No. 08-916

IN THE

Supreme Court of the United States

VFJ VENTURES, 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,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Alabama

BRIEF OF *AMICI CURIAE* COUNCIL ON STATE TAXATION AND NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

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INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of Petitioner ("VFJ") is filed on behalf of the Council On State Taxation ("COST") and the National Association of Manufacturers ("NAM").[1] COST is a non-profit trade

[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this

association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST represents more than 600 of the largest multistate businesses in the United States; companies from every industry doing business in every state. The NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards. *Amici* are in a unique position to offer its view on the constitutional and policy significance of this issue, informed by the business realities of the industries most affected by them.

Amici's members are concerned that Alabama's add-back statute, which imposes a discriminatory and extraterritorial restriction on a taxpayer's ability to deduct ordinary business expenses, has created a dangerous precedent and will subject taxpayers to inconsistent and unconstitutional taxation. *Amici*'s members are concerned that, if left standing, the Supreme Court of Alabama's acceptance of such an unconstitutional add-back statute will lead courts in other states that have enacted similar legislation to similarly uphold this unsound theory of taxation, thereby exacerbating the risk of multiple taxation of the same income or value.

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brief. The parties received timely notice of *amici's* intent to file this brief. Written consent of all parties to the filing of this brief has been filed with the Clerk of this Court.

STATEMENT OF THE CASE

This case raises the constitutional issue of whether a state can selectively and discriminately deny taxpayers the ability to deduct legitimate expenses, the resolution of which will greatly affect virtually every large company doing business in any state that attempts to enforce an add-back statute similar to that imposed by the State of Alabama. In 2001, the Alabama legislature amended Ala. Code § 40-18-35 (1975) by including one of the nation's first "add-back" provisions. This provision essentially restricts the ability of a taxpayer to deduct as expenses certain intangible and interest payments made to related companies. The statute does this by requiring those types of payments, when made to related companies, to be added back to the taxpayer's taxable income: added back because they were already deducted for purposes of the starting point of the tax, federal taxable income. By offering several exceptions, however, the statute allows taxpayers to deduct certain payments. While the Petitioner certainly raises legitimate concerns about the constitutionality of the overall operation of add-back statute, *Amici* will focus primarily on the application of the so-called "subject-to-tax" exception to the general add-back provision. Simply stated, the subject-to-tax exception allows taxpayers to deduct payments to some related entities, but only if those related entities are subject to a sufficient level of income tax in Alabama or another state.

The expenses targeted by the Alabama Department of Revenue ("ADOR") in this case were VFJ's royalty payments to H.D. Lee Company, Inc. ("Lee") and Wrangler Clothing Corp. ("Wrangler"). Lee and Wrangler actively manage VFJ's valuable trademarks

through employees and operations located in Delaware. VFJ manufactures and sells jeans and other clothing in Alabama and throughout the world. Relying on the add-back statute, the ADOR disallowed (or added back) VFJ's royalty payments to Lee and Wrangler. This resulted in a tax assessment of more than $1 million and a subsequent challenge of the statute's validity by VFJ.

In January 2007, the Circuit Court of Montgomery County, Alabama, held a four-day trial and concluded that the unreasonable exception to the add-back statute applied to VFJ's royalty payments because the payments had economic substance and a legitimate business purpose. The Circuit Court also briefly addressed whether the "subject-to-tax" exception applied. The Circuit Court held that the "subject-to-tax" exception should be measured on a pre-apportionment basis (before income is apportioned to Alabama). Accordingly, the court found that Lee's and Wrangler's income was subject to tax in another state—North Carolina. Because the court held in favor of VFJ on these points, the Circuit Court declined to address the challenges by VFJ that the entire add-back statute violated the United States Constitution.

In February 2008, the Alabama Court of Civil Appeals reversed the Circuit Court's finding that the add-back would be unreasonable. The Court of Civil Appeals adopted the ADOR's interpretation of what would qualify as "unreasonable," namely that the add back of income had to be out of proportion to the taxpayer's presence in Alabama. Regarding the "subject-to-tax" exception, the Court of Civil Appeals again gave great deference to the ADOR position that "subject-to-tax" should apply on a post-apportionment basis (income apportioned to Alabama) and not on a pre-apportionment basis as determined by the Circuit

Court. Lastly, addressing the constitutionality of the add-back provision, the Court of Civil Appeals held that Alabama's add-back provision passed constitutional scrutiny. The Court of Civil Appeals, counter to VFJ's arguments, found that the tax was fairly apportioned, was externally consistent, and was not facially discriminatory.

