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IN THE

Supreme Court of Virginia

RECORD NO. 160681

KOHL'S DEPARTMENT STORES, INC.,

Appellant,

v.

VIRGINIA DEPARTMENT OF TAXATION,

Appellee.

BRIEF OF APPELLEE

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INTRODUCTION

Virginia Code § 58.1-402(B)(8)(a) was specifically enacted to close a loophole exploited by companies with operations in different states. Prior to the statute's enactment, corporations were able to avoid income tax in Virginia by paying royalties or licensing fees for the use of intangible property to affiliated entities (commonly known as "intangible holding companies" or "IHC's") in other states. The company would deduct the royalties from its taxable income as business expenses, meaning that it would not be taxed on the royalties transferred to its affiliated IHC. Because IHC's were typically located in a state with little or no income tax, the royalties were not taxed in the hands of the IHC, either.

Simply put, corporations used the IHC loophole to shift income to an affiliate in a state where the income would not be taxed. Not surprisingly, a leading treatise on state and local tax described this use of IHC's as a "transparent effort" to "game" the system. Hellerstein & Hellerstein, STATE TAXATION ¶ 9.20 [3][j] (3d ed. 2009).

In the 1990's, the use of IHC's to avoid state income taxes was marketed heavily to corporations by accounting and consulting firms, and

many states saw a significant erosion of state corporate-tax revenues.[1] In 2004, the General Assembly relied on the Department's estimates that the use of IHCs to avoid corporate income taxes cost the Commonwealth between $22 million and $34 million per year. *HB5018ER, 2004 Special Session I; Department of Taxation, Fiscal Impact Statement HB 5018*.

Many states have enacted what is commonly referred to as an "add-back" statute to close the IHC loophole.[2] Generally, these statutes require a corporate taxpayer to "add back" to its calculation of state taxable income the royalty payments paid to an affiliated IHC that the taxpayer deducted from its federal taxable income. Hellerstein & Hellerstein, STATE TAXATION, ¶ 7.13[3][a]. Virginia joined this group in 2004, when the General Assembly closed the IHC loophole by amending Virginia Code § 58.1-402, the statute

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[1] For greater detail on the marketing of the IHC loophole and the impact it had on states around the country, see Glenn R. Simpson, *Diminishing Returns: A Tax Maneuver in Delaware Puts Squeeze on States*, Wall St. J., Aug. 9, 2002 at A1; *see also,* Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States* 1–2 (Center on Budget & Policy Priorities 2002), available at www.cbpp.org/4-9-02sfp.pdf.

[2] *See e.g.*, Ala. Code § 40-18-35(b); Conn. Gen. Stat. § 12-218(c); D.C. Code § 47-1803.02; Ga. Code § 48-7-28.3; 35 Ill. Comp. Stat. 5/203(a)(2); Ind. Code § 6-3-2-20; Ky. Rev. Stat. Ann., § 141.205; Md. Code § 10-3061; Mass. Gen. Laws, Ch. 63, § 31 I, J, K; Mich. Comp. Laws § 208.9; Miss. Code Ann. § 27-7-17; N.J. Stat. Ann. § 54:10A-4(k)-4.4; N.Y. Tax Law § 208(9)(o); N.C. Gen. Stat. § 105-130.7A(c); Or. Rev. Stat. § 150-314.295; S.C. Code Ann. § 12-6-1130; Tenn. Code Ann. § 67-4-2006 (b).

that governs the calculation of taxable income for corporate taxpayers. *2004 Acts of Assembly, Sp. Sess. I, Ch. 3.* In pertinent part, that statute provides:

> A. For purposes of this article, Virginia taxable income for a taxable year means the federal taxable income and any other income taxable to the corporation under federal law for such year of a corporation adjusted as provided in subsections B, C, D, and E.
>
> B. There shall be added to the extent excluded from federal taxable income:
> …
> 8. a. For taxable years beginning on and after January 1, 2004, the amount of any 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 to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes. 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;

Va. Code § 58.1-402(B)(8)(a)(1).

Thus, the operation of Virginia's add-back statute is quite simple. The starting point for determining a taxpayer's Virginia taxable income is

the taxpayer's federal taxable income. *Va. Code § 58.1-402(A).* The statute then identifies various items that may have been excluded from the calculation of a company's federal taxable income and requires that they be included in the company's calculation of taxable income in Virginia. *Va. Code § 58.1-402(B).* Pursuant to the 2004 amendment, intangible expenses (i.e. royalties) paid to a related IHC is one of the items that a taxpayer must add back when calculating its Virginia taxable income. *Va. Code § 58.1-402(B)(8)(a).*

In keeping with the General Assembly's intent to curb tax avoidance through the use of IHC's, the General Assembly determined – in an exercise of legislative grace – that the add-back would not be required for amounts paid to an IHC which were taxed in other states. *Va. Code § 58.1-402(B)(8)(a)(1).* This exception to Virginia's add-back statute (known as the "Subject to Tax Safe Harbor") is at issue in this case.

