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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REPLY 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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REPLY BRIEF OF *AMICUS CURIAE*
MULTISTATE TAX COMMISSION

I. SUMMARY OF ARGUMENT

Amicus Curiae Multistate Tax Commission (the Commission) contends that the trial court in this case erroneously held that Alabama's add-back statute, Ala. Code 1975, Section 40-18-35(b), has application only to payments to "sham" or "shell" corporations (C. 634), holding that denial of a deduction for payments to any other entity would be "unreasonable" and thus subject to the exception to the add-back requirement in Section 40-18-35(b)(2).

The Commission respectfully suggests that the proper test for application of the "unreasonableness" exception should be whether the add-back of the expense deduction would result in distortion by materially overstating the taxpayer's earnings in the state. The Commission believes the evidence in this case demonstrates overwhelming that no such distortion has occurred under the State's assessment.

The Commission further argues that the trial court erred when it suggested that because the expenses in this case were attributable to a payment to an out-of-

state entity, the payment necessarily relates to income generated outside of Alabama, and necessarily causes the amount of taxpayer's Alabama income to be overstated. An identical argument challenging a similar add-back statute was rejected by the U.S. Supreme Court in *Amerada Hess v. Director, Div. of Taxation*, 490 U.S. 66 (1989), and the Commission urges this Court to following the reasoning of that case in ruling that Alabama's add-back statute has not distorted calculation of the taxpayer's income properly attributable to the state.

II. ARGUMENT

1. The Proper Test for Application of the "unreasonableness" Exception is Whether the Add-Back Results in Gross Distortion.

In the opening paragraph of its Response Brief ("Response") Plaintiff-Appellee VFJ Ventures, Inc. ("VFJ" or "the taxpayer") implicitly acknowledges that the add-back requirement of Ala. Code 1975, Section 40-18-35(b)(1) must have application beyond situations where a deduction is being claimed for payment to a "sham" or "shell" corporation. To that end, VFJ now claims that the trial court actually based its decision

on a finding that requiring an add-back of the $102 million paid to the Lee and Wrangler intangible holding companies ("IMCOs") would result in a *distortion* of VFJ's income generated in Alabama. (Response, p. 1). VFJ's change of direction is understandable since the state already had authority to deny deductions based on sham transactions, leaving no room for this statute to operate if its effect was limited to sham transactions.

Indeed, sub-section (b)(1) provides that the add-back requirement applies to "otherwise deductible" expenses and costs. Expenses arising from sham transactions are not "otherwise deductible" as ordinary and necessary business expenses under federal law, *Neontology Associates, P.A. v. Commissioner of Revenue*, 299 F.3d 221 (3rd. Cir. 2002), and therefore those same deductions would not be "otherwise deductible" under Alabama's laws. Code of Ala. 1975, §40-18-33.

In addition, where section (b)(3) of the statute *does* incorporate economic substance and business purpose tests for purposes of allowing a deduction for payments to related entities which are *not* primarily engaged in licensing intangibles, section (b)(2) would

be rendered superfluous if the same tests were employed for entities which *are* primarily engaged in licensing.

Just as tellingly, the richly-detailed account in the amicus brief filed by the Alabama Education Association, *et. al.*, of the growth of the Delaware intangible holding company "tax minimization" industry and the 2001 legislature's forceful response leaves no room to doubt that the legislature intended to limit the financial hemorrhaging which was occurring from *legal* tax sheltering in Delaware, in addition to the out-and-out shams. *Amicus Brief of Alabama Education Association, Auburn University, and Board of Trustees of the University of Alabama,* pp. 10-14, 41.

VFJ's attempted re-characterization of the trial court's decision, however, is simply incorrect. The central problem with the trial court's decision is that it did conclude that the Alabama legislature intended that the add-back statute apply only to transactions with "sham" or "shell" corporations which performed no activities, yet offered absolutely no basis for that

conclusion.[1] VFJ understandably wants to distance itself from the logical consequences of the lower court's reasoning: the Alabama legislature would have "rightfully been concerned" (C. 638) about the tax losses to Alabama from $102 million in payments to a related entity in Delaware which performed no activities, but the same legislature apparently would shrug over the same tax losses arising from payment of $102 million to a Delaware entity which had any arguable economic purpose and activity, even if carried out by a single employee.