In September 2008, the Supreme Court of Alabama summarily affirmed the judgment of the Alabama Court of Civil Appeals, adopting the court's analysis and opinion in its entirety as its own, stating that it "see[s] no need to explicate further." *Ex Parte VFJ Ventures, Inc. (Surtees v. VFJ Ventures, Inc.)*, No. 1070718 (Ala. Sept. 19, 2008). The Supreme Court of Alabama offered no independent analysis whatsoever regarding any of the constitutional issues presented, including those presented by *amici*.

SUMMARY OF THE ARGUMENT

This Court should grant review in order to preserve fundamental Due Process and Commerce Clause requirements it has long recognized. In its application, the Alabama add-back statute creates situations where a taxpayer's Alabama tax liability can vary not based on its activities in-state or changes in Alabama law, but based entirely on its activities and tax policy shifts outside of Alabama. Such overreaching by the State of Alabama is not fair apportionment and should not survive constitutional scrutiny. The Alabama add-back statute violates this Court's extraterritorial principle by inextricably linking the ability to deduct certain expenses with the amount of income tax a related company might have paid to another state. Increasing Alabama tax liability simply because another state or jurisdiction cannot or chooses not to tax income from the use of intangibles or tax

corporate groups on a combined basis is an unconstitutional enactment of extraterritorial law.

The issue of extraterritorial taxation from such add-back statutes unfortunately arises not only in Alabama, but also in the nearly 20 other jurisdictions across the country that have enacted similar legislation. Immediate review of the constitutionality of Alabama's add-back statute is essential for both taxpayers unduly burdened by these types of provisions, and states unnecessarily burdened by administrative costs and potential refund liabilities resulting from continued imposition of these types of unconstitutional taxing schemes. This Court's guidance and ultimate resolution regarding the limits of extraterritorial taxation will remove the fog of uncertainty over this issue and bring clarity to both taxpayers and the states.

ARGUMENT

I. THIS COURT SHOULD GRANT REVIEW IN ORDER TO PRESERVE FUNDAMENTAL DUE PROCESS AND COMMERCE CLAUSE RESTRICTIONS ON TAXING EXTRATERRITORIAL VALUE

The Petitioner has made sound and logical arguments as to why the Alabama add-back statute violates the nondiscrimination and fair-apportionment requirements of the Commerce Clause, thus compelling a grant of *certiorari* in this case. We agree with the petitioner's conclusions and will not restate all of those arguments here. Rather, this brief will focus on the extraterritorial encroachment of the Alabama add-back statute and the related violations of the fair apportionment requirements of the Commerce Clause and Due Process Clause.

Alabama's add-back provision, as interpreted by the Supreme Court of Alabama, unconstitutionally increases the tax burden of select businesses engaged in interstate commerce. It does so by punitively increasing the Alabama tax burden on taxpayers by requiring those taxpayers to add back certain payments made to select related members that are neither subject to income taxation in Alabama nor subject to sufficient level of tax in another state. This specific targeting of companies based upon the level of taxes imposed by other states violates the United States Constitution.

A. Alabama's Add-Back Provision Operating in Conjunction with the Subject-to-tax Exception Violates the Extraterritoriality Principles Embodied in *Gore*

During the last term, this Court took the opportunity to reiterate its long-standing principle that "[t]he Due Process and Commerce Clauses forbid the States to tax 'extraterritorial values.'" *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 128 S.Ct. 1498, 1502 (2008). Indeed, this court has acknowledged that the taxation of interstate commerce "provide[s] the opportunity for a State to export tax burdens and import tax revenues." *Trinova Corp. v. Mich. Dep't Treas.*, 498 U.S. 358, 374 (1991). The Alabama add-back statute operating in conjunction with the "subject-to-tax exception" violates this extraterritorial prohibition by inextricably linking the ability to deduct certain expenses with the amount of income tax a related company might have paid to another state. This linking of Alabama income tax liability to the amount of income tax paid in other states is an unconstitutional enactment of an extraterritorial law.