To understand the exception, one must appreciate the role of apportionment in state taxation. Under Constitutional limitations, a state can only tax the portion of a company's income that is attributable to the company's operations within that state, and a state cannot "tax value earned outside its borders." *Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164, 103 S. Ct. 2933 (1983) (citations omitted)*.

Apportionment is the statutory process used to determine the percentage of a corporation's income that is subject to income tax in each of the states in which the corporation conducts business. *Va. Code § 58.1-406, et seq.*

Because of apportionment, it is often the case that only a portion of a company's reported taxable income is actually subject to tax in a given state. Income transferred by a company doing business in Virginia via royalty payments to an out-of-state affiliate is not automatically subject to a tax imposed by another state, even if the affiliate reports the royalties as taxable income on its tax returns in other states. To the contrary, the affiliate will only be taxed on the income apportioned to the states where it does business. In recognition of this fact, the exception to Virginia's add-back statute applies only to the portion of royalty income that is **actually taxed** in the hands of the out-of-state affiliate.

The role of apportionment is conspicuous by its absence in the Opening Brief filed by Kohl's Department Stores, Inc. ("Kohl's"). Ignoring apportionment altogether, Kohl's argues that royalty payments received by a related member need not be taxed for the Subject to Tax Safe Harbor to apply. All that is necessary, according to Kohl's, is that the related member report those royalty payments as "taxable income" in another state. In

other words, Kohl's argues that the Subject to Tax Safe Harbor applies on a "pre-apportionment" basis.

Kohl's also avers that the exception applies not just to the portion of royalty income that is subject to tax in another state, but to all of the intangible expenses paid to a related member. So long as the related member pays a single dollar ($1.00) of tax in another state on royalties it received, Kohl's argues that the Virginia taxpayer need not add back **any** of its royalty payments to its Virginia taxable income.

Indeed, that is essentially the case here. In 2009, Kohl's paid roughly $441,000,000 in intangible expenses to its IHC affiliate, Kohl's Illinois, Inc. ("Kohl's Illinois"). Kohl's Illinois paid state income tax on less than 1% (approximately $3,600,000) of the royalties it received from Kohl's. Yet Kohl's avers that, merely because Kohl's Illinois reported those royalties as income on its tax returns and paid a minimal amount of tax in other states, Kohl's is exempt from Virginia's add-back requirement under the Subject to Tax Safe Harbor. In other words, Kohl's argues that the Safe Harbor allows Kohl's to continue re-directing income to Kohl's Illinois to shield it from income tax in Virginia. Kohl's arguments defy logic, the plain language of the add-back statute, and the obvious intent behind that legislation.

This dispute has played out in other jurisdictions around the country, and the use of add-back statutes to close the IHC loophole has been widely addressed in academic circles. Thus, this case is not about an honest debate over the intent of Virginia's add-back statute. Rather, it is a calculated and ultimately unpersuasive attempt by Kohl's to find a new loophole by attacking the statutory language used to close the old one. The Circuit Court properly effectuated the General Assembly's intent, and this Court should affirm the Circuit Court's well-reasoned decision.

STATEMENT OF THE CASE

This case presents a discrete question of statutory interpretation regarding the taxation of corporate income. The parties agree that Virginia Code § 58.1-402(B)(8)(a) requires corporations to add back to their calculation of Virginia taxable income any royalties or intangible expenses paid to a related member (i.e. an affiliated entity) that the corporation deducted from its federal taxable income as a business expense. Notably, Kohl's concedes that the add-back statute was intended to close a loophole by which companies shifted income to affiliates in other states in order to avoid state income tax in Virginia. *Opening Brief, p. 22.*

At issue in this case is an exemption to this "add-back" provision. Virginia Code § 58.1-402(B)(8)(a)(1) authorizes a corporate taxpayer to

exclude from its calculation of Virginia taxable income "any portion of the intangible expenses" it paid to a related member if "the corresponding item of income received by the related member is subject to a tax based on or measured by net income…imposed by Virginia [or] another state." The parties disagree about the impact of this "Subject to Tax Safe Harbor."

Kohl's avers that the Subject to Tax Safe Harbor applies on a **pre-apportionment** basis, so that a taxpayer's intangible expenses are exempt from the add-back whenever they are included in the related member's calculation of taxable income in one or more other states. Kohl's reading of the Safe Harbor would mean that the intangible expenses a company pays to a related member would be exempt from tax in Virginia even if the related member pays no income tax on those royalties in other states.

The Department interprets the Subject to Tax Safe Harbor on a **post-apportionment** basis. Under the Department's reading, which has remained consistent since the add-back statute was amended in 2004, the exemption 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.

MATERIAL PROCEEDINGS

The Department does not dispute the statement of the Material Proceedings set forth in Kohl's Opening Brief.