What is missing from the trial court's discussion of the legislative intent is the general concept that the purpose of the state's tax structure

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[1] The trial court explicitly held (C. 638):

"States have rightfully been concerned about taxpayers taking advantage of IMCO structures by setting up 'shell' or 'sham' corporations in low-tax jurisdictions such as Delaware or Nevada and shifting substantial portions of their income to low tax jurisdictions without any real business activity taking place in those other states. *See, e.g., Syms Corporation v. Comm'r of Revenue*, 765 N.E. 2d 758 (Mass. 2002). In response to taxpayers generating large deductions from these sham or shell corporations, several states passed statutes intended to deny taxpayers tax benefits from these sham corporations. Alabama's add-back statute is one of these statutes."

is to impose tax obligations in proportion to the amount of income generated within the state. If the 2001 legislature was determined to stop multi-million dollar deductions for payments made to an entity with no employees because it allowed taxpayers to pay less than their proportionate share of taxes, one would think that same legislature would be equally concerned with multi-million dollar payments to entities with a handful of employees (or, in Wrangler's case, no employees, just the shared services of a handful of Lee's employees). (R. 289; R. 473-VFJ Ex. 47). In both instances, the claimed deductions would have the same effect. In this case, the deduction, if allowed, would negate more than half of the tax obligations VFJ incurred in Alabama from the profits it generated with 600 employees and $163 million in plant and equipment in the state. (R. 91; R. 764- State's Ex. 2, Form 20C, line 1 and Schedule D-1; and Form 1120, line 1c). The presence of a handful of employees in Delaware would have the effect of reducing VFJ's liability to the state of Alabama by $1 million per year, (R. 764-State's Ex. 3), yet the trial court's conclusion was

that the legislature was only concerned with expenses paid where there were *no* employees in Delaware.

The trial court's all-or-nothing interpretation of the statute would simply encourage taxpayers to establish minimal levels of economic activity in Delaware and plausible business reasons for the incorporation of separate entities there, which is of course what many taxpayers had already done to avoid disallowance of deductions under the sham transaction doctrine. *See, e.g., Sherwin-Williams Co. v. Tax Appeals Tribunal,* 784 N.Y.S. 2d 178 (App. Div. 2004), *app. den.*, 4 N.Y.3d 709 (2005)(holding that administrative law judge should not have accepted stated business reasons for formation of intangible holding company without further investigation); *Kmart Properties v. Taxation and Revenue Department of the State of New Mexico,* 131 P.3d 27, 29 (2001), *rev'd in part, Kmart Corp. v. Taxation and Revenue Dept., 139 N.M. 172, 131 P.3d 22 (2005)* (detailing efforts to give substance to intangible holding company pursuant to Price-Waterhouse plan entitled "Utilization of an

Investment Holding Company to Minimize State and Local Income Taxes").

The concept of proportionality and the understanding of how and where income is generated do play central roles in any discussion of "distortion" of income, so the Commission welcomes VFJ's implicit concession that distortion is the appropriate test for whether an add-back would be unreasonable under Section 40-18-35(b)(2).

2. Add-Back of Expenses Paid to an Out-of-State Entities Does Not Automatically Equal Gross Distortion.

VFJ cites two paragraphs of the trial court's ruling that equate denial of an "ordinary and necessary" business expense deduction with increasing the cost of doing business in Alabama, a conclusion which in turn led the trial court to hold that Alabama was taxing income "fairly attributable to other states", thus "distort[ing] the amount of VFJ's income fairly attributable to this state." (C. 638-9); *quoted in,* Response, p. 21. The Commission, in its brief-in-chief, pointed out that this syllogism makes no sense because legislatures frequently choose not to follow

federal definitions of taxable income by denying or limiting various deductions for depreciation, taxes paid, net operating losses, passive losses and capital losses, to name a few. See 2006 Multistate Corporate Tax Guide, PP. I-175 through I-391 (CCH Inc. 2006). If denial of every federally-allowed deduction equaled the potential for taxation of extra-territorial income, states would be in constant litigation over every choice their legislatures made to limit federal deductions, turning on its head the well-recognized rule that deductions are a matter of legislative grace. *Ex parte Kimberly-Clark Corp.*, 503 So.2d 304 (Ala. 1987); *Ex parte City of Tuscaloosa*, 757 So.2d 1182 (Ala. 1999). VFJ does not directly challenge that rule, nor does it appear to dispute that states are accorded wide latitude in determining how much income is earned inside its borders, absent evidence of gross distortion or discrimination. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Moorman Manufacturing v. Bair*, 437 U.S. 267 (1978).