The Alabama add-back statute consists of a general rule and several complex exceptions. The general add-back rule does not allow a taxpayer to deduct most payments for intangibles or interest to related members even though the payment is deductible for federal income tax purposes. Ala. Code § 40-18-35 (1975). However, several statutory exceptions allow some related company payments to be deducted. The exception of relevance here is the "subject-to-tax" exception. *Id.*

The subject-to-tax exception essentially allows a deduction if the related company receiving the payment is subject to a sufficient level of income tax in another jurisdiction, or subject to Alabama's income tax. According to the Supreme Court of Alabama, it is not enough that the income of the related company is included in a return in another state. Rather the Supreme Court of Alabama, in wholly adopting the Court of Civil Appeals' opinion, requires "the income at issue [must be] actually taxed as a part of a tax on net income." *Surtees v. VFJ Ventures, Inc.*, No. 2060478, slip op. at 58 (Ala. Civ. App. Feb. 8, 2008). By asserting that Alabama will only allow deductions for a payment to the extent another state chooses to tax the recipient of the payment, Alabama has essentially anointed itself as tax collector for the rest of the states. It is simply not within Alabama's jurisdiction, no matter what direct or indirect means the state chooses, to assess tax outside its borders.

A simple and all-too-familiar fact scenario illustrates the extraterritorial nature of the Alabama add-back statute. For many years, the State of Texas imposed a franchise tax on the earned surplus or taxable capital of companies doing business in Texas. Tex. Tax Code Ann. § 171.001. Although the tax was labeled a franchise tax, it was generally considered a

tax on income. Effective January 1, 2007, Texas significantly altered its franchise tax, effectively replacing it with a "taxable margin tax," which is imposed on gross receipts rather than income. Tex. Tax Code Ann. § 171.001. A typical taxpayer with consistent and unchanged operations in Texas and Alabama might expect to see its Texas tax liability change because of the Texas law change. However, it is very likely that the same taxpayer could also see its Alabama tax increase solely because of the Texas law change.

Under the former Texas franchise tax, payments to a related company located in Texas would likely qualify for Alabama's subject-to-tax exception. However, payments to the same entity subject to the new taxable margin tax may not qualify for the subject-to-tax exception because the new margin tax is arguably not a tax on income. In its application, the Alabama add-back statute creates situations where a taxpayer's Alabama tax liability can vary not based on its activities in-state or changes in Alabama law, but based entirely on its activities and tax policy shifts outside of Alabama.

In a series of cases not involving taxes, this Court has crafted careful limits on the ability of a state to control activities beyond its borders. These cases support a conclusion that neither the activities of businesses in other states nor the taxing policies of other states are the proper subject of an Alabama statute. While "Congress has ample authority to enact such . . . polic[ies] for the entire Nation, it is clear that no single State could do so, or even impose its own policy choice on neighboring states." *See Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881) ("No State can legislate except with reference to its own jurisdiction. . . ."). *See also BMW of North America,*

Inc. v. Gore, 517 U.S. 559, 571 (1996) (stating that while Congress has the authority to enact policies for the entire nation, "it is clear that no single State could do so, or even impose its own policy choice on neighboring States"); *Bigelow v. Virginia*, 421 U.S. 809 (1975) (finding that while Virginia had a legitimate interest in maintaining the quality of medical care services provided within its borders, it had no authority to regulate such services provided in New York); *New York Life Ins. Co. v. Head*, 234 U.S. 149, 161 (1914) (finding that to permit the statutes of one state to operate beyond the jurisdiction of that state would remove "the constitutional barriers by which all the States are restricted within the orbits of their lawful authority and upon the preservation of which the Government under the Constitution depends. This is so obviously the necessary result of the Constitution that it has rarely been called in question and hence authorities directly dealing with it do not abound"). The "Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State." *Edgar v. MITE Corp.*, 457 U.S. 624, 642-43 (1982).

As *Gore* and its precedents make clear, the fact that other states choose not to impose income tax on income from the use of intangibles or to tax corporate groups on a combined basis is not an act Alabama can correct. As the leading Constitutional treatise notes, "the Court has articulated virtually a *per se* rule of invalidity for extraterritorial state regulations—*i.e.*, laws which directly regulate out-of-state commerce, or laws whose operation is triggered by out-of-state events." Laurence H. Tribe, *American Constitutional Law* § 7-8 at 1064 (3d ed. 2000). It is undisputed that the add-back statute and its subject-to-tax exception

are only triggered by events occurring outside of Alabama, events which have absolutely no relationship to a taxpayer's business activities in Alabama, and have no relationship to the measurement of earnings reasonably attributable to Alabama.