STATEMENT OF FACTS

Kohl's sells clothing and household goods at retail stores in Virginia and throughout the United States. *JA028, ¶1; JA029, ¶ 2*. Kohl's Illinois, an affiliate of Kohl's, manages, protects, utilizes, and licenses Kohl's intellectual property. *JA029, ¶ 7*. Kohl's Illinois is a Nevada corporation, with its principal place of business and commercial domicile in Illinois. *JA029, ¶ 4*. Though it operates retail stores in select states, Kohl's Illinois also manages intellectual property and licenses that intellectual property to its affiliates. *JA029, ¶¶ 5, 7-8.* Although Kohl's Illinois does not "engage[] in business within Virginia," it does license intellectual property to Kohl's for use in its operations in various states, including Virginia. *JA029, ¶¶ 2, 3, 6, 8*. Kohl's pays a royalty to Kohl's Illinois for that license. *Id.*

In calculating its federal taxable income in 2009 and 2010, Kohl's deducted as ordinary business expenses the royalties that it paid to Kohl's Illinois. *JA029*, ¶ *10*. In calculating its Virginia taxable income for 2009, Kohl's did not add back any portion of the royalties that it paid to Kohl's Illinois. *JA029, ¶ 12*. In calculating its Virginia taxable income in 2010,

Kohl's added back a portion of the royalties it paid to Kohl's Illinois, which Kohl's now characterizes as a "mistake." *JA003, ¶ 16*.

The Department conducted an audit of Kohl's for taxable years 2009 and 2010. *JA032-33, ¶¶ 31-38.* The Department recognized that Kohl's Illinois paid income tax in other states on a portion of the income Kohl's Illinois received as royalty payments from Kohl's. Accordingly, the Department treated the intangible expense payments on which Kohl's Illinois paid taxes in other states as exempt from the add-back statute under the Subject to Tax Safe Harbor to the add-back statute.

For example, for the taxable year ending January 2009, the total intangible expenses paid by Kohl's to Kohl's Illinois was $441,942,347. *JA029, ¶ 9.* The audit determined that Kohl's Illinois paid income tax in other states on $3,602,330 (less than 1%) of the expenses it received from Kohl's. *JA032-33, ¶¶ 31-38.* Pursuant to the Safe Harbor, the Department did not require Kohl's to add that $3,602,330 back to its Virginia taxable income. *Id.* The Department determined that the remainder of the intangible expenses deducted by Kohl's ($438,340,017) were not subject to tax in another state and should have been added back to Kohl's Virginia taxable income. *Id.* The Department then followed Virginia's apportionment process to determine how much of Kohl's taxable income

was subject to tax in Virginia. A similar process was applied to the taxable year ending January 2010. *JA033, ¶¶ 34, 35*.

At the conclusion of the audit, the Department issued two assessments, one each for 2009 and 2010, based on Kohl's failure to add back the royalty payments made to Kohl's Illinois as required under Virginia Code § 58.1-402(B)(8)(a). *JA032-33, ¶¶ 32, 33*. These assessments included $1,165,318.16 for 2009, and $681,582.84 for 2010, plus interest. *Id.*

ARGUMENTS AND AUTHORITIES

A. Standard of Review

This Court reviews the circuit court's application of law to the undisputed facts *de novo*. *Ford Motor Credit Co. v. Chesterfield County, 281 Va. 321, 334, 707 S.E.2d 311, 317 (2011).* In conducting its *de novo* review, this Court is bound by the same principles governing all requests for judicial relief from a tax assessment. *Commonwealth v. Lucky Stores, 217 Va. 121, 127, 225 S.E.2d 870, 875 (1976)*.

B. Law Governing Interpretation of Tax Statutes

The Department's assessment of a tax is presumed to be appropriate. Virginia Code § 58.1-205(1). This Court has previously noted:

> [Any] assessment of a tax by the Department shall be deemed *prima facie* correct. A presumption of

> validity therefore attaches to an assessment of tax, and the burden is on the taxpayer to show that such assessment was the result of manifest error or in total disregard of controlling evidence. Plainly, a court should not overturn the Department's decision unless the assessment is contrary to law, was an abuse of discretion, or was the product of arbitrary, capricious, or unreasonable behavior.

LZM, Inc. v. Va. Dep't of Taxation, 269 Va. 105, 109-110, 606 S.E.2d 797, 799 (2005) (internal citations omitted).

In addition to this presumption of correctness, this Court has long held that a statute which provides an exemption to taxation "must be strictly construed against the taxpayer, and any doubt as to whether the exemption applies must be resolved in favor of the Commonwealth." *Com. v. Manzer, 207 Va. 996, 1000, 154 S.E.2d 185, 189 (1967); see also, Com. v. Research Analysis Corp., 214 Va. 161, 163, 198 S.E.2d 622, 624 (1973).* The Circuit Court held that the Subject to Tax Safe Harbor is an exemption to the add-back statute. *JA111.* Notably, Kohl's did not assign error to this aspect of the Circuit Court's ruling. Thus, the Safe Harbor must be construed in the light most favorable to the Commonwealth.

C. Kohl's Ignores the Constitutional Restraints on State Income Tax and the Crucial Role of Apportionment in Calculating Each State's Ability to Tax a Corporation's Income.

