
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.

OPENING BRIEF

Craig B. Fields (Admitted *pro hac vice*)

Mitchell A. Newmark

(Admitted *pro hac vice*)

Nicole L. Johnson (Admitted *pro hac vice*)

Morrison & Foerster LLP

250 West 55th Street

New York, NY 10019

Telephone: (212) 468-8000

Facsimile: (212) 468-7900

CFields@mofo.com

MNewmark@mofo.com

NJohnson@mofo.com

William L.S. Rowe (VSB No. 13728)

William H. Wright, Jr.

(VSB No. 25576)

Hunton & Williams LLP

Riverfront Plaza, East Tower

951 East Byrd Street

Richmond, VA 23219

Telephone: (804) 788-8200

Facsimile: (804) 788-8218

WRowe@Hunton.com

CWright@Hunton.com

Counsel for Kohl's Department Stores, Inc.

TABLE OF CONTENTS

	<u>Page</u>
TABLE OF AUTHORITIES.....	iii
I. STATEMENT OF THE CASE	1
II. MATERIAL PROCEEDINGS	3
III. ASSIGNMENT OF ERROR	5
IV. STATEMENT OF FACTS	5
A. Operations of Kohl’s and Kohl’s Illinois.....	5
B. Income Tax Filings of Kohl’s.....	6
C. Income Tax Filings of Kohl’s Illinois.....	8
D. Income Tax Filings of Kohl’s and Kohl’s Illinois.....	8
V. ARGUMENT	10
A. Kohl’s’ Interpretation of the Subject to Tax Safe Harbor Respects the Rules of Statutory Construction	10
1. Standard of Review	10
2. Computation of Virginia Taxable Income	10
3. Rules of Statutory Construction.....	12
4. Kohl’s’ Interpretation is Consistent with the Plain Meaning of the Statute	12
5. The Department’s Regulation Confirms that the Royalties Were “Subject to Tax”	15
6. When the Three Safe Harbors Are Read Together, It is Clear that the Royalties Do Not Need to be Actually Taxed to Qualify for the Subject to Tax Safe Harbor	17

B.	The Circuit Court’s Interpretation of the Subject to Tax Safe Harbor is Not Supported by the Statute or the General Assembly’s Intent in Enacting the Statute.....	20
1.	Standard of Review	20
2.	The Circuit Court’s Interpretation Contradicts the Plain Language of the Statute	20
3.	The Circuit Court’s Interpretation Exceeds the Stated Purpose of the Legislation	22
4.	The Circuit Court’s Reliance on the Alabama Decision is Misplaced.....	24
C.	The Circuit Court Erred When it Failed to Find that the Department Incorrectly Calculated the Amount of the Subject to Tax Safe Harbor Under Kohl’s Alternative Argument	27
1.	Standard of Review	27
2.	The Circuit Court Failed to Address Kohl’s’ Alternative Argument.....	28
3.	The Royalties Were Actually Taxed in the Addback States	29
4.	The Royalties Were Actually Taxed in the Combined Return States	31
VI.	CONCLUSION	33

TABLE OF AUTHORITIES

	<u>Page(s)</u>
<u>Cases</u>	
<u>Allied-Signal, Inc. v. Director, Div. of Taxation,</u> 504 U.S. 768, 112 S. Ct. 2251 (1992)	17
<u>Bd. of Dirs. of Colchester Towne Condo. Council of Co-Owners v.</u> <u>Wachovia Bank, N.A.,</u> 266 Va. 46, 581 S.E.2d 201 (2003)	17-18
<u>Commonwealth, Dep't of Taxation v. Champion Int'l Corp.,</u> 220 Va. 981, 265 S.E.2d 720 (1980)	16
<u>Commonwealth, Dep't of Taxation v. Delta Air Lines, Inc.,</u> 257 Va. 419, 513 S.E.2d 130 (1999)	12
<u>Commonwealth v. Barker,</u> 275 Va. 529, 659 S.E.2d 502 (2008)	10, 20
<u>Commonwealth v. Gen. Elec. Co.,</u> 236 Va. 54, 372 S.E.2d 599 (1988)	10, 13
<u>Dykes v. Friends of the C.C.C. Road,</u> 283 Va. 306, 720 S.E.2d 537 (2012)	27
<u>Hubbard v. Henrico Ltd. P'ship.,</u> 255 Va. 335, 497 S.E.2d 335 (1998)	12, 21
<u>Indus. Dev. Auth. of the City of Roanoke v. Bd. of Supervisors,</u> <u>Montgomery Cnty.,</u> 263 Va. 349, 559 S.E.2d 621 (2002)	20
<u>Ragan v. Woodcroft Village Apts.,</u> 255 Va. 322, 497 S.E.2d 740 (1998)	17
<u>Signal Corp. v. Keane Fed. Sys., Inc.,</u> 265 Va. 38, 574 S.E.2d 253 (2003)	12
<u>Surtees v. VFJ Ventures, Inc.,</u> 8 So. 3d 950 (Ala. Civ. App. 2008), <u>aff'd sub nom.</u> , 8 So. 3d 983 (Ala. 2008)	24, 26, 27

<u>Wendy’s Int’l, Inc. v. Dep’t of Taxation,</u> 84 Va. Cir. 398 (2012), <u>pet. for appeal denied</u> , Record No. 121184 (Va. Nov. 20, 2012)	18, 19
--	--------

Statutes and Regulations

Ala. Code § 40-18-35(b)(1)	24, 25
D.C. Code § 47-1803.03(d)(7)(B).....	25
Del. Code. Ann. tit. 30, § 1902(b)(8)	22
I.R.C. § 63	10
I.R.C. § 162(a).....	10
I.R.C. § 162(a)(3)	10
Md. Code Ann., Tax-Gen. § 10-306.1(c).....	25
N.C. Gen. Stat. § 105-130.7A(a).....	30
Va. Code § 58.1-302	26
Va. Code § 58.1-402	10
Va. Code § 58.1-402.B.8.a.....	passim
Va. Code § 58.1-402.B.8.a(1)	passim
Va. Code § 58.1-402.B.8.a(2)	18, 19
Va. Code § 58.1-402.B.8.a(3)	19
Va. Code § 58.1-406	13
23 Va. Admin. Code § 10-120-120.....	15, 16
23 Va. Admin. Code § 10-120-120(B)(2)	2, 13, 15, 25