Since state legislatures regularly choose not to follow federal deduction amounts, there must be

something more to this deduction in the eyes of the trial court which would cause it to equate the legislative disallowance of the deduction with taxation of extra-territorial values. From the opinion, one could surmise that the trial court was concerned that the deduction represented expenses for activities occurring outside of Alabama. VFJ is only slightly more direct—it argues—without attribution, that the trial court made a "key factual finding: that the income of the IMCOs is indeed earned by the IMCOs and is fairly attributable to the states in which the IMCOs operate (and not Alabama)." Response, p. 26. VFJ goes on to note that "[t]he Department has not asserted, nor could it successfully [assert], that the IMCOs are doing business in Alabama." *Id.* Interesting, VFJ never identifies where the IMCOs *are* doing business in its brief, and the trial court's decision likewise avoids the uncomfortable fact that the IMCOs do almost no business anywhere. Presumably, though, VFJ contends that since the IMCOs' handful of employees were only located in Delaware, the IMCOs must have earned their $102 million in royalties in that state. Thus, VFJ

argues, any denial of a deduction for royalty amounts paid into a related entity's Delaware bank account, no matter how fleetingly the money stayed there before being returned to the corporate parent,[2] would necessarily overstate VFJ's Alabama earnings and understate its earnings in Delaware.

As it happens, VFJ's argument is not new. The U.S. Supreme Court heard just such a challenge to New Jersey's tax laws in 1989, and unanimously rejected the argument that the denial of a deduction distorts income attributable to the taxing state where the deduction is purportedly related to out-of-state activities. *Amerada Hess Corporation v. Director, Div. of Taxation,* 490 U.S. 66 (1979). The Commission respectfully suggests that the *Amerada Hess* decision forecloses the taxpayer's "overstatement of income" argument in this case absolutely, and urges this court to follow the Supreme Court's wisdom in upholding Alabama's essentially identical taxing system.

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[2] The royalty payments in question were wired from VJF's corporate parent, paid to Lee and Wrangler in Delaware, and swept back into the corporate parent's bank account on the same day. (R. 249, 250, 271)

The question in *Amerada Hess* was whether New Jersey's requirement that "windfall profits tax" be "added-back" into New Jersey's base income prior to apportionment resulted in extra-territorial taxation. The taxpayers in *Amerada Hess* argued that the windfall profits tax was measured by profits on crude oil production, and the taxpayers did not produce any crude oil in New Jersey. For the purpose of determining how much of a multi-state taxpayer's income should be attributable to each state, New Jersey uses the same "three factor" apportionment system used by Alabama, a formula which "has become…something of a benchmark against which other formulas are judged." *Amerada Hess,* 490 U.S. at 67, *citing, Container Corporation v. Franchise Tax Board,* 463 U.S. 159, 170 (1983). The taxpayers in that case made the identical argument which VFJ makes here:

> Appellants contend . . . that the windfall profit tax is an exclusively out-of-state expense because it is associated with the production of oil outside New Jersey. They argue that the denial of a deduction for an out-of-state expense causes a State to tax more than its fair share of a unitary business' income.

490 U.S. at 67. The Supreme Court rejected that argument because under the unitary business principle, which lies at the heart of the formulary apportionment system, particular expenses, like income, cannot be isolated in any jurisdiction but arise from the operation of the enterprise as a whole. The Court wrote:

> There can be no doubt that New Jersey has "a substantial nexus" with the activities that generate appellants' "entire net income," including oil production occurring entirely outside the State. Each appellant's New Jersey operations are part of an integrated "unitary business," which includes the appellant's crude-oil production.
>
> * * * *
>
> Appellants, however, underestimate the fact that, for apportionment purposes, it is inappropriate to consider the windfall profit tax as an out-of-state expense. Rather, just as each appellant's oil-producing revenue -- as part of a unitary business -- is not confined to a single State, *Exxon Corp., 447 U.S., at 226;* Brief for Appellants 3, so too the costs of producing this revenue are unitary in nature. See *Container Corp., 463 U.S., at 182* (the costs of a unitary business cannot be deemed confined to the locality in which they are incurred). Thus, when a State denies a deduction for a cost of a unitary business, the resulting net figure is still a unitary one, which a State may legitimately decide to apportion according to the standard three-factor apportionment formula.

