Alabama's VFJ Case: The Trial Court Got It Right!

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Last year, the Montgomery Circuit Court ("trial court") held that VFJ Ventures, Inc. ("VFJ") was entitled to claim the reasonableness exception to Alabama's add back statute with respect to royalty payments VFJ made to its affiliates.[1] The trial court's decision concluded that VFJ was entitled to claim this exception because the add back statute would otherwise operate to deny VFJ a deduction for necessary costs of doing business in Alabama, and thus tax income fairly attributable to other states.

The Alabama Court of Civil Appeals recently reversed the trial court's decision in *Surtees v. VFJ Ventures, Inc.*[2] The Court of Civil Appeals concluded that although the trial court's judgment included a finding that VFJ's income would be distorted by the application of the add back statute, the trial court made this decision based upon its determination that the underlying transactions had a valid business purpose and economic substance. The Court of Civil Appeals disagreed with this standard and held that VFJ did not qualify for any of Alabama's exceptions to the add back rule and that the statute was constitutional. The Supreme Court of Alabama has granted VFJ's petition for writ of certiorari.

Alabama's Add Back Statute

Alabama enacted its add back statute in 2001. The statute requires corporations to add back otherwise deductible interest and intangible expenses paid to or incurred with respect to related members.[3] There are several exceptions to this rule. For example, an exception applies if application of the add back statute would be unreasonable.[4] The "subject-to-tax" exception applies if the corporation establishes that the related member was subject to tax on such income by Alabama, another state, or a foreign country that has an income tax treaty with the United States.[5] An exception is also available if the related member is not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related entities, and the transaction did not have the avoidance of Alabama tax as its principal purpose.[6]

VFJ's Case

VFJ is a manufacturer and marketer of jeanswear, and paid royalties to H.D. Lee Company, Inc. ("Lee") and Wrangler Clothing Corp. ("Wrangler") for the use of their trademarks. VFJ deducted these royalties as ordinary and necessary business expenses for federal income tax purposes. However, because VFJ, Lee and Wrangler were direct or indirect subsidiaries of V.F. Corporation ("VF") and qualified as related members under Alabama's add back statute, VFJ was required to add back those amounts when calculating its taxable income for Alabama's corporate income tax unless one of the above-mentioned exceptions applied.

Lee and Wrangler are Delaware corporations engaged in the business of owning, managing and licensing trademarks ("intangible management companies" or "IMCOs"). The trial court acknowledged that establishment of Lee, Wrangler and other IMCOs reduced the VF corporate family's state tax liability by sourcing their royalty income to Delaware, where the IMCOs were not subject to an income tax, and creating deductions in states where operating entities such as VFJ

were subject to tax. However, the trial court found that the IMCOs also had several other purposes. For example, the trial court found that segregating the ownership and management of trademarks in the IMCOs created numerous efficiencies, facilitated the coordination and management of trademark licensing to third parties, facilitated the sale of various business lines, and created a more flexible business structure. The trial court also found that the IMCOs had numerous employees and carried on substantial activities.

The trial court noted that states were rightfully concerned about corporate families creating "shell" or "sham" corporations in low-tax jurisdictions and shifting substantial amounts of income to those states without any real business activities taking place in those jurisdictions, and that many states had passed add back statutes to address such abusive transactions. Having determined that Lee and Wrangler had several business purposes and carried on substantial activities, the trial court concluded that it would be unreasonable to require VFJ to add back its royalty expenses, and that disallowing these deductions would distort the amount of income fairly attributable to Alabama. The trial court thus held that VFJ was entitled to claim the reasonableness exception.

The Court of Civil Appeals held that the trial court's interpretation of the reasonableness exception to require only a showing of business purpose and economic substance was too broad, noting that this interpretation would effectively render meaningless Alabama's exception for payments to related members that were not IMCOs. The Court of Civil Appeals instead adopted the Department of Revenue's interpretation of reasonableness, which examines whether the application of the add back would result in taxation that was out of proportion to the corporation's activities in Alabama.[7] Finding that VFJ had not presented evidence demonstrating that this standard was met, the Court of Civil Appeals held that VFJ did not qualify for the reasonableness exception.

The Court of Civil Appeals also examined whether VFJ qualified for the subject-to-tax exception. As discussed above, this exception applies if the related member is "subject to a tax based on or measured by the related member's net income" where "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."[8] VFJ argued that the subject-to-tax exception should be interpreted to mean the entire amount of federal taxable income the IMCOs included on their separate-return state tax returns prior to apportioning that income to the state. The Court of Civil Appeals disagreed, concluding that "included in income for the purposes of a tax on net income" means "that the income at issue is actually taxed as a part of a tax on net income" and thus applied to income on a post-apportionment basis. The court thus rejected VFJ's argument that it was entitled to claim the subject-to-tax exception simply because Lee and Wrangler had filed in one separate-return state (i.e., North Carolina) and paid tax on the income apportioned to that state.[9]

The Court of Civil Appeals also addressed VFJ's constitutional arguments. The court first rejected VFJ's argument that the add back statute was effectively an attempt to tax the income of the IMCOs that Alabama lacked nexus to tax, noting that the add back statute disallowed a deduction sought by the taxpayer and that deductions are a matter of legislative grace. The court next rejected VFJ's argument that the add back statute caused Alabama's tax to be unfairly apportioned and lacked external consistency, finding that there was no showing that the tax was out of proportion to VFJ's activities in Alabama or that the resulting tax reached beyond the portion of value attributable to Alabama. The court finally rejected VFJ's argument that the add back statute discriminated against interstate commerce, noting that the subject-to-tax exception applied regardless of whether the related member was subject to tax in Alabama, another state or a foreign country with a U.S. income tax treaty.

