agree with the regulation's definition of an "unreasonable" adjustment of income as being a situation where the taxpayer's liability would be out of all proportion to its economic presence in the state. (C. 638-639). The

court went astray, however, when it concluded that because the transactions with Lee and Wrangler arguably had some legitimate business purpose, the full $102 million in claimed deductions represented a fair payment for economic activity occurring somewhere else--in Delaware. As the record below indicates, that economic activity largely consisted of a handful of Lee's employees (Wrangler had no employees of its own (C. 636)) contracting with third parties to conduct quality inspections or to bring trademark infringement suits, reviewing trademarks printed on "hang tags" on stores in the Delaware area, and maintaining registration statements in trademark offices. T. 157, Testimony of Helen Winslow.

The means by which Alabama has chosen to measure income generation within the state is through application of the three-factor apportionment formula in UDITPA. The "lynch-pin of apportionability" is the "unitary business principle", *Mobil Oil Corporation Commissioner of Taxes of Vermont,* 445 U.S. 425, 431 (1980). The unitary business principle allows that the portion of income of an integrated multi-state business

enterprise generated within a particular state's geographic borders is fairly measured by averaging the taxpayer's property, payroll and sales in that state compared to its property, payroll and sales everywhere.

Lee had just $188,982 in payroll (all in Delaware) in 2001 and a similar amount ($220,490) of real and tangible property. (C. 25, Exhibit 1 to Taxpayer's Complaint, page 2).[9] Wrangler had no property and no employees. (R. 289; R. 473, VFJ Ex. 47). The two companies nonetheless reported federal taxable income of $73,021,142 and $69,649,967, respectively. (C. 22, 30, Exhibits 1 and 2 to Taxpayer's Complaint). VFJ, meanwhile, had over a billion dollars in property, $377 million in payroll (with over 600 employees in Alabama), and two billion dollars in sales, yet it reported only $82 million in net income after payment of $102 million in royalty expenses to Lee and Wrangler. (R. 764, State's Exhibit 2, page 3, Schedule D-1; form 1120, Line 1C.)

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[9] Under UDITPA, the "property factor" for the apportionment formula excludes the value of intangible property. Ala Code 1975, Sec. 40-27-1 "Compact").

Ala. Admin. Code R. 810-3-35-.02(3)(h) looks to formulary apportionment concepts in determining whether an add-back of intangible expenses would be "unreasonable". The regulation provides that if disallowance of the intangible expense would generate a tax liability out of all proportion to the taxpayer's "Alabama presence", the adjustment called for in the statute would be "unreasonable." Although VFJ's income is determined separately from the income of Lee and Wrangler under Alabama's "separate entity" reporting system, when measuring whether a taxing system has resulted in extra-territorial taxation it is appropriate to apply apportionment principles to the economic unit as a whole, irrespective of corporate or divisional lines. *See, e.g., Bass, Ratcliff & Gretton, Ltd. V. State Tax Commission,* 266 U.S. 271 (1924); *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983); *Exxon Corporation v. Wisconsin,* 447 U.S. 207 (1980). The test is whether the tax system has produced a "grossly distorted amount" of income attributable to Alabama. *Norfolk & Western Railway v. State Tax Commission,* 390 U.S. 317, 329 (1968).

In this case, the "add-back" of the intangible expenses paid to Lee and Wrangler would not result in a gross distortion of Alabama income relative to VFJ's business presence, because almost no economic activity took place in Delaware. Adding Lee and Wrangler's property, payroll and sales in Delaware to VFJ's "everywhere" apportionment factors would barely change VFJ's Alabama apportionment percentage. Allowing a deduction of $102 million based on the activities of a handful of professional and clerical employees in Delaware, on the other hand, would result in a clear under-estimation of how much income VFJ actually earned in Alabama relative to its in-state business presence. *Cf., Microsoft Corporation v. Franchise Tax Board*, 39 Cal. 4th. 750, 47 Cal. Rptr. 3d 216 (Ca. 2006)(adjustment of apportionment formula was warranted where inclusion of gross amount of receipts from short-term treasury investments increased sales factor denominator by 62%, but generated only 1% of taxpayer's income).

The lower court appeared to be untroubled by the idea that a handful of Lee's employees, who were paid just $188,982 while working in a rented Delaware office,

could appear to generate more income than VJF Venture generated with its billion dollars in property, $377 million in payroll and $2 billion in sales activities, much of it in Alabama. The Alabama add-back statute passed in 2001 is a reasoned choice to remedy such distortions of Alabama income.

The application of formulary apportionment principles to determine the true source of VFJ's income is particularly apt in the context of trademarks. A trademark represents the goodwill of a business. "A trademark cannot exist apart from the business in which it is used." A. Gilson, K. Green, *Trademark Law and Practice*, Para. 1.03[7][b] (Lexis/Nexis, 3rd. Ed., 2006). Goodwill has been defined as: "the advantage or benefit acquired by a business beyond the mere value of the capital, stock, funds or property employed therein... ." *Gilmore Ford, Inc. v. Turner,* 599 So.2d 29, 31 (Ala. 1992). The trademarks in this case, although owned by Lee and Wrangler in the narrowest legal sense, are used in the business of VFJ Ventures conducted in Alabama and elsewhere. "Unlike patents or copyrights, trademarks are not separate property rights.

They are integral and inseparable elements of the goodwill of the business or services to which they pertain." *Visa, U.S.A., Inc. v. Birmingham Trust National Bank*, 696 F.2d 1371, 1375 (Fed. Cir. 1982). This is not a case of extra-territorial taxation because the income from trademarks (embodying the goodwill of the enterprise) arises out of the operations of the company as a whole, not the minimal administrative and legal services performed by Lee and Wrangler in Delaware. The marks, therefore, could not be said to have generated income in Delaware in any meaningful sense.

The Alabama legislature, having eschewed transactional accounting in favor of formulary apportionment for purposes of sourcing a taxpayer's income, presumably intended to follow those same principles in determining when it would be "unreasonable" to deny a deduction for intangible expenses. Because the add-back would not result in a distortion of VFJ Ventures' business presence relative to its earnings in this state, the lower court erred in

concluding that add-back would be unreasonable under these circumstances.

IV. Conclusion

The Commission urges this court to reverse the decision of the lower court, and to construe the statute as a whole to accomplish the statute's clear purpose: to ensure that Alabama taxes no more and no less than its fair share of the earnings of interstate taxpayers, while avoiding a return to the morass of litigation and uncertainty so purposely departed in 2001.

Respectfully submitted,

Bruce J. Fort, Esq.
Counsel for *Amicus Curiae*
Multistate Tax Commission
444 North Capitol Street, NW
Suite 425
Washington, D.C. 20001-1538
(202) 624-8699
N.M. Bar Number 960

CERTIFICATE OF SERVICE

I certify that I served a true and correct copy of the foregoing Brief of Amicus Curiae Multistate Tax

Commission upon the following, by placing that copy in the United States mail, properly addressed, postage prepaid, on August 6, 2007:

Joe Mays, Bruce Ely, and Chris Grissom
Bradley, Arant, Rose & White LLP
One Federal Place
1819 Fifth Avenue North
Birmingham, Alabama

Jeff Patterson, Esq.
Park Place Center, Suite 204
8650 Minnie Brown Road
Montgomery, Alabama 36117

Bruce J. Fort, Esq.