No. 1070718

IN THE SUPREME COURT OF ALABAMA

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

Petitioner,

v.

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

Respondents.

BRIEF OF THE *AMICUS CURIAE* MULTISTATE TAX COMMISSION IN SUPPORT OF RESPONDENTS

On a Writ of Certiorari to the Alabama Court of Civil Appeals, Cause No. 2060478.

From the Circuit Court of Montgomery County, Alabama, Case No. CV-03-3172.

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

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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 G. Thomas Surtees and the State of Alabama Department of Revenue. The Commission submits this brief to express the interests its member states share in sustaining the Alabama legislature's clearly expressed intent to close a loophole in its corporate income tax structure, a loophole which had encouraged taxpayers to create thousands of so-called intangible holding companies as a method to avoid payment of tax obligations.

In recent years, Alabama has joined nineteen other states and the District of Columbia in enacting what are referred to as "add-back" statutes in an effort to close that loophole.[1] §40-18-35(b), Alabama Code 1975. Those

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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 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;

statutes generally require an "add-back" of claimed expense deductions for royalty and interest payments made to affiliated holding companies nominally located in tax-haven countries or states which do not impose corporate income taxes. By transferring legal ownership of their intangible property assets to these affiliated holding companies, taxpayers can establish an accounting basis for paying a royalty to the affiliates for the use of those assets. Taxpayers can then deduct those payments on their state income tax returns, secure in the knowledge that the states would have difficulty asserting jurisdiction ("nexus") to tax the income of the out-of-state affiliates, even if the payments were discovered. The leading treatise on state taxation describes this maneuver as "a blatant attempt to 'game'

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.

the system." W. Hellerstein, *State Taxation*, ¶20[3][j] (3rd. Ed., 2007 Westlaw). As the facts of this case so amply demonstrate, the tax losses to the states from this technique can be enormous.[2]

Once the extent of the intangible holding company practice became widely understood, many state legislatures, including Alabama's, acted to stop this deliberate distortion of tax liability by denying royalty expense deductions in these circumstances.[3]

Petitioner VFJ Ventures, Inc. (hereinafter, "the Taxpayer") challenges both the application of the statute to its facts and the statute's constitutionality. The Commission respectfully suggests that Alabama's statute was intended to and does apply to the exact circumstances presented in this case, and further, that the add-back statute in its operation and effect does not impose an unconstitutional burden on interstate commerce.

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[2] The Taxpayer estimated this practice reduced its state tax burden by some $5.7 million in 2000 and $6.1 million in 2001. (R 764-State Ex. 12; R 133-134).

[3] Another twenty states use "combined reporting", similar to the federal system of consolidated filing, where the income and losses of all interrelated companies are combined on a single schedule, eliminating any tax benefit from income-shifting between entities.

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.[4] Acts 1967, No. 395, p. 982, Sec. 1. The substantive provisions of Article IV of the Compact have been incorporated in Alabama Code 1975, §40-27-1, Alabama Code 1975.

UDITPA's system of formulary apportionment plays a central role in this case, because application of that formula to these facts demonstrates that Alabama's add-

[4] 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.

back statute results in a tax liability which is entirely commensurate with the amount of income generated by the Taxpayer within Alabama.

Acting through the Commission, member states develop model uniform laws and regulations pertaining to common issues in state taxation where uniformity will benefit the states and the taxpaying community.[5] 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 the challenged features of Alabama's add-back statute are also found in the statutes of numerous other states, the Commission urges this Court to give full effect to the intent of the Alabama legislature to put a stop to the accounting and legal gamesmanship so clearly demonstrated by the record of this case.

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[5] 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

II. SUMMARY OF ARGUMENT

Add-back statutes operate to correct the imbalance created when operating companies transfer their intangible property rights, often in the form of trademarks and trade names, to related entities, and then pay those entities for the use of that property while continuing to shoulder the great majority of the expenses associated with creating and maintaining the property's value, such as advertising and product development costs.

A transaction which serves to isolate income in a holding company, while maintaining the associated expenses in the operating company, will understate the operating company's true profitability, regardless of whether the transaction may also have had some non-tax purposes.

The Court of Civil Appeals appropriately interpreted the add-back statute in a manner that effectuated the legislative intent of avoiding distortions of income. The statute includes two exceptions to the requirement to add back expenses paid to affiliated entities. The first exception is that add-back is not required where failure to allow the expense deduction would be “unreasonable.” The Court of Civil Appeals properly gave deference to the State Department of Revenue’s administrative expertise in holding that that this exception should be invoked only where the disallowance of an expense deduction would result in a tax liability out of all proportion to the amount of income the taxpayer generated in Alabama. The Commission believes this interpretation of the exception properly reflects constitutional limitations on state taxing authority in accord with the intent and purpose of add-back statutes to fairly reflect the amount of income generated in the state.