In *Gore*, this Court rejected Alabama's imposition of economic sanctions to induce BMW to change a nationwide policy. The Supreme Court held that the amount of a state punitive damages award could not be based on BMW's failure to disclose presale repairs in other states. Although not a tax case, the similarity to Alabama's add-back statute with the subject-to-tax exception is striking. That is, just as Alabama sought to impose economic sanctions to discourage BMW from nondisclosure of presale repairs in other states, the ADOR contends that Alabama may penalize taxpayers who do not pay similar income taxes in other states.

In finding Alabama's punitive damages award unconstitutional in *Gore*, the Court held that a "State's power to impose burdens on the interstate market . . . is not only subordinate to the federal power over interstate commerce, but is also constrained by the need to respect the interests of other States." *Gore*, 517 U.S. at 571 (citation omitted). While modern commerce may be conducted in such a way that blurs strict geographical boundaries, the boundaries on Alabama's ability to impose tax remain crystal clear. Alabama simply is not permitted to enact a law that is triggered by out-of-state events.

B. Alabama's Add-Back Provision Violates This Court's Rulings Specific to Other State Taxes Because it is Not Fairly Apportioned

In addition to contradicting this Court's logic in *Gore*, the Alabama add-back provision also runs counter to this Court's established standards for examining the constitutionality of apportioned state taxes. The deliberate extraterritorial reach of the add-back statute and the subject-to-tax exception violates the Due Process Clause of the Fourteenth Amendment of the United States Constitution because the Due Process Clause requires that when a state taxes an interstate business, "the income attributed to the State for tax purposes must be rationally related to values connected with the taxing state." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978) (internal quotation omitted). An income measurement based on whether a taxpayer is subject to tax in another state can never be rationally related to values connected with Alabama.

The deliberate extraterritorial reach of the add-back statute and the subject-to-tax exception also necessarily results in a violation of the fair apportionment requirement of the Commerce Clause because it intentionally increases a taxpayer's Alabama tax liability based upon an amount of tax paid in other states. Although the states are given significant discretion in determining how to apportion income, the "central purpose behind the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction." *Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989). The add-back statute with the subject-to-tax exception violates the Commerce Clause by purposefully exceeding its "fair share" of the income relating to the interstate activi-

ties of corporations and by ignoring objective measures (*i.e.*, legitimate expenses) of a corporation's activities outside of Alabama.

The add-back statute operating in conjunction with the subject-to-tax exception also violates the external consistency requirement of fair apportionment. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983). The requirement of "external consistency" in an apportionment formula specifically looks to "whether a State's tax reaches beyond the portion of value that is fairly attributable to economic activity within the taxing State." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995). Accordingly, Alabama's taxing scheme violates the external consistency requirement by deliberately reaching beyond the portion of income that is fairly attributable to economic activity within Alabama.

II. REVIEW BY THIS COURT ON WHETHER THE ALABAMA ADD-BACK STATUTE VIOLATES THE COMMERCE CLAUSE AND DUE PROCESS CLAUSE WILL HAVE RAMIFICATIONS IN MANY STATES

The central issue in this brief *amici curiae* with respect to the application of the Commerce Clause to the Alabama add-back statute is whether the State impermissibly taxed extraterritorial values. Due to the recent, albeit misguided, popularity of the add-back concept to revenue agencies, many other states have also implemented add-back statutes that rely on activities or competing tax policies well beyond the borders of the taxing state in order to justify an increased in-state tax liability. These taxes resulting from add-back statutes are indeed extraterritorial in

nature, and a ruling on the Alabama add-back provision by this Court could very well affect the application of these taxes in other states.