Kohl's argues that the exemption to Virginia's add-back statute

applies so long as the intangible expenses paid to a related member are "included in the computation of a corporation's taxable income in another state." *Opening Brief, p. 14.* Thus, Kohl's argues that income is "subject to tax" whenever it is reported as taxable income on a state tax return, regardless of whether that income actually could be taxed by that state. Kohl's reading of the statute runs counter to well-established Constitutional limitations on a state's ability to tax corporate income.

It is fundamental that a state may only impose a tax on income which is earned in that state. "Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Container Corp., 463 U.S. at 164, (citations omitted).* Thus, only the portion of a company's taxable income that is earned within a particular state may legally be taxed (i.e. is "subject to tax") in that state.

To meet this Constitutional limitation on state taxation, states apply the process of **apportionment**. As the United States Supreme Court has explained, "[t]he 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, 109 S.Ct. 582, 588-89 (1989); see also, Surtees v. VFJ Ventures, Inc., 8 So. 3d 950, 956*

(Ala. Civ. App. 2008) ("The apportionment factor is used to determine the portion of the corporation's income that is subject to income tax in each of the states in which the corporation has activity.") (*emphasis added*). Thus, it is only after the apportionment process that a state can impose a tax on its fair share of a company's taxable income. **In other words, just because a corporation files a return and reports taxable income in a given state does not mean that all of that income is legally "subject to a tax…imposed by" that state**. Indeed, a state cannot "impose" any tax on the portion of a company's taxable income earned outside the state's borders.

Courts must presume that the legislature intended a result which is legal, and that it "acted with full knowledge of the law in the area in which it dealt." *Philip Morris USA Inc. v. Chesapeake Bay Found, Inc. 273 Va. 564, 576, 643 S.E.2d 219, 225 (2007).* Thus, when reading the add-back statute, the Court must assume that the General Assembly understood that only the portion of a company's income which is apportioned to a given state can legally be taxed there (i.e. is "subject to a tax…imposed by" that state).

In fact, the purpose of the Subject to Tax Safe Harbor was to make sure that the add-back statute would not run afoul of Constitutional

concerns regarding double-taxation. If any part of an IHC's income is subject to income tax imposed by another state, that portion of the income need not be added back in Virginia. Given the Constitutional limitations on a state's ability to tax corporate income, Kohl's broad interpretation of the phrase "subject to tax" is not reasonable.

In sum, Constitutional concerns and common sense both dictate that income is not "subject to a tax…imposed by" a given state unless it **legally can be taxed** by that state. To decide how much of a company's income a state may legally tax, the income must be **apportioned** to the various states in which the company operates. Ultimately, only the income attributable to a given state under the apportionment process is legally "subject to tax" in that state.

D. Kohl's Twists the Plain Language of the Statute and Violates Various Rules of Statutory Construction.

The add-back statute provides that the taxpayer is not required to add back intangible expenses that are "subject to a tax . . . imposed by . . . another state." *Va. Code § 58.1-402(B)(8)(a)(1)*. Thus, the Circuit Court properly held that "to fall within the exception, the intangible expenses paid to a related member must not only be subject to tax in another state, but that tax must actually be **imposed."** *JA112 (emphasis added).* As set forth above, a state can only **impose** an income tax on the portion of a

company's income that is attributed to that state under the apportionment process.

Notably, this conclusion is confirmed elsewhere in the add-back statute, which mandates that the add-back "shall not be required for **any portion** of the intangible expenses and costs" that meet one of the enumerated exemptions. *Va. Code § 58.1-402(B)(8)(a) (emphasis added)*. The inclusion of the "any portion" language evinces the General Assembly's intent that only those intangible expenses that are apportioned to and taxed by another state – not **all** of the taxpayer's intangible expenses – are exempt from the add-back.

In an effort to circumvent the plain language of the "subject to tax" language in the add-back statute, Kohl's advances several meritless arguments.

1. Kohl's confuses "taxable income" and "subject to tax."

The fundamental underpinning of Kohl's argument is that the phrase "subject to a tax" means the same thing as "taxable income." *See, e.g., Opening Brief, p. 13.* To reach this conclusion, Kohl's works backwards. Kohl's does not look to a definition of "subject to tax," but to the definition of a word ("taxable") which does not even appear in the text of the exemption.

Kohl's cannot look to the definition of one word ("taxable") to prop up its interpretation of another phrase ("subject to tax") in the add-back statute.

Even if "subject to tax" and "taxable" were synonymous, it is axiomatic that income is only "taxable" to the extent that a state has the ability, under Constitutional standards, to impose a tax on it. Thus, Kohl's engages in a further sleight of hand by conflating the definitions of "taxable" and "taxable income." *Opening Brief, p. 13.* However, "taxable income" is a term of art referring to the starting point for a corporation's calculation of income tax.[3] For state tax purposes, not all of a company's reported "taxable income" is actually "taxable" or "subject to tax."