The Court of Civil Appeals also correctly held that a second exception—that royalty expenses could be deducted to the extent those payments were “subject to tax” in hands of the recipient--should be interpreted to apply only to the extent the income was actually taxed by other states, and not simply included on a return in order to be apportioned. The intent of the “subject to tax” exception is to avoid “multiple” taxation of the same income; the intent was not to eviscerate the add-back statute by allowing taxpayers to avoid the add-back by merely listing income on a tax return in a state that had no ability to tax that income.

As the Court of Civil Appeals correctly found, the add-back statute does not impose any impediments to interstate commerce; no taxation of extra-territorial taxation arises because only the income earned in Alabama is subject to tax here, and no discrimination arises because the statute does not favor in-state economic interests over out-of-state interests. These are the recognized standards for determining whether a statutory tax system passes muster under the Commerce Clause of the U.S. Constitution, Art. 1, Sec. 8.

III. ARGUMENT

A. ALABAMA'S ADD-BACK STATUTE SHOULD BE CONSTRUED TO EFFECTUATE ITS PURPOSE OF ENSURING THAT INCOME GENERATED IN THE STATE DOES NOT ESCAPE TAXATION.

3. The Court of Civil Appeals Correctly Interpreted the Statute's "Unreasonable" Exception to Avoid Taxation of Extra-Territorial Income.

The crux of the dispute in this case is the proper analysis of where and how the Taxpayer and its affiliated intangible holding companies generate income. The state legislatures which adopted "add-back" statutes beginning in the late 1990's determined that a deduction for royalty payments to related entities for the use of intangible property presumptively distorts the true measure of in-state income.

Alabama is one of six states which have provided an exception to the add-back requirement where: "… the corporation establishes that the adjustments are unreasonable." §40-18-35(b)(2).[6]

The Court of Civil Appeals appropriately interpreted the "unreasonable" exception of §40-18-35(b)(2) in a manner that furthered the legislative intent of avoiding distortions of income attribution, by limiting the exception to situations where adding back intangible expense deductions would have the effect of grossly distorting the amount of income subject to tax in the state. *Surtees and Alabama Department of Revenue v. VFJ Ventures, Inc.,* No, 206047 (2/8/08), _So. 2d __ (Ala. Civ. App. 2008)("*Slip Op*.").

The Taxpayer suggests a very different purpose for the "unreasonable" exception to the add-back statute, a

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[6] Those six states are Connecticut, Illinois, Indiana, Massachusetts, New Jersey and Ohio. The "unreasonable" exception in each state's statutes varies from Alabama's in certain respects.

purpose entirely divorced from these underlying economic considerations. The Taxpayer argues that Alabama’s legislature intended the statute only as a means to prevent “sham” transaction lacking both economic substance and legitimate non-tax business purposes. The Circuit Court for Montgomery County agreed with the Taxpayer’s analysis. (C. 634-640.) The circuit court found that the taxpayer had established valid non-tax business purposes for the segregation of its trademarks and trade names in two intangible holding companies located in Delaware, Lee and Wrangler. (R. 473-VFJ Ex.’s 15, 16 & 20.) The circuit court further held that these entities performed “valuable services” for the Taxpayer, including monitoring the use of trademarks and maintaining registrations. (*Id.*) The circuit court concluded that requiring the Taxpayer to add back over $102 million in annual royalties paid to those holding companies in Delaware would be “unreasonable”, because it would deny the Taxpayer the ability to deduct expenses for its “costs of doing business in Alabama” (C. 638). Adding back the royalty payments would thus have the tax income earned outside the state. (Id.)

The circuit court's conclusion that denial of a "legitimate" deduction for royalty payments to an out-of-state affiliate caused an "unreasonable" over-taxation of Alabama earnings ignored the economic realities in this case. Although the transfer of ownership of assets to a Delaware holding company may establish an accounting basis for payments, it does not follow that the source of the income reported by that holding company are its activities in Delaware.

At the beginning of the audit year, the Lee holding company had only four full-time employees, and no trademark lawyer. (By the end of the audit year, Lee had added a handful of additional employees and hired its first trademark lawyer.) (R 237; R. 473-VFJ Ex. 47.) Lee reported just $188,982 in payroll expenses for the entire year and just $220,490 as the entire value of its real and tangible property. (C. 25, Exhibit 1 to Taxpayer's Complaint, page 2.) Wrangler had no property and no employees. (R. 289; R. 473, VFJ Ex. 47.) Yet, the two companies were able to report federal taxable income of $73,021,142 and $69,649,967, respectively. (C. 22, 30, Exhibits 1 and 2 to Taxpayer's Complaint.)

By contrast, the Taxpayer’s return filed in Alabama showed it had over a billion dollars in property (of which $163 million was located in Alabama), $377 million in payroll (with over 600 employees in Alabama), and $2 billion dollars in sales. (R. 764, State’s Ex. 2, page 3, Schedule D-1; form 1120, Line 1C). Yet, after payment of $102 million in royalty expenses to Lee and Wrangler, it reported only $82 million in net income. (*Id.*)

The distortions of earnings and resulting tax losses from these massive royalty payments to Delaware-based intangible holding companies is what prompted the legislatures of twenty states to put a stop to the practice.

a. The Origins of Add-Back Statutes Indicate the States’ Intent Was to Tax Income Where it is Generated.

