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IN THE

SUPREME COURT OF VIRGINIA

AT RICHMOND

Record No. 160681

KOHL'S DEPARTMENT STORES, INC.,

Appellant,

v.

VIRGINIA DEPARTMENT OF TAXATION,
An agency of the Commonwealth of Virginia,

Appellee.

REPLY BRIEF

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I. INTRODUCTION

The Department of Taxation's ("Department") brief reveals that it is not addressing the statute that was passed by the General Assembly. Instead, the enacted statute provides that, in calculating its Virginia taxable income, the royalty addition is not required "if" (not "to the extent") a safe harbor applies. Va. Code § 58.1-402.B.8.a. Here, the royalties are subject to a tax imposed by another state and the Subject to Tax safe harbor applies. Id. at B.8.a(1). The statutory language is plain and unambiguous.

Kohl's Department Stores, Inc. ("Kohl's") paid royalties to a related member, Kohl's Illinois, Inc. ("Kohl's Illinois"). The Department concedes that the royalties were subject to tax in a number of states. (Joint Appendix ("JA") 032, ¶ 26.) Thus, under the plain meaning of the statute, the royalties are not required to be added back.

Notwithstanding the clarity of the statute, the Department refers to academic treatises, a case from another state interpreting a differently worded statute and constitutional apportionment theory to incorrectly allege that only the portion of the royalties that were actually taxed qualify for the safe harbor provision. However, the Department cannot point to any statutory language that supports its interpretation.

Further, the plain meaning of the statute is reinforced by the Department's long-standing regulation providing that something is subject to tax even if no tax is imposed. 23 Va. Admin. Code § 10-120-120(B)(2).

Kohl's has established and the Department has conceded that the royalties were subject to tax in numerous states. Therefore, the Circuit Court's Opinion and Order ("Order") should be reversed.

II. STATEMENT OF FACTS

Kohl's disagrees with the portrayal of the facts as set forth in the Brief of Appellee. In particular, Kohl's disagrees with the following:

The Department incorrectly portrays Kohl's Illinois as an intangible holding company. Brief of Appellee ("Dept. Br."), p. 6. Unlike the single-purpose intangible holding companies portrayed by the Department, Kohl's Illinois' business operations, which included operating retail stores, exceeded merely owning intellectual property. (JA029, ¶ 5; Supplemental Joint Appendix ("SJA") 086-145.) Indeed, Kohl's Illinois paid millions of dollars of salaries, rent and utilities. (SJA086-145.)

Furthermore, the Department states that "corporations used the IHC loophole to shift income to an affiliate in a state where the income would not be taxed." Dept. Br., p. 1. However, the Department does not dispute

that Kohl's Illinois paid tax in other states. See Dept. Br., p. 10.[1] Further, $3,880,627 of income tax was paid in Illinois in 2008 alone, which was principally the result of Kohl's Illinois' activity in that State. (SJA244-258.) In addition, as Illinois' and other states' taxes were paid on Kohl's Illinois' income, the income was not shifted to a no tax state.

Therefore, as the facts lay bare, there is a fatal flaw in the Department's position – Kohl's Illinois is not an intangible holding company that prompted the addback legislation at issue here.

III. ARGUMENT

A. Standard of Review and Law Governing Statutory Interpretation

The parties agree that the standard of review here is de novo. See Dept. Br., p. 11. Assessments are entitled to a presumption of correctness. Va. Code § 58.1-205. Here, Kohl's has overcome that presumption by establishing that the assessment is contrary to law. Opening Brief, pp. 10-33; see also Chesapeake Hosp. Auth. v. Commonwealth, 262 Va. 551, 561, 554 S.E.2d 55, 60 (2001) (stating that an assessment can be overturned if it is contrary to law).

Moreover, the Department alleges that the Subject to Tax safe harbor "must be construed in the light most favorable to the Commonwealth"

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[1] The amounts referenced by the Department are not in the record, nor are they in the materials cited by the Department.

because Kohl's did not assign error to this aspect of the Order. Dept. Br., p. 12. However, contrary to the Department's unsupported position, this Court's de novo review is not conditioned on Kohl's assigning error to each and every distinct "aspect of the Circuit Court's ruling" that forms the predicate for its construction of the statute. See id. [2]

The Department incorrectly claims that the royalties are "excluded" from taxable income, thereby making this an exemption. Dept. Br., pp. 7-8, 12. However, the statute clearly states that if a safe harbor is satisfied, then the "addition shall not be required." Va. Code § 58.1-402.B.8.a (emphasis added). The addition of income to the tax base is an imposition, not an exclusion. "Statutes imposing taxes must be construed most strongly against the Commonwealth and in favor of the taxpayer." Commonwealth v. Gen. Elec. Co., 236 Va. 54, 64, 372 S.E.2d 599, 605 (1988); City of Richmond v. Bosher, 197 Va. 182, 187, 89 S.E.2d 36, 39 (1955) (stating that "words defining things to be taxed may not be extended beyond their clear import").