Other Authorities

Black’s Law Dictionary (9th ed. 2009)..... 13

Fiscal Impact Statement, HB 1079 (2004 General Session)..... 22, 23, 26

Oxford English Dictionary (3d ed. 2004), available at
<http://www.oed.com/view/Entry/198263?redirectedFrom=taxable#e>
id (as of Dec. 5, 2016) 13

I. STATEMENT OF THE CASE

The plain language of the Virginia tax law provides that royalties paid to an affiliate (called a “related member” in the statute) are not required to be added back to a corporation’s taxable income if the royalties are “subject to a tax based on or measured by net income or capital imposed by Virginia, another state, or a foreign government.” Va. Code § 58.1-402.B.8.a (containing the “Subject to Tax” safe harbor). The statutory language is plain and unambiguous.

Under the plain wording of this statute, the corporation is not required to add back the royalties it paid to a related member if: (1) the royalties are subject to a tax; (2) based on or measured by net income or capital; (3) imposed by Virginia, another state or a foreign government.

As conceded by the Department of Taxation (“Department”), the royalties that Kohl’s Department Stores, Inc. (“Kohl’s”) paid its affiliate, Kohl’s Illinois, Inc. (“Kohl’s Illinois”), were subject to tax in numerous states that imposed a tax on net income. Therefore, Kohl’s is not required to add back the royalties to its federal taxable income in calculating its Virginia taxable income.

This conclusion is consistent with the Department’s long-standing regulation, which provides that a corporation is subject to a tax if another

state has jurisdiction to tax. 23 Va. Admin. Code § 10-120-120(B)(2). The Department's regulation specifically states that a tax does not need to actually be imposed to be subject to tax. Id.

Notwithstanding the clarity of the statute, the Circuit Court added another requirement to the statute: that the royalties must actually be taxed in other states (i.e., that the royalties be subjected to tax as opposed to only being subject to tax) in order to qualify for the Subject to Tax safe harbor. The Circuit Court's interpretation improperly limits the safe harbor to only the portion of the royalties that were subjected to tax.

In addition, the Circuit Court failed to address Kohl's' alternative argument that the Department erred in calculating the safe harbor amount. The Subject to Tax safe harbor provides that royalties shall not be included in a corporation's Virginia taxable income if the income is subject to a tax. Va. Code § 58.1-402.B.8.a(1). Thus, the statute only requires that the royalties be subject to a tax imposed by another state, not that the recipient of the royalties be subject to tax.

Kohl's now seeks reversal, in whole or in part, of the Circuit Court's Opinion and Order ("Order").

II. MATERIAL PROCEEDINGS

Kohl's timely filed its Virginia Corporation Income Tax Returns. (Joint Appendix ("JA") 029, ¶ 11.) In calculating its Virginia taxable income for the tax year ended January 31, 2009, Kohl's did not add back the royalties that it paid to Kohl's Illinois to its federal taxable income. (JA030, ¶ 12.)

In calculating its Virginia taxable income for the tax year ended January 30, 2010, Kohl's added back to its federal taxable income a portion of the royalties that it paid to Kohl's Illinois. (JA030, ¶ 13.) Kohl's then timely filed a refund claim for \$460,100 on the grounds that, for purposes of calculating its Virginia taxable income, Kohl's was not required to add back any of the royalties that it paid to Kohl's Illinois. (JA030, ¶¶ 14, 15.)

The Department audited Kohl's' Virginia Corporation Income Tax Returns. (JA032, ¶ 31.) On February 11, 2011, the Department issued Notices of Assessment to Kohl's. (JA032-33, ¶ 32, 33.)

For each of the tax years ended January 31, 2009 and January 30, 2010 ("Years in Issue"), the Department added back some of the royalties that Kohl's paid to Kohl's Illinois in calculating Kohl's' Virginia taxable income (i.e., Kohl's was not allowed to deduct all of the royalties in calculating its Virginia taxable income). (JA033, ¶¶ 34, 35.) Further, the safe harbor amount calculated by the Department included only a portion of

those royalties that were actually taxed (i.e., only the royalties that were actually taxed in Arkansas, Iowa, Louisiana, New Jersey, New Mexico, North Carolina, Oklahoma and South Carolina). (JA033, ¶ 35.)

Kohl's timely applied to the State Tax Commissioner for a correction of the Notices of Assessment. (JA033, ¶ 36.) On October 27, 2011, the State Tax Commissioner issued a letter upholding the Notices of Assessment. (JA033, ¶ 37; JA044-048.) On November 10, 2011, the Department issued a Bill Detail Information for each of the Years in Issue. (JA033-34, ¶ 38; JA049-052.)

Kohl's appealed to the Circuit Court for the City of Richmond on April 16, 2012. Both parties filed Motions for Summary Judgment on November 13, 2015. The Honorable Walter W. Stout, III issued an Order on February 3, 2016 granting Defendant's Motion for Summary Judgment and denying Kohl's Motion for Summary Judgment.

On March 1, 2016, Kohl's timely filed a Notice of Appeal. Kohl's filed its Petition for Appeal on May 3, 2016. The Department filed its Brief in Opposition on May 24, 2016.

On October 31, 2016, this Court awarded Kohl's an appeal. This Opening Brief follows.

III. ASSIGNMENT OF ERROR

1. The Circuit Court erred in granting the Department's Motion for Summary Judgment when it ruled that royalties must actually be taxed by another state to qualify for the Subject to Tax safe harbor. Kohl's preserved this error during the oral argument on the parties' Motions for Summary Judgment. (JA066, lines 2-25; JA067, lines 1-25; JA068, lines 1-21; see also Record ("R") 202, 206-233.)