The jurisprudential history of state responses to the creation of intangible holding companies as a tax planning technique provides strong support for the proposition that add-back statutes were intended to prevent tax losses resulting from income being shifted away states in which it was generated. The construction of the statute should be informed by that over-riding legislative purpose.

The determination of how much of a multi-jurisdictional taxpayer's income is generated in the state, and thus properly subject to taxation is a product of two factors: (1) determination of what an entity's total "taxable" income should be, and (2) correctly sourcing that income among taxing jurisdictions, either through formulary apportionment or "arms-length" accounting. The tax maneuver at the center of this controversy is possible because states rely on federal taxable income standards as their starting point for determining state "base" income. Many aspects of the Internal Revenue Code, however, are premised on the national government's ability to tax income earned anywhere in the country. The Code accordingly imposes few impediments on transfers of property between related domestic entities. See, e.g., IRC §351(a) (allowing tax-free transfer of property in exchange for stock). If, as a result of such a transfer, one entity's net income decreases while the other's increases, there will be no effect on federal revenue collections. State taxing jurisdiction is much more limited, however. If intangible property rights are transferred to an entity doing business in the state, requiring the taxpayer to pay rents or royalties to continue using the property in its business, the taxpayer's net income will decrease but the state may lack the ability to impose tax on the holder of the intangible property being used in the state. If the transferee is located in Delaware or a similar state which does not impose income taxes, reliance on the federal tax code, coupled with constitutional restrictions on state taxing authority, results in a continuing tax loss.

The extent of the problem created by transfers of intangible property to holding companies and its consequences to state treasuries has now been well-documented in both the general and tax press. See, e.g., R. Glenn Simpson, *Diminishing Returns: A Tax Maneuver Puts The Squeeze on States*, Wall Street Journal, 9/1/02, p. A1; M. Fatale, *State Tax Jurisdiction and the Mythical Physical Presence Standard,* 54 Tax Lawyer 105, 134-138; 30 (2000); Report of Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenues* (7/15/03)(estimating loss of $4.8 billion in state revenue for 2001 from domestic tax shelters, principally intangible holding companies), available at www.mtc.gov., under studies and reports.

Beginning with the case of *Geoffrey, Inc. v. South Carolina*, 437 S.E. 2d 13 (S.C. 1993), the states fought a series of battles to establish nexus over intangible holding companies despite their lack of a physical presence within the taxing states. Some 14 years later, the right of states to directly tax such holding companies licensing trademarks to affiliates within the state appears to be firmly established. See *Lanco v. New Jersey*, 908 A. 2d 176 (2007); *A&F Trademark, Inc. v. Tolson*, 605 S.E. 2d 187 (N.C. App. 2004); *Kmart Corp. v. Taxation and Revenue Dept.,* 131 P. 3d 22 (N.M. 2005).

State attempts to combat the use of intangible holding companies through the use of the sham transaction doctrine have been far less successful, since taxpayers quickly learned to document business purposes for the creation of the holding companies. See, e.g., *Aaron Rents, Inc. v. Collins,* Fulton County

(Georgia), Superior Court No. D-96025 CCH GA-TAXRPTR, ¶ 200-242 (6/27/94)(citing findings of Board of Directors to establish business purpose for creation of holding company); *In the Matter of the Protest of Wal-Mart Stores, Inc.,* No. 06-07, CCH NM-TAXRPTR ¶ 401-130 (5/1/06)(describing planning document identifying need to establish "plausible" business purposes); *Sherwin-Williams Co. v. Commissioner of Revenue,* 778 N.E. 2d 504 (Mass. 2002)(finding state did not prove payments to holding company constituted sham transactions); *but see*, *Sherwin-Williams Co. v. Tax Appeals Tribunal*, 784 N.E. 2d 178 (App. Div., New York 2004)(finding transactions lacked economic substance and non-tax business purpose).

Add-back statutes like §40-18-35(b) correct for those weaknesses by keeping income in the operating company's tax base so that it may be properly apportioned to the states in which it is generated. The Court of Civil Appeals correctly construed Alabama's add-back statute, and its exceptions, in accord with that paramount goal of ensuring that income is taxed where it is earned.

The Taxpayer's interpretation of the add-back statute's "unreasonable" exception would return the states to the position of having to litigate the legitimacy of these transactions on a case-by-case basis, with no guarantee of achieving consistent results. Moreover, whether or not a holding company has a non-tax business purpose is not the issue. The transfer of the legal ownership of business assets to intangible holding companies serves to understate the operating company's income in the state, regardless of whether the holding company has a business purpose.

B. States Have the Ability to Fairly Tax Income Generated Within Their Borders, And Can Chose to De-Conform From Federal Income Standards to Further that Goal.