Currently, twenty other states and the District of Columbia have adopted similar add-back statutes, while other states continue to contemplate such action. *See* 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 7.17[3] n.550 (3d ed. 2008) (noting the following jurisdictions have enacted add-back provisions to their income tax statutes: Alabama, Arkansas, Connecticut, District of Columbia, Georgia, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Ohio, Rhode Island, South Carolina, Tennessee, Virginia, and Wisconsin); *see also* John C. Healy & Micheal Schadewald, *Multistate Corporate Tax Guide* I-405 (2009) (noting, in addition to the states listed above, Michigan and Oregon also have enacted add-back provisions to their income tax statutes); Almost all of these add-back statutes contain a subject-to-tax exception similar to that used in Alabama.[2] The Alabama add-back statute is typical of the types being implemented across the states and is, in fact, commonly used in scholarly works as the quintessential example describing this category of statutory provisions. *See* Hellerstein, at ¶ 7.17[3][a]

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[2] *See* Ark. Code Ann. 26-51-423(g)(1); Conn. Gen. Stat. § 12-218(c); D.C. Code § 47-1803.03(a)(19)(B); Ga. Code Ann. § 48-7-28.3(d)(2); 35 Ill. Comp. Stat. 5/203(a)(2)(D-18); Ind. Code § 6-3-2-20(c)(2); Ky. Rev. Stat. Ann. § 141.205(3)(b); Md. Code Ann., Tax-Gen. § 10-306.1(c); Mass. Gen. Laws ch. 63, § 31I; 830 Mass. Code Regs. 63.31.1; Mich. Comp. Laws § 208.1201(2)(f)(ii); N.J. Stat. Ann. § 54:10A-4.4; N.J. Admin. Code § 18:7-5.18(b)(3); N.C. Gen. Stat. 105-130.7A.; Ohio Rev. Code Ann. §§ 5733.042, .055(A)(2); R.I. Gen. Laws § 44-11-11(f)(3); Va. Code Ann. § 58.1-402(B)(8)(a)(1).

("Most of the state's expense disallowance provisions require a taxpayer to add back to income otherwise deductible expenses that fall within an identifiable set of related-company transactions. The Alabama statute is typical. It requires a taxpayer to . . ." (emphasis added)). In addition, the Multistate Tax Commission (MTC)—an organization of state tax administrators who strive to enact uniform laws—has even adopted a model statute requiring taxpayers to add back certain intangible and interest expenses in computing state taxable income. *See* Multistate Tax Comm'n, *Model Statute Requiring the Add-Back of Certain Intangible & Interest Expenses* (2008).

The heavy burdens ultimately felt by the continued use of these types of unconstitutional taxation schemes are not limited to the taxpayers alone. It is apparent that taxpayers are currently unduly burdened by such add-back provisions, with VFJ's own tax liability having increased by over $1 million in a single tax year. In addition, however, this current lack of constitutional clarity has resulted in considerable administrative costs borne by states currently involved in contentious litigation regarding the matter. Many of the states (including those planning to adopt such provisions) may also be exposed to ever-growing refund liabilities and resulting budget shortfalls that coincide with mandatory retroactive relief they will be forced to provide should the unconstitutionality of these types of add-back provisions be confirmed. Swift clarification by this Court would alleviate such unnecessary burdens for both taxpayers and the states.

CONCLUSION

In its application, the Alabama add-back provision creates situations where a taxpayer's Alabama tax liability can vary not based upon its Alabama activities, but based entirely upon its activities outside of Alabama. Such overreaching by the State of Alabama should not survive constitutional scrutiny. The Alabama add-back statute operating in conjunction with the "subject-to-tax exception" violates this extraterritorial prohibition by inextricably linking the ability to deduct certain expenses with the amount of tax a related company might have paid to another state. This linking of Alabama tax liability to the amount of tax paid in other states is an unconstitutional enactment of an extraterritorial law.

The issue of extraterritorial taxation arises not only in Alabama, but also in other states across the country (and even in other areas of state and local taxes). Immediate review of the constitutionality of Alabama's add-back statute is essential for both taxpayers unduly burdened by these types of provisions, and states unnecessarily burdened by high administrative costs, potential refund liabilities, and associated budgetary deficits resulting from continued imposition of these types of unconstitutional taxing schemes. This Court's guidance and ultimate resolution regarding the limits of extraterritorial taxation will remove the fog of uncertainty over this issue and bring clarity not only to taxpayers, but also to states that have enacted (or are planning to enact) these types of impermissible add-back statutes.

Respectfully submitted,

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