The United States Supreme Court recognized this point in *Shell Oil Co. v. Iowa Dept. of Revenue, 488 US 19, 30-31, 109 S. Ct. 278 (1988).* The Supreme Court noted that "income that is included in the pre-apportionment base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be

[3] "Under Federal tax law, taxable income is gross income reduced by adjustments and allowable deductions. It is the income against which tax rates are applied to compute an individual or entity's tax liability." *Black's Law Dictionary, 1460 (6th Ed. 1997).* Notably, in state tax law, the tax rate is not applied against a company's "taxable income," but against the amount that is "subject to tax" after applying apportionment. *Goldberg v. Sweet, 488 U.S. 252, 260-61,109 S.Ct. 582, 588-89 (1989).*

attributable to Iowa's taxing jurisdiction is taxed by Iowa." *Id.* Because of apportionment, a corporation's income that is actually "subject to tax" in a given state is often significantly less than the company's reported "taxable income."

In fact, the tax returns that Kohl's filed in Virginia highlight the distinction between "taxable income" and income which is "subject to tax." *Supplemental Joint Appendix ("SJA"), 001-02.* Kohl's 2009 tax return identifies Kohl's "**Virginia Taxable Income**" as $421,197,888. *SJA001, line 7.* However, after using apportionment to determine how much of that income was attributable to Virginia, the return identified only $16,759,885 (less than 4% of Kohl's "Virginia Taxable Income") as "**Income subject to Virginia tax**." SJA001, *line 8(a).* This confirms the general proposition that only the portion of "taxable income" that can be taxed legally by a state **after** the apportionment process is "subject to tax" in a given jurisdiction.

By conflating "subject to tax" with "taxable income," Kohl's runs afoul of the well-established canon of statutory construction that courts "must assume that the legislature chose, with care, the words it used when it enacted the relevant statute, and we are bound by those words as we interpret the statute." *Barr v. Town & Country Properties, Inc., 240 Va. 292, 295, 396 S.E.2d 672, 674 (1990*). Indeed, if the General Assembly had

intended the Subject to Tax Safe Harbor to apply to intangible expenses that merely are reported in the related member's "taxable income," it would have used that language in the safe harbor. It did not. Instead, the General Assembly authorized an exemption to the add-back only for the portion of intangible expenses paid to a related member that is "subject to a tax…imposed by" a given state.

Kohl's recognizes that legislative intent is ascertained from the words used in a statute. *Opening Brief, p. 18.* It is for that very reason that Kohl's argument, which seeks to treat one term of art ("subject to tax") as synonymous with another ("taxable income"), must be rejected.

2. Kohl's Reliance on A Regulatory Definition of "Subject to Tax" Is Misguided.

Kohl's also tries to justify its strained reading of "subject to tax" by pointing to 23 Va. Admin. Code § 10-120-120, which provides that:

> A **corporation** is "subject to" [income tax]…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.

(emphasis added). Kohl's argues that this definition supports its interpretation of the add-back statute because it demonstrates that "only the **ability** (i.e. jurisdiction) to impose a tax is necessary" for income to be

"subject to tax." *Opening Brief, p. 15 (emphasis added).* Kohl's argument on this point is without merit.

The regulatory definition in 23 VAC § 10-120-120 applies to "corporations," not "income." This is an important distinction. A corporation may be "subject to tax" in a state even if only a portion of its income is "subject to tax" there. The same is not true when speaking of "income." Income is divisible, and under the Constitutional limitations set forth above, only that portion of income which is earned in a state is "subject to tax" there.

Put another way, a corporation is "subject to tax" in a given state even if only 1% of its income may legally be taxed there. However, this does not mean that the remaining 99% of the company's income is "subject to tax" in that state. Only the 1% of income which was earned in the state and legally can be taxed by that state is "subject to tax" there.

With that distinction in mind, the regulatory definition of "subject to tax" actually supports the Department's interpretation of the add-back statute because it reaffirms the Constitutional principles addressed previously in this brief. Just as a state may only tax income that is earned within its borders, a state only has jurisdiction to tax a corporation that has

a sufficient business nexus with the state.[4] Thus, for example, Indiana cannot levy income tax on a company that operates solely in North Dakota.

The regulation cited by Kohl's reflects these Constitutional limits, noting that a "corporation" is only "subject to tax" in a state if it conducts sufficient business activity there to fall within that state's legal authority to tax the company's income. In other words, the regulation confirms that the phrase "subject to tax" refers to something (a corporation) that **legally** may be taxed by a state. Thus, the definition in the regulation supports the Department's contention that an item of income is only "subject to a tax…imposed by…another state" if that income **legally** may be taxed by such state. And, as set forth above, only the portion of the income that is earned within the state may legally be taxed there. Thus, in those states where a **corporation** is "subject to tax," one must use apportionment to determine how much of the corporation's **income** is "subject to tax" in each state.