The recurring theme of the taxpayer's case is that federal taxable income standards represent the "true" measure of income, and any legislative variance from that standard with respect to "out-of-state" expense constitutes taxation of extra-territorial income. Brief-in-Chief, pp. 20, 34-46. This syllogism led the circuit court below to hold that denial of any deduction which could have been claimed federally "would distort the amount of VFJ's income fairly attributable to this state” (C. 634). The circuit court thus concluded it would be “unreasonable” to deny any deduction available under federal law if the taxpayer could meet a minimal burden of showing that the expenses had economic substance and business purpose. Not surprisingly, the taxpayer continues to marshal facts it believes would prove that its holding companies were established for legitimate business purposes. (Brief-in-Chief, pp. 8-17.) As imaginative and exhaustive as that litany of post-hoc justifications might be[7], the recitation does nothing to establish that Alabama has taxed more than its fair share of the Taxpayer’s income for the 2001 tax year.

The disallowance of federal deduction amounts for “out-of-state” expenses does not constitute extra-territorial taxation, contrary to what the circuit court explicitly held. (C 634). Legislatures invariably make adjustments to federal income standards when

[7] The record reflects a surprising absence of contemporaneous documents justifying non-tax purposes for isolating the Taxpayer’s trademarks in Delaware. In addition, it bears noting that virtually all of the alleged benefits of centralized management of these trademarks in Delaware could have been accomplished without segregating legal ownership in Lee and Wrangler.

establishing state tax policy. *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, and taxation of state and local bonds. *Id.* Like its sister states, Alabama has chosen to "de-conform" from 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 loss deductions. Ala. Code Sec. 40-18-35(a). The states are entitled to de-conform from federal standards because the federal tax code itself represents a series of policy choices, such as accelerated depreciation allowances to encourage purchases of new equipment. See IRC §§167-168.

The glaring error in the circuit court's reasoning was the assumption that these "ordinary and necessary" royalty expenses must be attributable entirely to activities occurring in Delaware, such that the denial of a deduction for those expenses would overstate Alabama income. The expenses for maintaining the Taxpayer’s goodwill arose everywhere the Taxpayer did business. When a state disallows such an expense deduction, therefore, it does not increase its own share of a taxpayer’s net income at the expense of other states’ share of that income.

The means by which Alabama has chosen to measure the amount of net income properly attributable to the state is through application of the formulary apportionment system of Uniform Division of Income for Tax Purposes Act (UDITPA), Ala. Code § 40-27-1 (1975).

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 income (and losses) arising from activities and assets used in an integrated multi-state business enterprise cannot be segregated and assigned to a particular geographic location or state. Instead, income (and losses) from the entire “unitary” business are apportioned according to a formula based on the percentages of property, payroll and sales within each state. In *Amerada Hess v. Director, Division of Taxation,* 490 U.S. 66 (1989), the U.S. Supreme Court made clear that unitary expenses, just like unitary income, do not arise from a single location but are incurred everywhere the unitary business operates. The taxpayers in that case contended that New Jersey had taxed extra-territorial income by denying them a deduction for windfall taxes paid on oil production in other states. The Court wrote:

> [J]ust as each appellant's oil-producing revenue—as part of a unitary business—is not confined to a single state, [citations omitted], so too the costs of producing this revenue are unitary in nature.

490 U.S. at 67.

Add-back statutes do not give rise to extra-territorial taxation even though the expenses are paid to an out-of-state entity. The expenses of maintaining goodwill arise from the activities of the unitary business as a whole.

a. <u>Income from Trademarks is Generated Where the Marks are Used, Not Merely Where they are Owned.</u>

Every facet of the taxpayer's case is premised on the assumption that Alabama's add-back statute directly or indirectly taxes earnings derived from economic activity which takes place in Delaware. The assumption is not in accord with economic principles or taxing norms. The activities of the holding companies in Delaware were meager by any almost any measure. The real source of Lee and Wrangler's ability to charge the taxpayer $102 million in royalties was not the professional services performed in Delaware (which should reasonably be valued at less than $200,000, Lee's salary expenses) but rather the legal ownership of $5 billion in intangible properties. The properties in question were VFJ's trademarks and trade names, representing its on-going goodwill value. 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, were 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). "A trademark cannot exist apart from the business in which it is used." A. Gilson, K. Green, *Trademark Law and Practice*, ¶1.03[7][b] (Lexis/Nexis, 3rd. ed., 2006).

The activities of the holding companies were quite clearly *de minimis.* The source of the income they reported was the intangible property. That property had a taxable "business *situs"* in the states where it was employed. The idea that the value of intangible property should be confined to a taxpayer's commercial domicile was rejected by the U.S. Supreme Court over a hundred years ago. *Adams Express Co. v. Ohio,* 165 U.S. 194, 223-224 (1897). So too, in *Whitney v. Graves*, 299 U.S. 366 (1937), the Court held that New York could impose an income tax on an out-of-state resident on the capital gain received from the sale of a membership on the New York stock exchange. The Court wrote in that case:

> When we speak of a 'business situs' of intangible property in the taxing State we are

> indulging in a metaphor. We express the idea of localization by virtue of the attributes of the intangible right in relation to the conduct of affairs at a particular place.