2. The Circuit Court erred in denying Kohl's Motion for Summary Judgment when it ruled that royalties must actually be taxed by another state to qualify for the Subject to Tax safe harbor. Kohl's preserved this error during the oral argument on the parties' Motions for Summary Judgment. (JA064, lines 13-25; JA065, lines 1-25; see also R202, 206-233.)

3. The Circuit Court erred in denying Kohl's Motion for Summary Judgment when it failed to address Kohl's alternative argument that the royalties that Kohl's paid to Kohl's Illinois were actually taxed in the Addback States and the Combined Return States. Kohl's preserved this error during the oral argument on the parties' Motions for Summary Judgment. (JA074, lines 1-25; JA075, lines 1-7; see also R203, 206-233.)

IV. STATEMENT OF FACTS¹

The material facts are not in dispute. The parties have stipulated to the following facts and have agreed that the documents referred to are true and accurate copies.

A. Operations of Kohl's and Kohl's Illinois

Kohl's, a Delaware corporation with its principal place of business in Wisconsin, is engaged in the business of operating retail stores throughout

¹ Unless indicated to the contrary, all facts relate to the Years in Issue.

the United States, including stores in Virginia. (JA028, ¶ 1; JA029, ¶ 2.) A variety of clothing and household goods are sold at Kohl's' retail stores.

(JA029, ¶ 2.)

Kohl's Illinois, a subsidiary of Kohl's, is a Nevada corporation with its principal place of business in Illinois. (JA029, ¶ 4.) Kohl's Illinois is engaged in the businesses of operating retail stores and of managing, protecting, utilizing and licensing intellectual property that it owns (the "Intellectual Property"). (JA029, ¶¶ 5, 7.) Kohl's Illinois did not operate any retail stores in Virginia. (JA029, ¶ 6.) Kohl's Illinois had substantial business operations. It paid salaries of between \$395 million and \$430 million for the Years in Issue. (Supplemental Joint Appendix ("SJA") 086-145.) In addition, Kohl's Illinois paid rent of between \$116 million and \$139 million and paid utilities of over \$40 million for each of the Years in Issue. Id.

Kohl's Illinois licensed the right to use the Intellectual Property to Kohl's. (JA029, ¶ 8.) As a result, Kohl's paid royalties to Kohl's Illinois for the use of the Intellectual Property. (JA029, ¶ 9.)

B. Income Tax Filings of Kohl's

In calculating its federal taxable income, Kohl's deducted the royalties that it paid to Kohl's Illinois as ordinary and necessary business expenses.

(JA029, ¶ 10.) Similarly, Kohl's deducted its other expenses, including its payroll, rent and advertising, as ordinary and necessary business expenses. (SJA044-085.)

As a result of its business activities, Kohl's filed income tax returns in a number of jurisdictions. (JA030, ¶ 16.) In calculating its taxable income in Connecticut, Maryland and Massachusetts, Kohl's was required to add back, and did so add back, all of the royalties that it paid to Kohl's Illinois. (JA030, ¶ 17; SJA003-018, 028-043.)²

In calculating its taxable income in Georgia and New Jersey, Kohl's was required to add back, and did so add back, a portion of the royalties that it paid to Kohl's Illinois. (JA031, ¶ 18; SJA019-027, 044-085.)

Consequently, by including the royalties in Kohl's' taxable income, tax was paid on the royalties that Kohl's Illinois received from Kohl's in each of the following states: Connecticut, Georgia, Maryland, Massachusetts and New Jersey (collectively, the "Addback States"). (See JA030, ¶ 17; JA031, ¶ 18; SJA003-085.)

Each of the Addback States imposed a tax based on or measured by net income or capital. (JA031, ¶ 19; SJA003-085.)

² For the tax year ended January 31, 2009, Kohl's filed a separate return in Massachusetts. For the tax year ended January 30, 2010, Kohl's and Kohl's Illinois were included in a combined return that was filed in Massachusetts. (SJA036-043, 321-354.)

C. Income Tax Filings of Kohl's Illinois

In calculating its federal taxable income, Kohl's Illinois included the royalties that it received from Kohl's. (JA031, ¶ 20; SJA086-145.)

As a result of its business activities, Kohl's Illinois filed tax returns in Arkansas, Florida, Iowa, Louisiana, New Jersey, New Mexico, North Carolina, Oklahoma and South Carolina (collectively, the "Separate Return States"). (JA031, ¶ 21.)

The royalties that Kohl's Illinois received from Kohl's were included in Kohl's Illinois' taxable income in each of the Separate Return States. (JA031, ¶ 23.) Consequently, tax was paid the royalties that Kohl's Illinois received from Kohl's in the Separate Return States. (JA031, ¶ 23; JA032, ¶ 26.)

Each of the Separate Return States imposed a tax based on or measured by net income or capital. (JA032, ¶ 25.)

The Department concedes that the "royalties that Kohl's Illinois received from Kohl's were subject to a tax based on or measured by net income or capital in each of the Separate Return States." (JA032, ¶ 26.)

D. Income Tax Filings of Kohl's and Kohl's Illinois

In addition to the Separate Return States, Kohl's Illinois was included in combined tax returns filed in Alaska, California, Idaho, Illinois, Kansas,

Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Utah, Vermont, West Virginia and Wisconsin (collectively, the “Combined Return States”). (JA032, ¶¶ 27, 29; SJA146-747.)

A combined return is a method of reporting the tax due for two or more affiliated entities to a state. (See JA032, ¶ 28.) The taxable incomes of the corporations are added together to form the taxable income of the combined group in that state.

Kohl’s Illinois’ taxable income, which included the royalties that it received from Kohl’s, was included in the combined taxable income in each of the Combined Return States. (SJA146-747.) Consequently, tax was paid on the royalties that Kohl’s Illinois received from Kohl’s in the Combined Return States. (Id.)

Each of the Combined Return States imposed a tax based on or measured by net income or capital. (JA032, ¶ 30; SJA146-747.)