Ultimately, Kohl's argument on this point is self-defeating. Kohl's avers that "only the **ability** (i.e. jurisdiction) to impose a tax on a

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[4] "The bedrock constitutional principle that a state may not tax activities with which it lacks a concrete connection generally confines the exercise of a state's tax power to activities conducted within its borders." *State Taxation*, Jerome R. Hellerstein and Walter Hellerstein, 3rd Ed., Sec. 8.07[1], 2008.

corporation is necessary [to render income 'subject to tax']" and that "royalties are subject to tax if another state has the **ability** to tax the royalties." *Opening Brief, p. 15 (emphasis added).* What Kohl's overlooks in making this statement is that a state only has the **ability** to impose a tax on income that is assigned to that state after going through the apportionment process. A state cannot impose income tax on royalties earned outside its borders, and only the portion of royalty income which is apportioned to a state and can actually be taxed there is "subject to a tax…imposed by" that state. Thus, Kohl's own arguments on this point ultimately support the Department's interpretation of the statute.

3. Kohl's Selectively Applies the Rule That A Statute Must Be Read In Its Entirety.

Kohl's also argues that the Subject to Tax Safe Harbor is an "all or nothing" proposition. *Opening Brief, pp. 17-20.* Kohl's avers that it need not add back to its calculation of income in Virginia any of the more than $441,000,000 in royalties it paid to Kohl's Illinois so long as a single dollar ($1.00) of those royalties is taxed in another state. In effect, Kohl's argues that if any tax is paid on any portion of the royalty income, then the add-back statute does not apply and the IHC loophole remains open.

Hoping to prop up its unreasonably expansive reading of the exception, Kohl's points out that the independent exception found in

§ 58.1-402(b)(8)(a)(3) (the "Conduit Safe Harbor") limits relief to "such portion" of a related member's royalty income that was not passed through to a third-party. *Opening Brief, p. 19.* Kohl's then argues that, if the General Assembly had intended to limit the Subject to Tax Safe Harbor to only the portion of royalty income that is actually taxed by another state, it would have included the words "such portion" or other similar language in that exception. *Id.* Kohl's argument on this point fails for several reasons.

First, the add-back statute expressly provides that "[t]his addition shall not be required for **any portion** of the intangible expenses and costs if one of the [exceptions] applies." *Va. Code § 58.1-402(b)(8)(a) (emphasis added)*. Kohl's urges the Court to read the words "any portion" as meaning the entirety of the intangible expenses paid to a related member. Under Kohl's argument, if any intangible expenses paid to a related member are "subject to tax" in another state, then **all** of the intangible expenses are exempt from the add-back requirement, not just the **portion** of such expenses which are "subject to tax" elsewhere.

However, this reading of the statute renders the use of the word "portion" entirely meaningless. Had the General Assembly intended to so broaden the scope of the exceptions to the add-back statute, it would not have included the word "portion" at all. To illustrate this point, one need

only read the last sentence of § 58.1-402(b)(8)(a) without that word: "This addition shall not be required for any…of the intangible expenses and costs if one of the following applies." The General Assembly's inclusion of the word "portion" in the statute demonstrates its intent that the exception would apply only to that part of a company's intangible expenses which satisfy the elements of any of the safe harbors.

The fact that the Conduit Safe Harbor refers to "such portion" of intangible expenses only reinforces this point. The phrase "such portion" refers back to the "any portion" language in the last sentence of § 58.1-402(b)(8)(a), and it affirms that "any portion" means a part (i.e. something less than the entirety) of the intangible expenses paid to a related member.

Second, the Subject to Tax Safe Harbor is expressly limited to "**the corresponding item of income** received by a related member." *Va. Code. § 58.1-402(b)(8)(a)(1) (emphasis added)*. Like the inclusion of "such portion" in the Conduit exception, the "corresponding item of income" refers back to the "portion" of the intangible expenses paid by the taxpayer to a related member. Thus, when read as a whole, the present exception only applies to "any portion" of Kohl's intangible expenses for which the "corresponding item of income" received by Kohl's Illinois was "subject to a tax…imposed by…another state."

Finally, Kohl's citation to *Wendy's Int'l, Inc. v. Dep't of Taxation*, *84 Va. Cir. 398 (2012)*, is a red herring. The Court in *Wendy's* looked solely at the "Franchise Safe Harbor" in § 58.1-402(b)(8)(a)(2), and it did not discuss the other safe harbors. Nor did the Court address the use of the term "any portion" in the statute. The three exceptions to the add-back statute operate independently, and the Court's interpretation of the Franchise Safe Harbor in *Wendy's* has no impact on the proper construction of the Subject to Tax Safe Harbor in this matter.[5]

E. Kohl's Argument Defies the Legislative Intent behind the Add-Back Statute.

The Circuit Court also found that Kohl's interpretation of the Subject to Tax Safe Harbor ran counter to the General Assembly's intent in enacting the add-back statute. JA112-13.