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[2] Kohl's argued below, in opposition to the Department's summary judgment motion, that the statute was an imposition statute. (Record "R" 267-68.) The Circuit Court's rejection of Kohl's' argument and acceptance of the Department's is part and parcel of the Circuit Court's summary judgment holding interpreting the statute. (JA110-13.) By assigning error to that holding, Kohl's has directly raised in this Court the correctness of the Circuit Court's interpretation of the statute.

In any event, the statute is plain and unambiguous. Therefore, the Court need look no further than the plain language of the statute. See Nielsen Co. (US), LLC v. Cnty. Bd. of Arlington Cnty., 289 Va. 79, 88, 767 S.E.2d 1, 4-5 (2015) (stating that this Court does "not defer to an agency's construction of a statute" and "absent ambiguity, the plain language controls and the agency's interpretation is afforded no weight"); Commonwealth v. Delta Air Lines, Inc., 257 Va. 419, 426, 513 S.E.2d 130, 133 (1999) (stating that "[w]hen a statute, as written, is clear on its face, this Court will look no further than the plain meaning of the statute's words"). The Department never alleged that the statute is ambiguous. See Dept. Br., pp. 1-37.

B. The Department's Interpretation of the Subject to Tax Safe Harbor is Contrary to the Plain Meaning of the Statute

1. The Plain Meaning of the Subject to Tax Safe Harbor

To arrive at Virginia taxable income, in certain circumstances, royalties paid to a related member are added back to federal taxable income. Va. Code § 58.1-402.B.8.a. In essence, the addition results in a previously allowed deduction being added back. Significantly, the General Assembly provided three safe harbors where the addition is not made. Id.

The safe harbor provision at issue here is as follows:

> This addition shall not be required for any portion of the intangible expenses and costs if one of the following applies:
>
> (1) The corresponding item of income received by the related member is subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government;

Id. (emphasis added).

The Department twists the "any portion" language contained in the statute. Dept. Br., p. 23. Instead, such language comes into play when a taxpayer pays royalties to more than one related member. In such instance, if the royalties that the taxpayer paid to one related member ("RM1") qualified for the Subject to Tax safe harbor and the royalties paid to another related member ("RM2") did not, it is only that portion of the total royalties that the taxpayer paid to RM1 that are not required to be added back under the statute. The remaining royalties paid to RM2 are required to be added back.

Any other interpretation of the phrase "any portion" would render the General Assembly's later use of the phrase "such portion" in the Conduit safe harbor meaningless. Hubbard v. Henrico Ltd. P'ship., 255 Va. 335, 340, 497 S.E.2d 335, 338 (1998) (stating that "every part of a statute is

presumed to have some effect and no part will be considered meaningless unless absolutely necessary"). As used in the Conduit safe harbor, "such portion" serves to limit the royalties paid to a related member to only those royalties that are paid to a third party. See Va. Code § 58.1-402.B.8.a(3).

Contrary to the Department's assertions, the phrase "any portion" does not mean "to the extent." Dept. Br., p. 32. Had the General Assembly sought that meaning, it knew how to use the phrase "to the extent," as that phrase was used 10 times in Virginia Code Section 58.1-402. See Va. Code §§ 58.1-402.B, B.1, B.2, B.4, B.8.a, B.9.a, B.11, C, C.1 and C.16.

The Department's attempts to redefine the use of "imposed by" in the statute are equally unpersuasive. Dept. Br., pp. 15-16. The phrase "imposed by" refers to the types of governments which must impose such tax (e.g., Virginia or another state). Va. Code § 58.1-402.B.8.a(1). For example, if the royalties were only subject to a federal tax, then the safe harbor would not apply as the tax was not imposed by a state.

2. The Department's Interpretation is Contrary to the Plain Language of the Statute

The Department incorrectly asserts that the Subject to Tax safe harbor "only applies to that portion of the related member's taxable income that is apportioned to – and therefore taxed by – one or more different

states." Dept. Br., p. 8. Again, the Department fails to cite to any language in the statute to support its position. See Dept. Br., pp. 8, 12-15.

Instead, the Department relies on its own tax forms for support. Id., p. 18. It is unsurprising that the Department's tax forms, which merely reflect the Department's interpretation, support its position. Such forms are issued and created by the Department – not the General Assembly. See Va. Code § 58.1-205 (stating that administrative interpretations "shall be accorded no weight").