299 U.S. at 372. See also, *Wheeling Steel Corporation v. Fox,* 298 U.S. 193 (1936)(intangible property acquires a taxable business situs where employed); *Curry v. McCanless*, 307 U.S. 357, 367 (1939)(same); Accord, *A&F v. Tolson,* 605 S.E.2d 187 (N.C. App. 2004)*; Kmart Properties, Inc. v. Taxation and Revenue Dep't.,* 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed, rev'd in part,* 131 P.3d 22 (N.M. 2005).

Further, the Internal Revenue Code adopts the same view of where goodwill earnings should be sourced for purposes of international taxation, where the proper sourcing of income between competing jurisdictions is critical. Under IRC §865(d)(3), payments for goodwill shall be treated as from sources in the country in which such goodwill was generated. Likewise, under IRC §862, royalties for the use of trademarks are sourced to the country where the marks are used, not to where they are owned or controlled.

Alabama and nineteen of her sister states have chosen to de-conform from federal taxable income standards for a category of transactions where economic theory and tax policy norms would indicate that income earned in the state would otherwise be shifted to another jurisdiction. It is an imminently rational decision that is well within the scope of legislative prerogative.

The “unreasonable” exception to the add-back requirement must be applied to further Alabama’s determination to source income from intangible property to where it is employed in the licensee’s business. Interpreting the exception to apply in all situations except where the taxing agency can demonstrate a lack of economic substance and business purpose would eviscerate the statute.

4. The Court of Civil Appeals Correctly Interpreted the “Subject to Tax” Exception to Allow a Deduction Only to the Extent the Income of its Holding Companies Was Actually Taxed in Other Jurisdictions.

The Court of Civil Appeals properly rejected the Taxpayer’s contention that the language of the “subject to tax” exception to the add-back requirement should be interpreted to allow the taxpayer to deduct 100% of its royalty expenses even though the holding companies receiving that income paid tax on only 2.8% and 3.9% of their net incomes to a single state. *Slip Op*. at 50. The relevant portions of §40-18-35(b)(1)read:

> (1) For purposes of computing its taxable income, a corporation shall add back otherwise deductible … intangible expenses and costs directly or indirectly paid … to … one or more related members, except to the extent the corporation shows, upon request by the commissioner, that the corresponding item of income was in the same taxable year: a. subject to a tax based on or measured by the related member's net income in Alabama or any other state …. For purposes of this section, "subject to a tax based on or measured by the related member's net income" means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return which includes the payor.

The Taxpayer maintains that because North Carolina requires multistate taxpayers to report their entire domestic net income prior to apportionment among the states in which taxpayers operate, the full amount of its full pre-apportioned income was “subject to” tax in that state as the phrase is defined in the statute. Brief-in-Chief, pp. 47-60. Unquestionably, under this reading of the statute, if even a single dollar of tax was paid to a single state on the $102 million in royalty income received by its intangible holding companies, the Taxpayer would be entitled to deduct all $102 million in determining its own income tax liability. The add-back statute would be rendered a nullity, useless even in preventing deductions based on sham transactions, if the income recipient paid any tax anywhere, no matter how *de minimis*. The Taxpayer never suggests the legislature intended such a result, but maintains that because the phrase “included in net income” is a term of art in the tax world for “income before apportionment”, its reading of the statute is the only possible one and this Court is bound to uphold it. Brief-in-Chief, pp. 58-60.

The Court of Civil Appeals disagreed, properly applying the cardinal rule of statutory construction, which is to discover and give effect to the intent of the legislature in enacting a statute. *IMED Corp. v. Systems Engineering Assoc. Corp.*, 602 So. 2d 344 (Ala. 1992).

The Court of Civil Appeals wrote:

> An interpretation of the subject-to-tax exception that, in most cases, would result in a taxpayer's ability to avoid the application of the add-back statute would be "unreasonable, and, consequently, [it cannot] be considered to be the intent of the legislature." *John Deere*

> *Co. v. Gamble*, 523 So. 2d at 100. Such an interpretation would also serve to place Alabama back in the position it was in before the enactment of the add-back statute. "The legislature surely did not intend such a nonsensical result." *Ex parte State Dep't of Revenue,* 441 So. 2d at 604. We will presume that the legislature "'intended a rational result.'" *Ex parte Berryhill,* 801 So. 2d at 10 (quoting *John Deere Co. v. Gamble,* 523 So. 2d at 100).

Slip Op. at 60.

In addition to relying on the doctrine that statutes should be construed to effectuate legislative intent, the Court of Civil Appeals noted that the Alabama Department of Revenue’s long-standing administrative interpretation of the statute as applied to post-apportioned income was entitled to deference.

The Commission believes that the phrase “subject to tax” should be interpreted in accordance with constitutional limitations on a state’s power to tax income. North Carolina presumptively did not have the authority to tax more than 3% and 4% of the intangible holding companies’ incomes. Lee and Wrangler was not “subject to tax” on income earned outside that state.