"The primary objective of statutory construction is to determine legislative intent." *Harward v. Com., 229 Va. 363, 365, 330 S.E.2d 89, 90 (1985).* The "plain, obvious, and rational meaning of a statute is always

[5] Notably, the Circuit Court in *Wendy's* noted that the purpose of Virginia's add-back statute is "to prevent the taxpayer from expensing fees paid to a holding company set up to hold the taxpayer's intangible personal property such as patents and trademarks." *84 Va. Cir. 398.* This purpose would be frustrated if a company like Kohl's could continue expensing the fees it pays to Kohl's Illinois. Thus, even if *Wendy's* were applicable precedent, it does not support Kohl's arguments here.

preferred over a curious, narrow, or strained construction." *Id*. The General Assembly is presumed to understand existing law when it enacts a statute, and it is presumed to have acted with a meaningful purpose, and not to achieve a futile result. *Philip Morris USA Inc. v. Chesapeake Bay Found., Inc., 273 Va. 564, 576, 643 S.E.2d 219, 225 (2007)*; *Shaw v. Com., 9 Va. App. 331, 334, 387 S.E.2d 792, 794 (1990)*.

The add-back statute was designed to close the IHC loophole in Virginia and ensure that income attributable to Virginia is, in fact, taxed here. The Fiscal Impact Statement issued by the Department for the 2004 General Session expressly provided:

> This bill would close two corporate income tax loopholes that allow corporations to avoid paying taxes on income not taxed in any state and on money paid to intangible holding companies in the form of royalties, interest and other intangible income. The loopholes are closed by requiring the corporation to … add back any deductible … intangible expenses and costs paid, accrued or incurred to one or more related members.

R187, Fiscal Impact Statement, HB 1079 (2004 General Session), p. 1.

Yet, Kohl's posits that so long as an IHC pays tax on some portion of its income in another state – however small that portion of its income may be – the company operating in Virginia need not add back any of its intangible expenses paid to the IHC. Kohl's reading of the statute would

enable companies who exploit the IHC loophole to continue doing so simply by arranging to have the IHC pay minimal tax in another state.

In fact, that is exactly the model that Kohl's follows. Kohl's paid almost $442 million in royalty payments for licenses and other intangible expenses to Kohl's Illinois in 2009. Kohl's Illinois only paid tax on $3.6 million of that income in other states, leaving over $438 million of the income that Kohl's transferred to Kohl's Illinois untaxed by any state. The add-back statute allows Virginia to include that $438 million in Kohl's taxable income so that Kohl's pays tax on the amount of that $438 million that is attributable to Virginia under the Commonwealth's apportionment formula. Under Kohl's argument, however, Kohl's could escape Virginia taxation on any of the $442 million it siphoned off to Kohl's Illinois simply because Kohl's Illinois paid tax on less than 1% of that income in other states.

The IHC loophole is a tax avoidance scheme that often involves the payment of some minimal tax by a related member in one or more states. That is true here, where Kohl's Illinois paid state income tax on less than 1% of the intangible expense income it received from Kohl's. The General Assembly did not set out to close the IHC loophole only to leave the door wide open for companies to continue exploiting IHC's for tax avoidance

purposes. Given the obvious intent of the General Assembly in enacting the add-back statute, the only logical way to read the Subject to Tax Safe Harbor is to limit its application to the portion of intangible expense income received by a related member that is actually taxed in another state.

Kohl's advances two separate – but equally flawed – arguments in hopes of undermining the General Assembly's obvious intent.

First, referring to the Department's 2004 Fiscal Impact Statement regarding the add-back statute, Kohl's argues that "the General Assembly only intended to include the royalties that were not taxed in '<u>any state</u>.'" *Opening Brief, pp. 22-23.* Emphasizing the reference to "any state," Kohl's posits that the Safe Harbor applies to all of a taxpayer's income even if the related IHC only pays minimal tax on its royalty income in one other state. In making this argument, Kohl's confuses the two loopholes addressed by the Fiscal Impact Statement.

As explicitly set forth in the Fiscal Impact Statement, the General Assembly sought to close two distinct loopholes when considering the enactment of an add-back statute. *R187, Fiscal Impact Statement, HB 1079, pp. 1.* The Fiscal Impact Statement only used the phrase "any state" in reference to the first of those loopholes, known as the "nowhere income" loophole. The phrase "any state" did not refer to the IHC loophole.

Rather, the Fiscal Impact Statement described the IHC loophole as occurring when "corporations …avoid paying taxes…on money paid to intangible holding companies in the form of royalties, interest and other intangible income." *Id.* Thus, Kohl's argument simply mischaracterizes the language and import of the Fiscal Impact Statement.