General Observations

Three aspects of the Court of Civil Appeals' decision are particularly troubling. First, as the trial court noted, add back statutes were initially enacted to curb potentially abusive transactions. Narrowing the reasonableness exception to reach only instances where the tax resulting from the add back is out of proportion to the corporation's activities in Alabama does not ensure this purpose is met. Moreover, the Court of Civil Appeals' interpretation of Alabama's reasonableness exception would effectively render meaningless Alabama's analog to section 18 of the Uniform Division of Income for Tax Purposes Act, which allows taxpayers and tax administrators to petition for the use of alternative methods where the standard allocation and apportionment provisions fail to fairly represent the extent of the taxpayer's business activity in the state.[10]

Second, the Court of Civil Appeals reasoned that the add back statute disallowed a deduction sought by the taxpayer, and thus dismissed VFJ's argument that the add back statute was effectively an attempt to tax the income of the IMCOs that Alabama lacked nexus to tax. However,

as the United States Supreme Court recognized in *Hunt-Wesson, Inc. v. Franchise Tax Board*,[11] the denial of a deduction may constitute an impermissible taxation of income outside the state's jurisdictional reach, particularly where the deduction disallowed is effectively matched with that income. Accordingly, Alabama's attempt to reach and tax Lee's and Wrangler's royalty income via an add back statute applied to VFJ should be subject to the same scrutiny and constitutional constraints, including nexus and factor representation, as if Alabama had sought to tax this income directly.

This conclusion is strengthened by the United States Supreme Court's recent decision in *MeadWestvaco Corp. v. Illinois Department of Revenue*, which confirmed the need for a connection between the apportionment formula used by the State and the income the State seeks to tax.[12]

Finally, we remain troubled by the question whether a state, through its tax regime, may effectively penalize a taxpayer for doing business with an affiliate that operates in another state with a favorable tax regime. Should Alabama be permitted to condition a taxpayer's right to a deduction upon whether Delaware or Nevada exercises its right to tax the corresponding item of income or whether the recipient is located in a state that employs combined reporting? Similarly, should other separate-company filing states, such as Maryland or Massachusetts, be permitted to condition a taxpayer's right to a deduction upon whether such income was taxed at a sufficiently high rate?[13] Although add back statutes such as Alabama's may not discriminate against interstate commerce on their face, the add back requirement only arises in response to the related member's decision to conduct business outside the add back state's jurisdiction because, under Alabama's exception, where the recipient is in Alabama, the add back does not apply. The fact that the same exception applies where the recipient chooses to operate in a state that Alabama views as imposing an acceptable tax does not change the fact that the add back influences the conduct of interstate commerce by discriminating against taxpayers doing business in the other non-approved states. While states may have some license to design their tax systems to prevent abusive tax planning, that license should be construed narrowly to prevent a state from discriminating based upon another state's decision to adopt a more favorable tax regime. In our view, the Alabama trial court had it right: Alabama's add back statute should be limited to cases where the arrangement lacked business purpose and economic substance.

VFJ represents the first of several cases challenging states' add back statutes.[14] The implications of *VFJ* remain to be seen, as each state's add back statute and exceptions vary significantly, as do the specific facts of taxpayers challenging these statutes.[15] These questions are likely to be raised and answered in future cases contemplating the scope and constitutionality of such statutes.

Footnotes:

[1] *VFJ Ventures, Inc. v. Surtees*, No. CV-03-3172, Ala. Tax Rep. (CCH) ¶ 201-181 (Ala. Cir. Ct., Montgomery County, Jan. 24, 2007).

[2] No. 2060478, 2008 Ala. Civ. App. LEXIS 50 (Ala. Civ. App., Feb. 8, 2008).

[3] Ala. Code § 40-18-35(b)(1) (2007).

[4] Ala. Code § 40-18-35(b)(2) (2007).

[5] Ala. Code § 40-18-35(b)(1) (2007).

[6] Ala. Code § 40-18-35(b)(3) (2007).

[7] *See* Ala. Admin. Code r. 810-3-35.02(3)(h) (adopted in 2003).

[8] Ala. Code § 40-18-35(b)(1) (2007).

[9] Although the trial court was not required to reach this question, the court noted in its opinion that if the Legislature had intended the subject-to-tax exception to apply to post-apportionment income, then the Legislature would have stated so in the statute.

[10] Ala. Code § 40-27-1, art. IV(18) (2007).

[11] 528 U.S. 458 (2000).

[12] No. 06-1413, 2008 U.S. LEXIS 3473 (Apr. 15, 2008).

[13] Md. Code Ann., [Tax – Gen] § 10-306.1(c)(3)(ii); Mass. Gen. Laws Ann. ch. 63, § 31J (2007).

[14] *See*, *e.g.*, *Family Dollar Stores of Ohio, Inc. v. Wilkins*, No. 2005-V-469, Ohio Tax Rep. (CCH) ¶ 403-786 (Ohio Bd. of Tax Appeals Jan.4, 2008); *Deluxe Fin. Servs., Inc. v. Director, Div., of Taxation*, No. 005522-2006 (N.J. T.C., filed May 30, 2006).

[15] H.R. 350, 2008 Reg. Sess. (Ala.), which is currently pending before the Alabama Legislature, would amend Alabama Code section 40-18-35 to "clarify" that the subject-to-tax exception applies to income subject to tax on a post-apportionment basis and that the reasonableness exception is intended as a savings clause to protect only against violations of the U.S. Constitution.