In rewriting the statutory language, the Department adds the requirement that royalties that are "subject to tax" must also be "apportioned" in order to qualify for the Subject to Tax safe harbor. Dept. Br., pp. 13-15. However, the statutory language does not contain any apportionment requirement. See Va. Code § 58.1-402.B.8.a. The Department is prohibited from reading words into a statute that is plain and unambiguous. Shelor Motor Co. v. Miller, 261 Va. 473, 479, 544 S.E.2d 345, 349 (2001) (stating that courts "are not permitted to add language to a statute") (internal citations omitted); Gen. Elec. Co., 236 Va. at 64, 372 S.E.2d at 605 (stating that statutes "should not be extended by implication beyond the clear import of the language used"). The statutory language

does not contain any requirement of apportionment. Va. Code § 58.1-402.B.8.a. The Department is incorrect.[3]

Moreover, the Department's protesting about the constitutional restrictions is without merit. See Dept. Br., pp. 13-15. Apportionment is the division of the tax base (i.e., taxable income). The constitutional restraints on apportionment come into play only after taxable income is computed. See Hellerstein & Hellerstein, STATE TAXATION ¶ 8.02 (3d ed. 2012). Apportionment is not used to determine the amount of other addbacks nor deductions to Virginia taxable income. Va. Code § 58.1-402. Thus, it is not appropriate to require apportionment in calculating the Subject to Tax safe harbor.

The Department attempts to summarily dispense with the Circuit Court for the City of Richmond's decision in Wendy's International, Inc. v. Department of Taxation. Dept. Br., p. 25. Contrary to the Department's claims, Virginia Code Section 58.1-402.B.8.a must be read in its entirety.

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[3] The Department relies on the U.S. Supreme Court's decision in Goldberg v. Sweet, 488 U.S. 252, 260-61, 109 S. Ct. 582, 588-89 (1989), to support its assertion that the tax rate is applied "against the amount that is 'subject to tax' after applying apportionment." Dept. Br., p. 17 n. 3. However, that case contains no such proposition – and, instead, supports Kohl's. Goldberg, 488 U.S. at 260-61, 109 S. Ct. at 588-89. In referencing "subject to tax," the Supreme Court referenced "Illinois residents who are subject to and have paid telecommunications taxes." 488 U.S. at 257, 109 S. Ct. at 586 (emphasis added). Therefore, the Supreme Court considers income that is "subject to tax" to be separate from income that is "actually taxed."

Bd. of Dirs. of Colchester Towne Condo. Council of Co-Owners v. Wachovia Bank, N.A., 266 Va. 46, 51, 581 S.E.2d 201, 203 (2003) (stating that "[u]nder basic rules of statutory construction, we examine the language of a statute in its entirety") (emphasis added). The Circuit Court's analysis of the Conduit safe harbor in Virginia Code Section 58.1-402.B.8.a(3) is, therefore, relevant to the application of the Subject to Tax safe harbor. See Wendy's Int'l, Inc. v. Dep't of Taxation, 84 Va. Cir. 398, 399-400 (2012), pet. for appeal denied, Record No. 121184 (Va. Nov. 20, 2012).

In accordance with Wendy's, when a safe harbor applies to only a portion of the royalties – as in the Conduit safe harbor – the General Assembly clearly stated "such portion" in the statute. Va. Code § 58.1-402.B.8.a(3). Similarly, when the safe harbor is to apply to all of the royalties if the statutory conditions are satisfied – as in the Subject to Tax and the Franchisor safe harbors – the General Assembly clearly so stated in the statute and the words "such portion" do not appear. Va. Code §§ 58.1-402.B.8.a(1) and (2).

The Department's interpretation conflicts with the plain meaning of the statute. Therefore, the Circuit Court's Order should be reversed.

C. The Department's Interpretation Conflicts With Its Long-Standing Regulation that Tax Does Not Actually Need to be Imposed to be Subject to Tax

Without support, the Department claims that its interpretation of the Subject to Tax safe harbor is long-standing. Dept. Br., p. 8. However, the Department has failed to issue any regulations to this effect. Quite the contrary, the Department's regulation defining "subject to tax" directly contradicts the Department's current position. 23 Va. Admin. Code § 10-120-120.

Pursuant to the Department's regulation, a corporation is subject to tax if another state has jurisdiction to tax "whether or not such other state actually imposes" the tax. Id. While the Department spends pages distinguishing corporations from income, such distinctions are irrelevant. See Dept. Br., pp. 19-22. Instead, it is the aspect of the regulation that a corporation is subject to tax whether or not the tax is actually imposed that is key. Yet, the Department fails to even address this element. See id.

In accordance with the Department's own long-standing regulation, as with corporations, royalties do not actually have to be taxed in order to be "subject to tax." Therefore, the Circuit Court's Order should be reversed.

D. The Legislative Intent Does Not Support the Department's Interpretation

As demonstrated above, Kohl's Illinois is not an intangible holding company upon which the General Assembly frowned and the Department's assertions to the contrary fall flat. See Dept. Br., pp. 6, 26-29. Therefore, the General Assembly was not seeking to preclude companies like Kohl's from qualifying for the Subject to Tax safe harbor.