As the Court of Civil Appeals found, it is equally plausible that the phrase “included in income for purposes of a tax on net income" was *not* intended as a term of art signifying pre-apportioned income, but was intended refer to income actually taxed, effectuating the legislative purpose of minimizing double-taxation. Slip Op. at 58-60.

In a recent article published in State Tax Notes, *Further Thoughts on the 'Subject to Tax' Exception in State Corporate Income Tax Expense Disallowance Statutes,* respected tax scholars Walter Hellerstein and John Swain write that:

> [I]t would be absurd to construe the exception to [Alabama's] addback statute to allow a taxpayer to avoid the addback merely because a related party reported income that was apportionable, *but not constitutionally taxable,* in other states.

2008 State Tax Notes 597, 598 (May 15, 2008) (emphasis in original).

C. ALABAMA'S ADD-BACK STATUTE DOES NOT IMPERMISSIBLY BURDEN INTERSTATE COMMERCE AS IT DOES NOT TAX EXTRA-TERRITORIAL VALUES, AND DOES NOT DISCRIMINATE FACIALLY OR IN EFFECT.

1. The Taxpayer has Failed to Demonstrate that the Denial of a Deduction for Intangible Expenses Results in a Tax Liability Disproportionate to its Earnings in Alabama.

In the seminal case of *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977), the Supreme Court identified four factors to consider in evaluating whether a state tax on transactions in interstate commerce interstate is permissible under the Commerce Clause: (1) the activity being taxed has a substantial nexus with the state; (2) the tax is fairly apportioned; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to services provided by the state. The Court of Civil Appeals applied those factors in determining that the operation of the add-back statute did not operate to impermissibly burden interstate commerce when applied to the facts of this case. Slip Op., pp. 64-74.

The Taxpayer challenges that portion of the Court of Civil Appeals' decision which concluded that the tax was fairly apportioned. Brief-in-Chief, pp. 25-28. The court noted that the taxpayer had the burden of demonstrating "by clear and convincing evidence" that the income attributed to Alabama by operation of the add-back statute was "out of all appropriate proportion to the business transacted in Alabama" or had led to a "grossly distorted result." *Slip Op*. at. 73, quoting, *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 267, 274 (1983). The court concluded that the Taxpayer had made no attempt to meet the significant burden imposed upon it. *Id.*

Determining where income arises has been likened by the Supreme Court to “slicing a shadow.” *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159, 192 (1983). The states accordingly enjoy broad latitude in determining the means by which the in-state amount of a taxpayer’s earnings are computed and taxed. *Moorman Manufacturing v. Bair,* 437 U.S. 267 (1978).

In fact, the U.S. Supreme Court has invalidated the application of a state tax only once on the basis of a lack of “fair apportionment” or “external consistency”, in the case of *Hans Rees’ Sons, Inc. v. North Carolina,* 238 U.S. 123 (1931). The apportionment formula invalidated in that case employed a single factor (property), and the taxpayer was able to demonstrate that the formula distorted its tax liability by some 200% over what it would have owed using arms-length accounting principles. By contrast, Alabama employs an evenly-weighted three factor formula, which the Supreme Court has held to be the “benchmark” by which other formulas should be judged for fairness. *Container Corp.,* 463 U.S. at 170.

Undeterred, the Taxpayer challenges the Court of Civil Appeals' conclusion by asserting that the court misapprehended the focus of the fair apportionment prong—the prevention of extra-territorial taxation. Brief-in-Chief, p. 31. According to the Taxpayer, the statute is unconstitutional because it is not "directed at determining the amount of income fairly attributable to Alabama…because the statute determines the amount of tax based solely on the tax laws of the state where the IMCO is located." *Id*. at 31-32.

No authority is cited by the Taxpayer for the proposition that allowing an offset for taxes paid in other states results in extra-territorial taxation. A state can reasonably choose not to tax all of the income to which it might lay claim in order to avoid the potential for double-taxation. Alabama, like many states, allows a personal income tax credit for taxes paid on income which is also subject to Alabama tax. Ala. Code §40-18-21. The fact that Alabama chooses not to tax some income does not answer the question of whether the income that is taxed is fairly attributable to activity within the state.

The Taxpayer also suggests that the effect of the add-back statute is to indirectly tax its intangibles holding companies, and so the factors of the holding companies should be used to apportion that income, and not the Taxpayer's factors. Brief-in-Chief, pp. 33-34.

It is true that the state could have chosen to tax the holding companies directly under the current understanding of "nexus" to tax. See, e.g., *Lanco v. New Jersey*, 908 A. 2d 176 (N.J. 2007); See also, W. Hellerstein, *State Taxation*, ¶ 6.11[3], and cases listed therein. Had the State decided to take that route, however, Ala. Code §40-27-1, Art. IV, Section 18 proves ample authority to modify the apportionment formula to better reflect where the holding companies actually earned their income. In such an eventuality, income from the intangible holding companies would likely have been sourced in accordance with VFJ's factors. See, e.g., *Comptroller of Treasury v. SYL, Inc.,* 825 A. 2d 399, 415 (Md. 2003) (income of intangible holding company apportioned using factors of licensee); *Kmart*

Properties v. New Mexico, supra (UDITPA’s §18 equitable adjustment authority invoked to apportion income using licensee’s apportionment factors).