V. ARGUMENT

A. Virginia Code Section 58.1-402.B.8.a is Plain and Unambiguous

1. Standard of Review

This argument relates to assignments of error one and two and presents a matter of statutory interpretation that is reviewed de novo.

Commonwealth v. Barker, 275 Va. 529, 536, 659 S.E.2d 502, 504-05 (2008).

2. Computation of Virginia Taxable Income

A corporation computes its Virginia income tax liability by starting with its federal taxable income. Va. Code § 58.1-402; Commonwealth v. Gen. Elec. Co., 236 Va. 54, 62, 372 S.E.2d 599, 604 (1988). Federal taxable income begins with a corporation's gross income and is reduced by its ordinary and necessary business expenses. I.R.C. §§ 63, 162(a). A corporation's expenses include the royalties that it pays to affiliated entities. See I.R.C. § 162(a)(3). In computing its Virginia taxable income, additions and subtractions are made to a corporation's federal taxable income. Va. Code § 58.1-402.

In certain circumstances, one adjustment to arrive at Virginia taxable income is the addition of royalties paid to a related member that were deducted in computing federal taxable income. Va. Code § 58.1-402.B.8.a.

However, this addition is not made if any of three statutory safe harbors applies. Id. The safe harbor provisions are 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 [the Subject to Tax safe harbor];

(2) The related member derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members, and the transaction giving rise to the expenses and costs between the corporation and the related member was made at rates and terms comparable to the rates and terms of agreements that the related member has entered into with parties who are not related members for the licensing of intangible property [the Franchisor safe harbor]; or

(3) The corporation can establish to the satisfaction of the Tax Commissioner that the intangible expenses and costs meet both of the following: (i) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person who is not a related member, and (ii) the transaction giving rise to the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any portion of the tax due under this chapter [the Conduit safe harbor].

Va. Code § 58.1-402.B.8.a. (emphasis added).

3. Rules of Statutory Construction

In interpreting a statute, when the statutory language is “clear on its face, this Court will look no further than the plain meaning of the statute’s words.” Commonwealth, Dep’t of Taxation v. Delta Air Lines, Inc., 257 Va. 419, 426, 513 S.E.2d 130, 133 (1999). In addition, “every part of a statute is presumed to have some effect and no part will be considered meaningless unless absolutely necessary.” Hubbard v. Henrico Ltd. P’ship., 255 Va. 335, 340, 497 S.E.2d 335, 338 (1998).

Moreover, “courts are required to apply the plain meaning of statutes, and...are not free to add language, nor to ignore language, contained in statutes.” Signal Corp. v. Keane Fed. Sys., Inc., 265 Va. 38, 46, 574 S.E.2d 253, 257 (2003).

4. Kohl’s’ Interpretation is Consistent with the Plain Meaning of the Statute

The Subject to Tax safe harbor provides that royalties paid to a related member that were subject to a tax by another state are not added to federal taxable income if that state imposes a tax that is based on or measured by net income or capital. Va. Code § 58.1-402.B.8.a(1).

Therefore, for the safe harbor to apply: (1) the income must be subject to a

tax; (2) based on or measured by net income or capital; (3) imposed by another state.³ Id.

The statute does not define “subject to a tax.” See Va. Code § 58.1-402.B.8.a(1). Black’s Law Dictionary defines the term “taxable” as “[s]ubject to taxation.” Black’s Law Dictionary 1598 (9th ed. 2009). The Oxford English Dictionary defines “taxable” as “subject to a tax.” Oxford English Dictionary (3d ed. 2004), available at <http://www.oed.com/view/Entry/198263?redirectedFrom=taxable#eid> (as of Dec. 5, 2016). Thus, the plain and ordinary meaning of income being “subject to a tax” is that the income is “taxable.” See e.g., Gen. Elec. Co., 236 Va. at 65, 372 S.E.2d at 606 (relying on the dictionary definition of “improperly” in construing the statute at issue); see also 23 Va. Admin. Code § 10-120-120(B)(2) (as discussed infra p. 15 defining “subject to tax” the same way).

In Virginia, income is subject to a tax (i.e., taxable) if it is included in the computation of Virginia taxable income. Va. Code § 58.1-406. Thus, under the plain and ordinary meaning of the Subject to Tax safe harbor, if

³ Although the Subject to Tax safe harbor also applies to royalties that were subject to a tax in Virginia and certain foreign governments, the royalties that Kohl’s paid to Kohl’s Illinois were not subject to those taxes. Therefore, those provisions are not at issue in this appeal.

income (e.g., royalties) is included in the computation of a corporation's taxable income in another state, then that income is subject to a tax.

In this case, Kohl's Illinois filed income tax returns in each of the Separate Return States. (JA031, ¶ 21.) In computing its taxable income in each of those states, Kohl's Illinois included all of the royalties that it received from Kohl's. (JA031, ¶ 23.) Further, the Separate Return States each imposed a tax based on or measured by net income or capital. (JA032, ¶ 25.)

Indeed, the Department explicitly conceded that “[t]he royalties that Kohl's Illinois received from Kohl's were subject to a tax based on or measured by net income or capital in each of the Separate Return States.” (JA032, ¶ 26.) The Department did not limit its concessions to only those royalties for which tax was actually imposed. Further, the Department conceded that “[e]ach of the Separate Return States imposes a tax based on or measured by net income or capital.” (JA032, ¶ 25.)

The Department's factual concessions and the plain language of the Subject to Tax safe harbor establish that the royalties that Kohl's paid to Kohl's Illinois qualify for the Subject to Tax safe harbor. See Va. Code § 58.1-402.B.8.a(1). Therefore, the Circuit Court erred when it failed to grant Kohl's' Motion for Summary Judgment, it erred when it granted the

Department's Motion for Summary Judgment and the Order should be reversed.

5. The Department's Own Regulation Confirms that the Royalties Were "Subject to Tax"

In 1985, the Department promulgated a regulation that determines when a corporation is subject to tax in another state. 23 Va. Admin. Code § 10-120-120. The Department defines "subject to tax" as follows:

A corporation is "subject to" one of the taxes [e.g., tax imposed on net income, tax measured by net income]...if it carries on sufficient business activity within any other state so that the other state has jurisdiction to impose one of the enumerated taxes, whether or not such other state actually imposes one of the enumerated taxes.

