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Alabama's Addback Of Intangible Expense Held "Unreasonable"

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On January 24, 2007, the Circuit Court of Montgomery County, Alabama handed down the first-ever court decision analyzing an "addback statute" in *VFJ Ventures, Inc., v. Alabama Department of Revenue*, No. CV-03-3172. This is the first court decision to address a taxpayer challenge of recently enacted "addback" statutes. At least 17 states have adopted statutes in recent years that require taxpayers to add formerly-deductible interest and/or royalty payments made to affiliates back to their taxable income. Even the Multistate Tax Commission has promulgated a "model" addback statute.

In *VFJ Ventures*, the Court held that the taxpayer was not required to add back the royalty expenses it had paid to its affiliates because such a requirement would be "unreasonable" where the arrangement had business purpose, economic substance, and was not abusive.

Background

VFJ Ventures, Inc. ("VFJ" or "the Taxpayer") is a jeanswear manufacturer and marketer of the brands "Lee®" and "Wrangler®," with distribution centers and a cutting facility located in Alabama. In 2001, VFJ paid more than $100 million in royalties to affiliated intangible management companies ("IMCOs") located in Delaware as consideration for using "Lee," "Wrangler," and other trademarks owned by the IMCOs.

Since the royalties were not subject to the Delaware corporate income tax, the royalty income received by VFJ's IMCOs escaped taxation. Alabama adopts federal taxable income as the starting point for computing State taxable income. At least prior to 2001, VFJ was able to deduct the royalty payments from its Alabama income, resulting in a substantial reduction in its Alabama tax bills.

Alabama, like many other states, began to fight back to close the so-called "intangible holding company" loophole. In 2001, the Alabama legislature enacted ALA. CODE § 40-18-35(b)(1), which requires corporations to "add back otherwise deductible … intangible expenses and costs directly or indirectly paid, accrued, or incurred to … one or more related members," unless certain exceptions apply. Based on this statute, the Alabama Department of Revenue ("AL-DOR") assessed VFJ with additional income taxes exceeding $1 million for the 2001 tax year.

VFJ appealed the final assessment to the Circuit Court, arguing that it should not be subject to the addback because its transactions with the IMCOs fell within two of the exceptions listed in the statute. First, VFJ argued that it fell within the exception that applies when "the corporation establishes that [the addback] adjustments are unreasonable."[1] Second, it argued that the income that would otherwise be subject to addback in Alabama was subject to tax in another state and therefore fell within another statutory exception.[2] Finally, VFJ challenged the validity of the addback statute on constitutional grounds.

Addback of Necessary Business Costs Deemed "Unreasonable"

An exception contained in the Alabama addback statute applies when "the corporation established that the adjustments are unreasonable;" the term "unreasonable," however, was not defined.[3]

Without a statutory definition, the Court determined that the term "unreasonable" must be interpreted in accordance with the legislature's intent in enacting the statute. The Court noted that Alabama, like other states that have enacted addback statutes, sought to prevent taxpayers from deriving tax benefits from the creation of "sham" or "shell" corporations in low-tax jurisdictions with no business purpose or economic substance. Accordingly, the Court determined that the legislative purpose was to thwart abusive deductions and ensure that the income fairly attributable to Alabama was subject to tax.

In light of this determination, the Court then analyzed the business purposes behind VFJ's transferal of its intangible assets to separate IMCOs. It concluded that there were in fact numerous valid, non-tax-avoiding reasons behind the structure. Centralized ownership and management of the trademarks increased the efficiency with which the assets could be monitored and protected, developed the expertise of the IMCOs' employees in registering the trademarks and combating infringement, and facilitated the licensing of the trademarks to third parties. As a direct consequence of its establishment of the IMCOs, VFJ was able to reduce its trademark management costs by more than $60,000 a month.

The Taxpayer was equally effective in demonstrating to the Court that the IMCOs had economic substance and, thus, were not just "sham" or "shell" entities. The IMCOs had 3,200 square feet of office space in Delaware where at least 15 employees – including two trademark attorneys, six trademark paralegals, one licensing paralegal, three trademark assistants, controller, staff accountant, and receptionist – worked on a full-time basis. There was no dispute that the IMCOs charged a arm's-length rates for intercompany and third party licensing of the trademarks or that the royalties were actually paid by the affiliates.

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[1] ALA. CODE § 40-18-35(b)(2).

[2] ALA. CODE § 40-18-35(b)(1).

[3] ALA. CODE § 40-18-35(b)(2).

The Court also found that the royalty payments made by VFJ to the IMCOs were "ordinary and necessary" business costs because they granted VFJ the right to manufacture jeanswear with the valuable Lee® and Wrangler® trademarks. Even though the transactions may have been motivated, at least in part, by tax considerations, the Court paid homage to the well-established principle that taxpayers are free to arrange their affairs in order to minimize tax liability.