Id. at 67-68. In the present case, there can be no question that the operations of VFJ, Lee and Wrangler are just as unitary in nature. VFJ's tax manager, Joe McGraw, conceded the unitary nature of the entities at trial. (Tr. 104). VFJ, Lee and Wrangler have common ownership and control through VF Corporation. 78% of Lee's royalty income and 96.8% of Wrangler's royalty income derived from VF Corporation affiliates. (C. 634) Lee and Wrangler "…perform essential functions in the VF Group's worldwide business operations." Response Brief, pp. 29-30. The trademarks nominally owned by Lee and Wrangler and licensed to VFJ produce income (equal to 5% of gross sales) only when VFJ sells trademarked clothing in Alabama and other states. (C. 634) Thus, just as the income generated from selling trademarked merchandise arises from the operations of the unitary enterprise as a whole, so too do the expenses arise from the unitary enterprise as a whole. As in *Amerada Hess*, sourcing expenses to a particular geographic locations runs contrary to the concept of formulary apportionment of income. Denying a deduction for expenses which arise

from unitary operations, therefore, does not act to distort the amount of income apportioned to any particular jurisdiction, any more than denying a deduction for net operating losses would act to overstate income apportion to a particular state.

One cannot distinguish *Amerada Hess* by arguing that the expenses (windfall profits taxes) attributable to the purported out-of-state activities were incurred by the same entities which reported the income, while in the present case, the income was reported by the IMCOs while the expenses remained with VFJ. The Commission suggests that is exactly why the Alabama legislature properly denies intangible expense deductions in related party situations: to properly align income with expenses. The failure to align income with expenses results in the incongruous situation VFJ champions here, where eleven mostly low-level workers in Delaware purportedly generate more income than thousands of workers in the remainder of the unitary business, including 600 employees in Alabama.

It has long been recognized that application of the unitary business principle to properly apportion income between jurisdictions is fully appropriate where the enterprise includes separately incorporated legal entities, even if they are incorporated in foreign countries. *Bass, Ratcliff & Gretton Ltd. v. State Tax Commission*, 266 U.S. 271 (1924); *Butler Brothers v. McGoglan*, 315 U.S. 401 (1942). VFJ, Wrangler and Lee, each commonly owned and controlled by VF Corporation, are fully unitary under any recognized standard. As the taxpayer argues, "the payments [to] and activities of Lee and Wrangler were necessary and beneficial for the group's business operations." Response, p. 30.

The *Amerada Hess* analysis definitively disposes of the trial court's argument that the distortion is created by the denial of a deduction for unitary expenses which arguably could be "sourced" outside the state. While Alabama, like New Jersey, has chosen not to mandate "unitary combined filing", it certainly was within its authority to adopt tax policies which achieve similarly accurate sourcing results over the objection of taxpayers who have chosen to engage in "a

blatant attempt to game the system." W. Hellerstein, *State Taxation*, ¶ 20[3][j](3rd. Ed., Westlaw 2007).

3. Failure to Apply the Add-back would Result in Distortion of Income Attributable to Alabama

VFJ argues that the activities of eleven employees[3] in Delaware realistically generated $102 million in receipts. *See* Response, pp. 29-30: "Lee and Wrangler. . . perform essential functions in the group's worldwide business operations. Their extensive activities support a finding that the income with regard to the trademarks was indeed earned outside Alabama." But the real source of the IMCOs' profits was not the "extensive" oversight and clerical tasks performed by these employees in Delaware; it was the estimated $5 billion dollar value (C. 635) of the trademarks themselves. Professor Hellerstein makes this point in the context of apportioning income arising from short-term "treasury" investments, but it is equally

[3] The record suggests that only four employees worked for Lee for the entire audit year (while simultaneously performing services for the nineteen other IMCOs that had no employees) with another seven employees, including the only professional employees, hired during the same year (2001). (R. 473-VFJ Ex. 47.) The trial court's "findings" reference instead the number of Lee's employees ("at least fifteen") as of the trial date in 2006. (C 634)

applicable with respect to VFJ's attempt to equate the value of the limited professional services performed by Lee's employees in Delaware with income generation in that state:

> It is not primarily the brilliance of a few portfolio managers that generates millions of dollars of interest income on short-term money market instruments, or, indeed, of capital gains from long-term investments. . . . What generates the intangible income, of course, is the assets themselves, and the command over resources that they represent. To suggest that the geographical location of intangible property (and the income it produces) follows the location of investment managers is to let a very small tail wag a very large dog.