Id. at (B)(2).

As the Department states in its regulation, actually being taxed is not required in order to meet the definition of "subject to tax." Id. Instead, only the ability (i.e., jurisdiction) to impose a tax on a corporation is necessary. Similarly, a State has the ability (i.e., jurisdiction) to impose a tax on income if there are sufficient contacts between that income and the State.

Applying the Department's own definition of "subject to tax" to the income at issue in this case, the royalties are subject to tax if another state has the ability to tax the royalties. The interpretation of "subject to tax" for

purposes of the Subject to Tax safe harbor should align with the Department's definition provided in its regulation.

Further, the Department's regulation was in place for almost 20 years before the General Assembly enacted the Subject to Tax safe harbor. 23 Va. Admin. Code § 10-120-120 (effective January 1, 1985); Va. Code § 58.1-402.B.8.a(1) (effective January 1, 2004). Consequently, the General Assembly was aware of the Department's definition of "subject to tax" and chose not to amend that definition for purposes of the Subject to Tax safe harbor. Commonwealth, Dep't of Taxation v. Champion Int'l Corp., 220 Va. 981, 992, 265 S.E.2d 720, 726 (1980) (stating that "[i]f the interpretation placed upon a statute by those charged with its enforcement has continued for a long period of time, it is presumed the legislature has acquiesced in the interpretation").

In this case, Kohl's Illinois was subject to tax in each of the Separate Return States inasmuch as Kohl's Illinois was required to file, and did so file, returns in each of those states. Furthermore, Kohl's Illinois included the royalties that it received from Kohl's in the computation of Kohl's Illinois' taxable income in each of the Separate Return States. Indeed, if the Separate Return States did not have jurisdiction over the royalties, then the royalties could not have been included in Kohl's Illinois' taxable income in

those states. See Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 778, 112 S. Ct. 2251, 2258 (1992). It is undisputed that the royalties were properly included in taxable income. Significantly, the Department concedes that the royalties were subject to tax in each of the Separate Return States. (JA032, ¶ 26.)

Moreover, the definition of “subject to tax” should not be altered solely for purposes of the safe harbor. See Ragan v. Woodcroft Village Apts., 255 Va. 322, 325, 497 S.E.2d 740, 742 (1998) (stating that statutes will be accorded “a meaning that does not conflict with any other statute”).

Therefore, in accordance with the Department’s own regulation and its concessions, the royalties were subject to tax and Kohl’s qualifies for the Subject to Tax safe harbor and is not required to add back any portion of the royalties.

6. When the Three Safe Harbors Are Read Together, It is Clear that the Royalties Do Not Need to be Actually Taxed to Qualify for the Subject to Tax Safe Harbor

When the entire subdivision of Virginia Code Section 58.1-402.B.8.a is read together, as it is required to be read, it is clear that once a taxpayer demonstrates that it meets the Subject to Tax safe harbor then no addition to federal taxable income is required. See 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 and determine the intent of the General Assembly from the words contained in the statute.”) (emphasis added).

Virginia Code Section 58.1-402.B.8.a sets forth two safe harbors in addition to the Subject to Tax safe harbor (i.e., the Franchisor safe harbor and the Conduit safe harbor) whereby royalties are not required to be added to federal taxable income in calculating a corporation’s Virginia taxable income.

The Franchisor safe harbor provides that no addition to federal taxable income is required if at least one-third of the royalty income received by the related member comes from unrelated third-parties. Va. Code § 58.1-402.B.8.a(2). Neither this safe harbor, nor the Subject to Tax safe harbor, requires any proration of the amounts not required to be added to federal taxable income in calculating Virginia taxable income if the statutory condition is satisfied. Va. Code §§ 58.1-402.B.8.a(1) and (2).

In Wendy’s International, Inc. v. Department of Taxation, the Circuit Court of the City of Richmond confirmed that the Franchisor safe harbor applied to all of the royalties, not merely a portion, when the statutory conditions were satisfied. 84 Va. Cir. 398, 399 (2012), pet. for appeal

denied, Record No. 121184 (Va. Nov. 20, 2012). This Court refused an appeal in that case. Wendy's, pet. for appeal denied, Record No. 121184 (Va. Nov. 20, 2012) (stating that “the Court is of opinion there is no reversible error in the judgment complained of”).

In direct contrast to the language of the first two safe harbors, the Conduit safe harbor requires that, in calculating Virginia taxable income, the corporation add to its federal taxable income “such portion” of the subject intangible expenses that were not paid by the related member to a third-party. Va. Code § 58.1-402.B.8.a(3) (emphasis added). The statute specifically limits this safe harbor to only a portion of the royalties that were paid to a related member. Id.

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. Id. Thus, when the safe harbor is to apply to all of the royalties if the statutory conditions are satisfied -- as in the Subject to Tax safe harbor and the Franchisor safe harbor -- 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). It is a cardinal rule of statutory construction that “when the General Assembly includes specific language in one section of an act, but omits that language from another section, [the

court will] presume that the exclusion of the language was intentional.”

Indus. Dev. Auth. of the City of Roanoke v. Bd. of Supervisors,

Montgomery Cnty., 263 Va. 349, 353, 559 S.E.2d 621, 623 (2002).

Therefore, in accordance with the plain meaning of the statute, Kohl’s qualifies for the Subject to Tax safe harbor and the Circuit Court’s Order should be reversed.

B. The Circuit Court’s Interpretation of the Subject to Tax Safe Harbor is Not Supported by the Statute or the General Assembly’s Intent in Enacting the Statute

1. Standard of Review

This argument also relates to assignments of error one and two and presents a matter of statutory interpretation that is reviewed de novo.

Barker, 275 Va. at 536, 659 S.E.2d at 504-05.