2. Application of the Add-Back Statute to the Taxpayer Did Not Result in Taxation of Extra-Territorial Values.

The Court of Civil Appeals correctly rejected the claim that denial of an expense deduction for royalty payments violated the test for external consistency announced in *Oklahoma Tax Commission v. Jefferson Lines,* 514 U.S. 175, 179 (1995).

Although the Taxpayer failed to offer any evidence to support its claim, application of unitary business principles embodied in UDITPA’s formulary apportionment system clearly demonstrates that the resulting tax is within constitutionally-accepted parameters. See, Ala. Code § 40-27-1, Article IV, Section 10.

The Taxpayer’s return shows it had over a billion dollars in property, $377 million in payroll (with over 600 employees in Alabama), and $2 billion dollars in sales, yet, after payment of $102 million in royalty expenses to Lee and Wrangler, it reported only $82 million in net income. (R. 764, State’s Exhibit 2, page 3, Schedule D-1; form 1120, Line 1C.)

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). Wrangler had no property and no employees. (R. 289; R. 473, VFJ Ex. 47.) The two companies reported federal taxable income of $73,021,142 and $69,649,967, respectively. (C. 22, 30, Exhibits 1 and 2 to Taxpayer’s Complaint.)

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).

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 the Taxpayer’s business presence in the state, 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 employees in Delaware, on the other hand, would result in a clear under-estimation of how much income the Taxpayer actually earned in Alabama relative to its in-state business presence. In a recent decision by the California Supreme Court, the question of income distortion was answered by using a similar comparison between income and the factors used to generate that income. *Microsoft Corporation v. Franchise Tax Board*, 47 Cal. Rptr. 3d 216 (Ca. 2006). The issue in the case was whether inclusion of the gross sales amounts from “overnight” sales of securities held as short-term working capital served to under-represent the economic contributions resulting from the sale of the taxpayer’s software products. The court noted that inclusion of the gross amount of securities transactions increased the sales factor by some 62%, yet that treasury function generated only 1% of the taxpayer’s income. The California court determined that the apportionment formula should be adjusted to reflect the true profitability of sales of software in California and other “market” states versus the profitability of the overnight sales of securities held as working capital.

A similar distortion would occur here if Alabama *did not* deny the deduction for $102 million in intangible expenses. Lee & Wrangler earned a total of $142,671,109, some $60 million more than the Taxpayer’s net income, yet had just 1/20th of one percent of the Taxpayer’s payroll expenses and 1/50th of one percent of the Taxpayer’s property expenses. There should be little doubt as to why the Taxpayer did not attempt to present evidence to support its claim that denial of the intangible expense deduction distorted the amount of income it earned in Alabama.

By any reasonable measurement, the denial of a deduction for royalty expenses did not result in an overstatement of the amount of income the Taxpayer earned in Alabama.

3. The Statute Does Not Facially Discriminate Against Interstate Commerce Because it Allows an Offset For Taxes Paid in any State.

In Alabama as elsewhere, legislative enactments carry a strong presumption of constitutionality, and courts must sustain an act unless it is clear beyond a reasonable doubt that it is unconstitutional. *Moore v. Mobile Infirmary Association*, 592 So. 2d 156, 159 (Ala. 1991); *Kirby v. State*, 899 So. 2d 968, 972-73 (Ala. 2004). The Taxpayer's novel arguments in this case concerning the application of the "dormant" Commerce Clause to §40-18-35(b) (2) are insufficient to overcome that presumption. The taxpayer claims that the statute facially discriminates because the "subject to tax" allowance "favors IMCO's located in selected states and penalizes those located in other states." Brief-in-Chief, p. 26. The basis of the favoritism argument is difficult to fathom. As the Court of Civil Appeals noted, the "subject to tax" provisions are the epitome of a facially neutral provision because the offset is allowed for taxes paid "in Alabama <u>or any other state</u>." Slip Op. at 76. (Emphasis in original). The taxpayer explains, however, that if a Alabama taxpayer locates a holding company in Nevada, it must add back its royalty payments, but if the taxpayer located its holding company in Alabama, it would not. Brief-in-Chief, p. 27. Of course, in such a situation, the holding company located in Alabama would itself be subject to tax. The net tax burden on the income generated from licensing the intangible property would be the same.