See W. Hellerstein, *State Taxation of Corporate Income from Intangibles*, p. 57, n. 531, TAX MGMT. MULTISTATE TAX (BNA 1996).

In judging whether Alabama's denial of a deduction for intangible expenses distorts the measure of VFJ's income tax liability compared to its Alabama presence, Ala. Admin Code r. 810-3-35-.02 (2003), the proper question is not where the earnings of Lee's eleven employees might be sourced, but rather, where the income from the trademarks themselves should be sourced. To the extent the trial court considered the matter, it can only be said that the trial court

thought the trademark income was properly sourced outside of Alabama.

VFJ similarly fails to identify where the IMCOs generated their $102 million in revenue. No where in the Response is there any recognition that the revenues from the minimal professional services rendered in *managing* the marks are distinct from the revenues received for the right to *use* the marks themselves. VFJ insists nonetheless that the revenue stream from the licensing agreements could not possibly be sourced to Alabama. Response, p. 26. VFJ is mistaken. Whether through legislation or court decisions, royalties received by intangible holding companies like Lee and Wrangler are now customarily sourced to and subject to tax in the jurisdictions where the licensee conducts its business, despite the licensor's purported lack of nexus. *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); Geoffrey, *Inc.* v. *Oklahoma Tax*

Commission, 132 P.3d 632 (Ok. 2005); *Lanco v. New Jersey*, 908 A.2d 176, *cert. den.*, _U.S._ (2007). *See also*, Arkansas Regulation 1996-3, Apportionment of Business Income Arising from Intra-group Intangible Licensing Transactions, *available at* CCH MCIT-GUIDE AR ¶14-816.

The Internal Revenue Code (IRC) also provides guidance on where income from licensing intangible property should be sourced in the context of international taxation. While the IRC generally imposed taxation based on the taxpayer's residence or commercial domicile, *see, e.g.*, IRC Section 872, income from intangible property is treated differently. That income is sourced to where the property is used by the licensor, and not where the property is managed, held or owned. IRC Sections 861(a)(4) and 862(a)(4) provide parallel rules for sourcing income from intangible property either within or without the United States based upon where the property is used to generate income. In both statutes, the taxation of the income is given to the jurisdiction wherein the intangible is

used, regardless of the citizenship of the owner. Section 862(a) provides:

> The following items of gross income shall be treated as income from sources without the United States:
>
> (4) …rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights…good will, trademarks, trade brands, franchises and other like properties;

See also, Revenue Ruling 66-443(1968)(income from trademarks properly sourced outside the United States where products bearing trademarks intended for foreign market); *Commissioner of Revenue v. Wodehouse*, 337 U.S. 369 (1948)(non-resident alien subject to tax on copyright royalties received for serialization of articles in U.S. publications).

The enforcement of these sourcing rules for taxpayers lacking a nexus with the United States is effectuated through a 30% withholding tax on the domestic payor, imposed under IRC Sections 1441 through 1446. Alabama's add-back statute accomplishes the same ends with respect to payments to entities like the IMCOs in this case, which claim nexus only where they are not subjected to a tax on their earnings.

The Commission respectfully suggests that the trial court erred when it assumed that the licensing income reported by the IMCOs could only have been earned outside of Alabama. Under federal income tax sourcing standards, income from licensing trademarks is properly sourced to the location where the trademarks are used, not where they are nominally owned or managed.

Alabama, of course, apportions a multi-state taxpayer's "unitary" income among jurisdictions pursuant to the Uniform Division of Income for Tax Purposes Act ("UDITPA"), and not according to federal sourcing rules. Ala. Code 1975, § 40-27-1. The application of the three-factor apportionment formula embodied in that statute to the facts of this case is accordingly the more appropriate method for determining if Alabama's add-back statute has resulted in a distortion of VFJ's income tax liability relative to its Alabama business presence.

The U.S. Supreme Court's decision in *Amerada Hess* establishes the proposition that an expense incurred by a unitary business arises from the operations of the

business as a whole and cannot be isolated from the remainder of the unitary business and sourced to a single geographic location. 490 U.S. at 67. Instead, such expenses are properly assigned to the overall unitary operations of the enterprise pursuant to the formulary apportionment system. Despite that rule, in this case the taxpayer argues that the income reported by Lee and Wrangler represents income-producing activity occurring outside of Alabama, and that any failure to recognize a deduction for the expenses charged for that activity results in extra-territorial taxation.