2. The Circuit Court’s Interpretation Contradicts the Plain Language of the Statute

For the Subject to Tax safe harbor to apply: (1) the income must be subject to a tax; (2) based on or measured by net income or capital; (3) imposed by another state. Va. Code § 58.1-402.B.8.a(1).

Contrary to the plain language of the statute, the Circuit Court added a fourth requirement that the tax must actually be imposed on the royalties. Order, pp. 3, 4. Specifically, the court stated that the royalties “must not

only be subject to a tax in another state, but that tax must actually be imposed.” Id. at 3. However, the Circuit Court’s interpretation renders the statutory requirement that the royalties be “subject to a tax” meaningless. If a tax is actually imposed on the royalties, then those royalties are automatically subject to that tax (in such a case the royalties would be both subject to tax and subjected to tax). Thus, the Circuit Court’s additional requirement renders the phrase “subject to a tax” superfluous and without meaning.

Instead, the statutory language of “imposed by Virginia, another state, or a foreign government” refers to the types of governments which must impose such tax. Va. Code § 58.1-402.B.8.a(1). For example, if a corporation were only subject to a city tax the safe harbor would not apply as the tax was not imposed by a state or foreign government.

As required by the rules of statutory construction, the foregoing gives meaning to both the phrase “subject to a tax” and the phrase “imposed by.” See Hubbard, 255 Va. at 340, 497 S.E.2d at 338 (stating that “every part of a statute is presumed to have some effect”). Therefore, the Circuit Court’s interpretation of the Subject to Tax safe harbor violates the rules of statutory construction and should be reversed.

3. The Circuit Court's Interpretation Exceeds the Stated Purpose of the Legislation

The General Assembly enacted Virginia Code Section 58.1-402.B.8.a to close loopholes that allow corporations to avoid paying any income taxes on “money paid to intangible holding companies in the form of royalties, interest and other intangible income.” R187, 191 (Fiscal Impact Statement, HB 1079 (2004 General Session), pp. 1, 5). However, the Circuit Court stretches that purpose beyond its objective. See Order, pp. 3, 4.

The General Assembly's intent was to prevent income from escaping taxation that was not subject to a tax in “any state.” Fiscal Impact Statement, HB 1079 (2004 General Session), p. 5. This goal is consistent with taxing the income of the intangible holding companies that pay no state income tax anywhere and do not establish a taxable presence in any state other than their state of incorporation. See e.g. Del. Code. Ann. tit. 30, § 1902(b)(8) (exempting from Delaware income tax those companies whose Delaware activities are limited to maintaining and managing intangible property).

However, Kohl's Illinois is not the type of company upon which the General Assembly frowned (i.e., an intangible holding company). The Department stipulated that Kohl's Illinois operates retail stores in a number of states. (JA029, ¶ 5.) Kohl's Illinois' business activities resulted in the

payment of substantial salaries, rent and utilities to conduct its operations during the Years in Issue. (SJA086-145.) In addition, Kohl's Illinois' business activities required it to file and pay tax in the nine Separate Return States. (JA031, ¶ 21.) Further, Kohl's Illinois' business activities required it to be included in combined returns in 19 more states. (JA032, ¶¶ 27, 29.) Therefore, the royalties were subject to income tax in numerous states.

Consistent with the General Assembly's intent to penalize that income which was not subject to tax in any state, the General Assembly created the Subject to Tax safe harbor. The safe harbor provides that none of the royalties are required to be added back to income if those royalties were "subject to a tax based on or measured by net income or capital imposed by...another state," that is, any other state. See Va. Code § 58.1-402.B.8.a(1) (emphasis added).

However, the Circuit Court's interpretation severely limits the application of the Subject to Tax safe harbor only to royalties to the extent that they were actually taxed in other states. However, such a constrained interpretation was not intended by the General Assembly. Instead, the General Assembly intended to include in a corporation's taxable income only the royalties that were not subject to tax "in any state." R191 (Fiscal Impact Statement, HB 1079 (2004 General Session), p. 5).

Therefore, the Circuit Court's interpretation is not supported by the General Assembly's intent and the Order should be reversed.

4. The Circuit Court's Reliance on the Alabama Decision is Misplaced

The Circuit Court misguidedly cites to an Alabama decision in support of its findings. Order, pp. 3-4 (citing Surtees v. VFJ Ventures, Inc., 8 So. 3d 950 (Ala. Civ. App. 2008), aff'd sub nom., 8 So. 3d 983 (Ala. 2008)).

However, the Alabama statute at issue in that case and the Subject to Tax safe harbor at issue here are markedly different. The Alabama statute provides as follows:

For purposes of computing its taxable income, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members, except to the extent the corporation shows, upon request by the commissioner, that the corresponding item of income was in the same taxable year: a. Subject to a tax based on or measured by the related member's net income in Alabama or any other state of the United States, or b. subject to a tax based on or measured by the related member's net income by a foreign nation which has in force an income tax treaty with the United States, if the recipient was a "resident" (as defined in the income tax treaty) of the foreign nation.

Ala. Code § 40-18-35(b)(1) (emphasis added). Significantly, the Alabama statute does not contain a safe harbor, but instead specifically limits the

addback “to the extent” that such exception applies. Id.⁴ The Virginia statute does not contain any comparable limiting language. Va. Code § 58.1-402.B.8.a(1). Instead, the safe harbors in the Virginia statute apply to “any portion” (note that the Virginia Subject to Tax safe harbor also does not contain more limiting language, such as “the portion” or “to the extent”). Id.

Significantly, the Alabama statute defined “subject to a tax based on or measured by the related member’s net income” as meaning “that 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.” Ala. Code § 40-18-35(b)(1) (emphasis added).

In contrast to the Alabama statute, the Virginia Subject to Tax safe harbor does not define “subject to a tax” and the Department’s regulation defines “subject to tax” very differently than the Alabama statute. Va. Code § 58.1-402.B.8.a(1); 23 Va. Admin. Code § 10-120-120(B)(2). Further, the Alabama statute was enacted years before the Virginia statute. Ala. Code § 40-18-35(b)(1) (enacted in December 2001); Va. Code § 58.1-

⁴ Contrary to the Virginia statute, other states have limited their statutory exception by the inclusion of “to the extent” language, similar to Alabama. See D.C. Code § 47-1803.03(d)(7)(B); Md. Code Ann., Tax-Gen. § 10-306.1(c).