Because VFJ's royalty payments represented real and essential costs of doing business in Alabama and had business purpose and economic substance, the Court held that the AL-DOR's disallowance of the royalty deductions actually undermined the legislature's intent in enacting the statute by distorting the amount of the Taxpayer's income that was fairly attributable to Alabama. Thus, the Court concluded that the add-back was unreasonable in this case.

Subject-to-Tax Exception

Although not central to its holding, the Court noted in *dicta* that another exception to the addback statute would also likely have applied. The statute provides that taxpayers do not have to add back otherwise deductible interest and intangible expenses and costs when they demonstrate that the corresponding item of income was "subject to a tax based on or measured by the related member's net income" in Alabama or any other state in the same taxable year.[4]

The Taxpayer took the position that the exception simply means included in any income, whereas the AL-DOR argued for a much narrower definition of "subject to tax," where the exception denotes only post-apportionment income. VFJ's interpretation of the statute would permit a full deduction of the expense by the payor of a royalty or interest as long as the corresponding item of income is included in the tax base of the IMCO in another state. The AL-DOR's interpretation, however, would only permit a deduction for the payor of the royalty or interest equal to the amount of the IMCO's corresponding item of income in another state times the IMCO's apportionment percentage in that state (*i.e.*, if the IMCO was subject to tax in Georgia and had an apportionment factor of 5% in that state, the payor of a royalty would still have to add back 95% of its deduction).

The Court noted that "[i]t was clear … that if the legislature had wanted the 'subject-to-tax' exception to mean post-apportioned income, then they would have stated it in the statute." Thus, because the IMCOs each filed separate corporate income tax returns in North Carolina and were included in consolidated or combined income tax returns in California, Illinois, Kansas, and Colorado, the Court speculated that the Taxpayer would likely have prevailed with this argument had it not already won with its position that the addbacks were "unreasonable."

[4] ALA. CODE § 40-18-35(b)(1).

Implications for Taxpayers

Although this was an impressive victory in the first-ever court case scrutinizing addbacks, taxpayers should take note that this is a fact-intensive decision. The implications are unclear for IMCOs having less demonstrable business purposes or economic substance. The AL-DOR promulgated a regulation in 2003 interpreting the addback statute that was deemed inapplicable to the assessed tax period (2001) in the *VFJ* case. It is unclear how the regulation might have impacted the Court's decision in *VFJ*.

Impact of Regulations

The regulation provides that an addback is "unreasonable" if "[t]he taxpayer establishes that, based on the entirety of the taxpayer's particular facts and circumstances, the adjustments have increased the taxpayer's Alabama income tax liability to an amount that bears no fair relation to the taxpayer's Alabama presence…."[5] This definition appears to impose a higher standard than the legislative intent standard applied by the Court in *VFJ*.

The 2003 regulation defines the term "reported and included in income for purposes of a tax on net income" for the "subject-to-tax" exception as meaning "reported and included in post-allocation and apportionment income for purposes of a tax applied to the net income apportioned or allocated to the taxing jurisdiction."[6]

This definition directly conflicts with the Court's *ad hoc* definition of the term, which noted that if the legislature had been referring to inclusion in post-apportioned income, a much narrower term than "included in income," it would have so stated in the statute. Although courts often defer to state departments of revenue's regulations, those regulations cannot strain the plain language of the statute or frustrate the intent of the legislature in enacting the statute. Because this part of the decision was non-essential to the disposition of the case, however, it is unclear how much deference other courts will give to the Circuit Court of Montgomery County on this issue.

The Constitutional Issue

Interestingly, the Court included language in its holding that the denial of VFJ's deduction for an ordinary and necessary business expense resulted in the attribution of income to Alabama that was fairly attributable to other states, suggesting potential constitutionality issues with the addback. Unfortunately, the Court determined that it did not need to reach these constitutional issues.

Generally, the same constitutional limitations apply to the denial of an exemption as to the taxation of income. Addback statutes typically deny deductions only for multistate

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[5] ALA. ADMIN. CODE r. 810-3-35-.02(3)(h)(1).

[6] ALA. ADMIN. CODE r. 810-3-35-.02(3)(f).

taxpayers, raising the issue of inherent discrimination. Discrimination is not allowed unless there is no other reasonable way to address the state's interest.[7]

Stay tuned….■

[7] *See e.g. Maine v. Taylor*, 477 U.S. 131 (1986) (discrimination allowed where no other way to safeguard state interest); *Hughes v. Oklahoma*, 441 U.S. 332 (1979) (discrimination struck down due to less restrictive alternatives); *City of Philadelphia v. New Jersey*, 437 U.S. 617 (1978) (discrimination not permitted where less restrictive alternatives available).

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