Alabama, like New Jersey, has chosen to gauge income generation by reference to how much of a unitary business's "factors"--property, payroll and receipts--are located within the state (the numerator), versus how much is located everywhere (the denominator). The "unitary business enterprise" in this case includes not just VFJ's business, but Lee and Wrangler's business activity as well. See infra at 14. If the taxpayer is correct in arguing that Lee and Wrangler's income is generated by those entities' "extensive" activities

outside Alabama, but improperly included in VFJ's income taxed by Alabama by virtue of the add-back, it follows that the addition of Lee and Wrangler's "factors" to VFJ's apportionment formula should significantly reduce the percentage of VFJ's income apportioned to Alabama. By contrast, if adding Lee and Wrangler's factors to the apportionment formula does not materially change VFJ's Alabama apportionment percentage, then the taxpayer cannot claim that Alabama's add-back has taxed income generated outside the state.

Adding the IMCOs' factors to the denominator of VFJ's apportionment formula would barely change the percentage of VFJ's income apportioned to Alabama. As set forth in the Commission's brief-in-chief, the record indicates Lee had just $188,982 in payroll expenses, compared to $377 million in payroll expenses for VFJ. (C. 25, Exhibit 1 to Taxpayer's Complaint.) Lee had just $220,490 in property, compared to VFJ's property factor of over $1 billion, with $163 million of that property located in Alabama. (R. 764- State's

Ex. 2, Form 20C, line 1 and Schedule D-1; and Form 1120, line 1c).

The addition of Lee's property to VFJ's property factor would increase the denominator by just 0.022%. The addition of Lee's payroll to VFJ's payroll factor would increase the everywhere denominator by just 0.05017%. In *Container Corporation v. Franchise Tax Board*, the U.S. Supreme Court held that a reported distortion factor of 14% between alternative income measurements was too small to be of constitutional significance. 463 U.S. at 184. There is simply no basis from which to conclude that Alabama's add-back statute has resulted in the impermissible taxation of income earned outside Alabama. In *Amerada Hess*, the Court noted that the add-back of the windfall profits tax may result in:

> a somewhat 'imperfect' measure of the New Jersey component of their unitary net income. (citation omitted) But this fact alone does not render the tax on the appellants unlawful. . . . On the contrary, as we have said repeatedly, in order to show unfair apportionment, a taxpayer 'must demonstrate that there is no rational relationship between the income attributable to the State and the interstate values of the enterprise.'

490 U.S. at 75-76. By adding back inter-company royalty expenses into a taxpayer's pre-apportioned income base, and then apportioning that income among the states, the Alabama legislature has firmly aligned itself with the reasoning of *Amerada Hess*, which holds that income (and expenses) arise from the unitary operations of the entity as a whole. The denial of an expense deduction for payments made to an entity in Delaware does not mean that Alabama has distorted the amount of income properly attributable to that state. It means that Alabama has made a policy choice as to how to measure income generated in Alabama which may be different from the policy choices inherent in the Internal Revenue Code.

For the same reason, these different policy choices do not suggest discriminatory taxation, a specter raised in the closing pages of the Response, but one not addressed by the court below. In *Amerada Hess*, the Supreme Court emphatically rejected the notion that denial of deduction in these circumstances could constitute impermissibly double-taxation or discrimination, finding that New Jersey's tax system

was both internally and externally consistent. 490 U.S. at 75, n.8, 76-7. That conclusion is even stronger in this case where Alabama's add-back statute includes a tax credit mechanism to ensure that no income is subjected to double taxation. Ala. Code 1975, Section 40-18-35(b)(1).

III. CONCLUSION

The Commission respectfully urges the Court to interpret the term "unreasonable" as used Ala. Code 1975, §40-18-35(b)(2) as an imposition of the "distortion" test set out in *Amerada Hess*, 490 U.S. at 74-75, and as set out in Ala. Admin Code r. 810-3-35-.02. VFJ has failed to demonstrate that operation of the add-back statute would distort the amount of VFJ's income attributable to Alabama relative to its business presence there. To the contrary, the record demonstrates that allowing this deduction would enable VFJ to grossly understate its true earnings in the state. 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.

Respectfully submitted,

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