To take the most basic example, if a taxpayer with 100% of its apportionment factors in Alabama paid $100 to a related intangible holding company in Alabama for the right to use a trademark, the taxpayer would claim an expense deduction of $100 by virtue of the allowance for payments which are taxed in the hands of the recipient, and its tax liability would decrease by $6.50. See, Ala. Code §40-18-31(a). The intangible holding company, meanwhile, would have a tax liability of $6.50. If the intangible holding company were located in Delaware, however, and paid no state taxes, the Alabama taxpayer's liability would increase as a function of the add-back statute by $6.50, while the intangible holding company's liability would decrease by $6.50 compared to what it would have owed had it been located in Alabama. The total tax burden on the transaction in question-—the income generated from licensing the use of trademarks--would remain the same irrespective of whether the transaction was carried out across interstate borders. An Alabama taxpayer contemplating a licensing agreement with a related entity would have no incentive under Alabama law to locate that entity in Alabama versus any other state. Accordingly, there is no impermissible discrimination against interstate commerce.

The relevant inquiry is whether the *transaction or incident* is subject to equal tax burdens when it occurs within the state or in interstate commerce, and not whether the tax is borne by one party to the transaction or another. *Armco v. Hardesty,* 467 U.S. 638, 642 (1984); *Chemical Waste Management v. Hunt*, 504 U.S. 334 (1992). In *Henneford v. Silas Mason Co.,* 300 U.S. 577 (1937), the Court held that Washington's sales tax offset for sales or compensating tax paid in any state did not impose an impermissible burden on interstate commerce, even though the incidence of the tax was imposed on different parties depending on the location of the transaction:

> When the account is made up, the stranger from afar is subject to no greater burdens as a consequence of ownership than the dweller within the gates. The one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed.

300 U.S. at 584.

The Supreme Court revisited the issue more recently in *Associated Industries, Inc. of Missouri v. Lohman,* 511 U.S. 641 (1995), where the Court held that Missouri's compensating tax discriminated against interstate commerce but to the extent the tax imposed a higher overall burden on interstate transactions that the sales tax applicable to in-state transactions. The Court wrote:

> We have never deemed a hypothetical possibility of favoritism to constitute discrimination that transgresses constitutional commands. On the contrary, we repeatedly have focused our Commerce Clause analysis on whether a challenged scheme is discriminatory in "effect," see, e. *g.,* Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 270 (1984), and we have

> emphasized that "equality for the purposes of ... the flow of commerce is measured in dollars and cents, not legal abstractions." Halliburton, 373 U. S., at 70. See also Gregg Dyeing Co. v. Query, 286 U.S. 472, 481 (1932) ("Discrimination, like interstate commerce itself, is a practical conception. We must deal in this matter, as in others, with substantial distinctions and real injuries").

511 U.S. at 654.

All of the cases cited by the Taxpayer to support its facial discrimination argument involve statutes which treat in-state economic interests preferentially to out-of-state economic interests, which is the *sin qua non* for a finding of facial discrimination under the dormant Commerce Clause. See *Oregon Waste Systems, Inc. v. Department of Environmental Quality,* 511 U.S. 93, 99 (1994); *AT&T Corp. v. Surtees*, 953 So. 2d 1240, 1245 (Ala. Civ. App. 2006); *Hunt-Wesson, Inc. v. Franchise Tax Board,* 528 U.S. 458 (2000) (interest expense offset only against non-business income allocated *outside of* California). In *Fulton Corporation v. Faulkner*, 516 U.S. 325 (1996), North Carolina allowed an offset to its tax on dividends to the extent the dividend payor did business in the state. This had the effect of rewarding taxpayers for investing in North Carolina companies, exerting a hydraulic effect on the dividend payors to move their operations into the state in order to attract investors. There is no similar effect under Alabama's add-back statute. The income derived from the licensing transaction bears the same degree of tax liability regardless of whether the intangible holding company is located within Alabama or without. As a "matter of dollars and cents", *Associated Industries v. Lohman, supra,* the Taxpayer has failed to make out a claim of discrimination in the statute's operation or effect.

CONCLUSION

The Commission urges this court to affirm the decision of the Court of Civil Appeals, and to construe the statute as a whole to accomplish the statute's purpose of ensuring that Alabama taxes no more and no less than its fair share of the earnings of multistate taxpayers.

Respectfully submitted,

___/s/ Bruce Fort____
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, postage prepaid, on May 31, 2008 as follows:

Joe Mays, Bruce Ely, and Chris Grissom
Bradley, Arant, Rose & White LLP
One Federal Place
1819 Fifth Avenue North
Birmingham, Alabama 35203

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

Todd Lard
Council on State Taxation
122 C Street, NW, Suite 330
Washington, DC 20001-2109

Bing Edwards
Balch & Bingham LLP
1901 Sixth Avenue North
Birmingham, AL 35203-4642
Eli J. Dicker & Shirley S. Grimmett
Tax Executives Institute, Inc.
1200 G Street, NW, Suite 300
Washington, DC 20005

Susan E. Kennedy & Pamela B. Slate
Slate Kennedy LLC
One Commerce Street
Suite 850
Montgomery, AL 36104

Roy Crawford
Cabaniss, Johnston, Gardner, Dumas & O’Neal LLP
2001 Park Place North, Suite 700
Birmingham, AL 35203

___/s/ Bruce Fort___________
Bruce J. Fort, Esq.