402.B.8.a(1) (enacted in June 2004); see also R189 (Fiscal Impact Statement, HB 1079 (2004 General Session), p. 3 (acknowledging the already existing Alabama addback statute)). Therefore, had the General Assembly intended a result similar to the Alabama statute, it would have included “to the extent” and other limiting language of the Alabama statute in the Virginia statute. It did not.

Furthermore, the Virginia General Assembly enacted numerous other definitions related to the royalty addback. Va. Code § 58.1-302 (defining terms used in Virginia Code Section 58.1-402.B.8.a, including “intangible expenses and costs,” “intangible property” and “related member”). Notably, the General Assembly did not include a definition of “subject to tax” similar to Alabama’s statutory definition. Rather, it presumably adopted the Department’s regulation on that term. Therefore, there was no intent by the General Assembly to achieve the same result as Alabama.

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. In reviewing the Alabama addback statute, the court said that the Alabama Legislature intended the statutory terms “reported” and “included” to have different meanings. Id. Thus, the court held that “the term ‘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.” Id.

However, consistent with the General Assembly’s intent discussed above, the Virginia Subject to Tax safe harbor does not contain the terms “reported” and “included” and does not require that the royalties be “included in income.” See Va. Code § 58.1-402.B.8.a(1). Instead, the Virginia statute only requires that the royalties are subject to a tax. Id.

The decision in VFJ was dependent upon statutory language that is very different from the Virginia Subject to Tax safe harbor. The Alabama case only illustrates why the Virginia statute requires a different result. Therefore, the Circuit Court’s reliance on an out-of-state case and statute that are not on all fours with the Virginia statute is misplaced.

C. The Circuit Court Erred When it Failed to Find that the Department Incorrectly Calculated the Amount of the Subject to Tax Safe Harbor Under Kohl’s Alternative Argument

1. Standard of Review

This argument relates to the third assignment of error and concerns the application of the law to the facts, which is also reviewed de novo.

Dykes v. Friends of the C.C.C. Road, 283 Va. 306, 308, 720 S.E.2d 537, 538 (2012).

2. The Circuit Court Failed to Address Kohl's' Alternative Argument

The Circuit Court failed to address Kohl's' alternative argument that if the Subject to Tax safe harbor applies only "to the extent" that the royalties were actually taxed, then the Department incorrectly computed the amount of the safe harbor. In its assessments, the Department allowed a partial safe harbor. (JA033, ¶ 35.) The Department's calculation of the safe harbor amount included only those royalties that were actually taxed by the states in which Kohl's Illinois filed income tax returns (i.e., the Separate Return States). (Id.) The Department incorrectly excluded from its calculation the royalties that were actually taxed in the Addback States and the Combined Return States. (Id.)

Indeed, the Circuit Court's Order held that Kohl's was only required to add back those royalties "that were not actually taxed in another state." Order, p. 4. As the royalties were actually taxed by the Addback States and the Combined Return States, the Order should be reversed to include these amounts in the calculation of the safe harbor.⁵

⁵ Kohl's does not request that this Court calculate the amount of the Subject to Tax safe harbor. The parties agreed to endeavor to calculate the amount of the royalties that qualify for the Subject to Tax safe harbor as a result of the ruling in this case. (JA034, ¶ 43.)

3. The Royalties Were Actually Taxed in the Addback States

As previously discussed, the Subject to Tax safe harbor applies to royalties if “[t]he 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 ... another state.” Va. Code § 58.1-402.B.8.a(1) (emphasis added). The statutory language only requires that the “item of income” (i.e., the royalties) be subject to a tax. The statute contains no requirement that the related member that receives the royalties be the entity that pays the tax on that income. Va. Code § 58.1-402.B.8.a(1).

If the General Assembly had intended to limit the Subject to Tax safe harbor, it would have stated that the tax be imposed on the related member. It did not. Id.

In certain states, the payor of the royalty is required to add all or a portion of the royalties to its taxable income. The following is an example of the mechanics of such a requirement: Payor Co. (the royalty payor) pays \$10,000 of royalties to Recipient Co. (the royalty recipient), a related member. Payor Co. has federal taxable income of \$25,000, after deducting the royalties that it paid to Recipient Co. Connecticut requires Payor Co. to add back all of the royalties that Payor Co. paid to Recipient Co. Therefore, Payor Co. has Connecticut taxable income of \$35,000

(i.e., \$25,000 + \$10,000) and pays tax based on the \$35,000 of taxable income (i.e., the royalties are actually taxed in Connecticut).

Indeed, certain states, such as North Carolina, provide the royalty payor and royalty recipient an option. N.C. Gen. Stat. § 105-130.7A(a). The royalties can either be (i) deducted by the payor and included in the income of the recipient, or (ii) included in the income of the payor and excluded from the income of the recipient. Id. Both options result in the royalty income actually being taxed.

Kohl's was required to include all of the royalties that it paid to Kohl's Illinois in calculating its taxable income in Connecticut, Maryland and Massachusetts. (JA030, ¶ 17; SJA003-018, 028-043.) Furthermore, Kohl's was required to include a portion of the royalties that it paid to Kohl's Illinois in calculating its taxable income in Georgia and New Jersey. (JA031, ¶ 18; SJA019-027, 044-085.)

It is undisputed that Kohl's was required to include in the Addback States' taxable income the royalties that it paid to Kohl's Illinois and that such states imposed taxes that were based on or measured by net income or capital. (JA030, ¶ 17; JA031, ¶¶ 18, 19.) Furthermore, the Department concedes that if Kohl's Illinois had filed returns in each of the Addback States and included the royalties in its taxable income (rather than Kohl's

including the royalties in its taxable income), then the Subject to Tax safe harbor would apply. (See JA033, ¶ 35 (wherein the Department granted a partial safe harbor for the royalties Kohl's Illinois apportioned to New Jersey, but not for the royalties that Kohl's added back and apportioned to New Jersey).)