Moreover, the Department incorrectly accuses Kohl's of confusing the two issues to be remedied. Id., p. 28. However, in discussing intangible holding companies, the Fiscal Impact Statement provides that

> [t]he add-back would not be required if in the same taxable year of the payment the item of income received by the related member is subject to a tax on or measured by the related member's net income in any state of the United States or a foreign country that has an income tax treaty in force with the United States.

R191 (Fiscal Impact Statement, HB 1079 (2004 General Session), p. 5) (emphasis added). Therefore, as correctly stated by Kohl's, the General Assembly's intent was to prevent income from escaping taxation that was not subject to a tax in "any state." Id.

As the Department conceded, the royalties that Kohl's paid to Kohl's Illinois were subject to tax in numerous states. (JA032, ¶ 26.) Thus, Kohl's qualifies for the Subject to Tax safe harbor.

E. The Alabama Decision is Not "Persuasive Precedent" in Virginia

The Department devotes a significant portion of its brief to broadly discussing the Alabama decision in Surtees v. VFJ Ventures, Inc., 8 So. 3d 950 (Ala. Civ. App. 2008), which it incorrectly alleges is "persuasive precedent." Dept. Br., pp. 29-33. While the Department details the facts in the case, it fails to address the language of the Alabama statute and its significant differences from the Virginia statute. Id.

First, the Alabama statute defined "subject to a tax based on or measured by the related member's net income." Ala. Code § 40-18-35(b)(1). The Virginia statute provides no similar definition. Va. Code § 58.1-402.B.8.a(1).

Second, the Alabama statute does not contain a safe harbor, but instead specifically limits the addback "to the extent" that such exception applies. Ala. Code § 40-18-35(b)(1). The Virginia statute does not contain any comparable limiting language. Va. Code § 58.1-402.B.8.a(1).

It is these very differences in the Alabama statute that the Alabama court relied upon in issuing its decision. VFJ Ventures, 8 So. 3d at 975. Instead of addressing these differences, the Department states the specific language of the statutes should be ignored and instead this Court should rely on the "logic" of the Alabama decision. Dept. Br., p. 33. However,

Virginia law requires that the language of the statute prevail. Virginia Cellular LLC v. Virginia Dep't of Taxation, 276 Va. 486, 490, 666 S.E.2d 374, 376 (2008) (stating that "courts must apply the plain language of a statute").

Therefore, the Alabama decision interpreting significantly different statutory language is not "persuasive precedent" and does not evidence the intent of the Virginia General Assembly. See Dept. Br., pp. 29, 33.

F. The Department Fails to Refute Kohl's' Alternative Argument

Kohl's asserts that if the Department's interpretation is correct, then the Department incorrectly computed the amount of the Subject to Tax safe harbor. See Opening Br., pp. 27-33.

The Subject to Tax safe harbor applies if the "corresponding item of income received by the related member is subject to a tax." Va. Code § 58.1-402.B.8.a(1) (emphasis added). The Department incorrectly interprets that provision to mean that the related member must be subject to tax. Dept. Br., p. 34. However, the statute plainly states that it is the income that must be subject to tax, not the related member. Va. Code § 58.1-402.B.8.a(1). Therefore, the Subject to Tax safe harbor applies to the royalty amounts that were taxed in the Addback States and the Combined Return States.

The Department disputes whether the royalties were actually taxed by the Addback States and the Combined Return States. Dept. Br., pp. 35-36. However, the Department stipulated that the royalties were included in net income in the Addback States and that Kohl's Illinois was included in the Combined Return States. (JA030, ¶ 17; JA031, ¶20; JA032, ¶ 29.) Furthermore, the tax returns substantiate that tax was paid in those states. (SJA003-085; SJA146-747.) Thus, the Department's arguments are without merit.

Therefore, in the alternative, the Circuit Court's Order should be vacated and the case should be remanded to the Circuit Court for calculation of the royalties that were actually taxed in the Addback States and the Combined Return States.

Respectfully submitted,

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CERTIFICATE

Pursuant to the Rules of the Supreme Court of Virginia, counsel for the Appellant certifies the following:

1. Pursuant to Rule 5:26(h) this Reply Brief complies with Rule 5:26(b) by containing no more than 15 pages.

2. On January 17, 2017, ten bound copies of the Reply Brief were hand-filed with the Clerk of the Supreme Court of Virginia, along with one electronic version submitted via the Virginia Appellate Court eBrief System (VACES).

3. On January 17, 2017, one electronic version of the Reply Brief was served via email on counsel for Appellee.

4. On January 17, 2017, one electronic version of the Reply Brief was served via email on counsel for *amicus curiae* Michael Baker Jr., Inc.

Counsel for Appellant

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