The Subject to Tax safe harbor requires only that the "income" be subject to a tax. Va. Code § 58.1-402.B.8.a(1). It does not require that the recipient be subject to a tax. Id. Therefore, as the royalties were included in the Addback States' taxable income and actually taxed in each of the Addback States, the proper calculation of the safe harbor includes the royalty income to the extent it was actually taxed in those states.

4. The Royalties Were Actually Taxed in the Combined Return States

In a combined return, two or more related members are treated as a single entity. As a result, the taxable incomes of the corporations are added together to form the taxable income of the combined group in that state.

The following is an example of a combined group reporting: as before, Payor Co. (the royalty payor) pays \$10,000 of royalties to Recipient Co. (the royalty recipient), a related member. Payor Co. again has federal taxable income of \$25,000. Alaska requires Payor Co. and

Recipient Co. to file a combined return. The combined group’s Alaska taxable income is computed as follows:

	Payor Co.	Recipient Co.	Combined Group (Payor Co. + Recipient Co.)
Alaska Taxable Income	\$25,000	\$10,000	\$35,000

In addition, the apportionment percentages of Payor Co. and Recipient Co. are combined and applied to the combined group’s Alaska taxable income (i.e., \$35,000 which includes that \$10,000 of royalties).

In calculating its Combined Return States taxable income, Kohl’s Illinois’ income, which included the royalties, was included in the combined group’s taxable income. (JA032, ¶ 29; SJA146-747.) The income of the combined group was then actually taxed in each of those states. (SJA146-747.) Additionally, each of the Combined Return States imposed taxes that were based on or measured by net income or capital. (JA032, ¶ 30.)

The Subject to Tax safe harbor requires only that the “income” be subject to a tax. Va. Code § 58.1-402.B.8.a(1). There is no dispute that the royalties were included in the Combined Return States’ taxable income and that those states actually taxed that income. Therefore, as the royalties were included in taxable income and actually taxed in each of the

Combined Return States, the proper calculation of the safe harbor includes the royalty income to the extent it was actually taxed in those states.

VI. CONCLUSION

For the foregoing reasons, Kohl's respectfully requests that this Court reverse the Circuit Court's Order on the grounds set forth in assignments of error one and two, enter judgment for Kohl's and order a full refund to Kohl's in the amount of \$460,100, plus interest. Alternatively, Kohl's respectfully requests that this Court vacate the Circuit Court's Order on the grounds set forth in assignment of error three and remand the case to the Circuit Court for calculation of the royalties that were actually taxed in other states that the Department excluded from the Subject to Tax safe harbor and correction of the assessment in accordance therewith. Additionally, Kohl's requests that it be granted all other just and proper relief to which it may be entitled.

Respectfully submitted,

Kohl's Department Stores, Inc.



By Counsel

Craig B. Fields

(Admitted *pro hac vice*)

Mitchell A. Newmark

(Admitted *pro hac vice*)

Nicole L. Johnson

(Admitted *pro hac vice*)

Morrison & Foerster LLP

250 West 55th Street

New York, NY 10019

Telephone: (212) 468-8000

Facsimile: (212) 468-7900

CFields@mofocom

MNewmark@mofocom

NJohnson@mofocom

William L.S. Rowe (VSB No. 13728)

William H. Wright, Jr.

(VSB No. 25576)

Hunton & Williams LLP

Riverfront Plaza, East Tower

951 East Byrd Street

Richmond, VA 23219

Telephone: (804) 788-8200

Facsimile: (804) 788-8218

WRowe@Hunton.com

CWright@Hunton.com

*Counsel for Kohl's Department
Stores, Inc.*

CERTIFICATE

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

1. Appellant is Kohl's Department Stores, Inc.

Counsel for Appellant are:

Craig B. Fields (Admitted *pro hac vice*)
Mitchell A. Newmark (Admitted *pro hac vice*)
Nicole L. Johnson (Admitted *pro hac vice*)
Morrison & Foerster LLP
250 West 55th Street
New York, NY 10019
Telephone: (212) 468-8000
Facsimile: (212) 468-7900
CFields@mofo.com
MNewmark@mofo.com
NJohnson@mofo.com

William L.S. Rowe (VSB No. 13728)
William H. Wright, Jr. (VSB No. 25576)
Hunton & Williams LLP
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219
Telephone: (804) 788-8200
Facsimile: (804) 788-8218
WRowe@Hunton.com
CWright@Hunton.com

2. Appellee is Virginia Department of Taxation, an agency of the Commonwealth of Virginia.

Counsel for Appellee are:

Elizabeth B. Myers (VSB No. 80739)
Assistant Attorney General
Office of the Attorney General
900 East Main Street
Richmond, VA 23219
ebmyers@oag.state.va.us

Calvin W. Fowler, Jr. (VSB No. 27982)
Stephanie Anne Lipinski Galland (VSB No. 30688)
Harold Johnson (VSB No. 65591)
Andrew O. Mathews (VSB No. 77038)
Williams Mullen
Post Office Box 1320
Richmond, VA 23218
cfowler@williamsmullen.com

3. Pursuant to Rule 5:26(h) this Opening Brief complies with Rule 5:26(b) by containing a total of less than 50 pages.

4. On December 9, 2016, ten bound copies of the Opening 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).

5. Also on December 9, 2016, three printed copies of the Joint Appendix and the sealed Supplemental Joint Appendix were hand-filed with the Clerk of the Supreme Court of Virginia, along with one electronic version of each Appendix submitted via the Virginia Appellate Court eBrief System (VACES).

6. On December 9, 2016, one electronic version of the Opening Brief and Joint Appendix was served via email on counsel for Appellee. One printed copy of the sealed Supplemental Joint Appendix was served by hand on counsel for Appellee.

A handwritten signature in black ink, consisting of a series of connected loops and a long horizontal stroke extending to the right.

Counsel for Appellant

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