Second, Kohl's tries in vain to distinguish this case from the persuasive precedent of *Surtees v. VFJ Ventures, Inc.*, *8 So. 3d 950 (Ala. Civ. App. 2008), aff'd sub nom., ex parte VFJ Ventures, Inc., 8 So. 3d 983 (Ala. 2008).* The taxpayer in that case, VFJ, made the same arguments advanced here by Kohl's. VFJ, a manufacturer of Lee® and Wrangler® denim jeans, paid royalties to two IHCs, Lee and Wrangler, both of whom listed their federal taxable income on their North Carolina corporate tax returns. *Id*. *at 973.* For the 2001 tax year, Lee reported federal taxable income of $73,021,142, and Wrangler reported $69,644,967 in federal taxable income. *Id*. Each IHC applied its apportionment factor to determine the amount of its taxable income that was actually subject to tax in North Carolina. *Id*. Lee's apportionment factor for North Carolina was 2.8783%, and Lee paid $143,480 in North Carolina corporate income tax. *Id*. Wrangler's apportionment factor for North Carolina was 3.9415%, and it paid $190,155 in corporate income tax in that state. *Id*. Therefore, neither

Lee nor Wrangler paid North Carolina state income tax on the full amount of the taxable income stated on its North Carolina returns.

Like Kohl's, VFJ argued that the subject-to-tax exception should be applied on a pre-apportionment basis so that the entire amount of taxable income its related members listed on their respective North Carolina corporate income-tax returns was "subject to tax," even if only a small part was actually apportioned to North Carolina and taxed in that state. *Id.* The Alabama Department of Revenue responded that Alabama's subject-to-tax exception only applies to that portion of the IHC's taxable income that was apportioned to North Carolina. *Id.* In other words, only 2.8783% of Lee's income and 3.9415% of Wrangler's income could be considered "subject to tax" in that state. *Id.*

The court agreed with the Department of Revenue, holding that the subject-to-tax exception applies only to income that "is actually taxed as a part of a tax on net income," not income that is merely listed on a tax return on a pre-apportionment basis. *Id. at 975*. In doing so, the court stated that its holding was "consistent with the intention of the legislature in enacting the add-back statute." *Id. at 976*. The court reasoned that under VFJ's strained reading of the statute, "a corporation could easily avoid the application of an add-back statute that contains a subject-to-tax exception

by paying corporate income tax in a state in which its apportionment factor is relatively insignificant." *Id*.

The court further explained:

> [a]n interpretation of the subject-to-tax exception that, in most cases, would result in a taxpayer's ability to avoid the application of the add-back statute would be unreasonable, and, consequently, [it cannot] be considered to be the intent of the legislature. Such an interpretation would also serve to place Alabama back in the position it was in before the enactment of the add-back statute. The legislature surely did not intend such a nonsensical result. We will presume that the legislature intended a rational result.

Id. at 976 (internal citations and quotations omitted).

Kohl's attempts to distinguish *Surtees* on the grounds that the Alabama add-back statute contained limiting language that allowed an exemption only "to the extent" a corresponding item of income was subject to tax in another state. *Opening Brief, pp. 24-25.* Kohl's notes that the Virginia statute does not include the phrase "to the extent." *Id.* However, Kohl's again ignores that the Virginia statute does contain similar limiting language. The Subject to Tax Safe Harbor applies to "any portion" of intangible expenses which is subject to tax in the hands of the related member in another state. Thus, the exemption only applies to that portion of the related member's income which is actually subject to a tax imposed

by another state. The inclusion of the phrase "any portion" in the Virginia statute has the exact same impact as the inclusion of the phrase "to the extent" in the Alabama law.

Second, Kohl's completely overlooks the *Surtees* court's well-reasoned analysis of the role of apportionment in ascertaining the legislature's intent in passing Alabama's add-back statute. *8 So. 3d at 955-56, 972-76*. As the Alabama court held, reading the "subject to tax" exemption to apply on a pre-apportionment basis would render the statute meaningless. Companies could go on shielding income from tax by making royalty payments to related entities who pay minimal amounts of tax on those royalties in other states.

Notably, Virginia adheres to the same rules of statutory construction that underscored the Alabama court's decision in *Surtees*. *See, e.g., Meeks v. Com., 274 Va. 798, 802, 651 S.E.2d 637, 639 (2007)* (noting that a statute should not be construed in a manner that leads to "absurd results."); *Shaw v. Com., 9 Va. App. 331, 334, 387 S.E.2d 792, 794 (1990)* ("We will not construe legislative action in a manner that would ascribe to the General Assembly a futile gesture."); *Virginia Elec. & Power Co. v. Citizens for Safe Power, 222 Va. 866, 868, 284 S.E.2d 613, 614 (1981)*

("the General Assembly does not intend the application of a statute to lead to irrational consequences.")

Regardless of the specific employed in each state's add-back statute, the compelling logic of the *Surtees* court is directly applicable to the interpretation of the Virginia statute. Whether in Alabama or Virginia, an interpretation that would render a statute effectively meaningless must be rejected. The General Assembly did not intend for the Subject to Tax Safe Harbor to completely eviscerate the add-back statute.

F. Kohl's Alternative Argument that the Department Incorrectly Calculated the Amount of the Add-Back is Erroneous.

Kohl's argues that it is entitled to relief not just to the extent that Kohl's Illinois paid tax on the royalties it received from Kohl's, but also to the extent that Kohl's itself was subject to tax in other add-back states. Kohl's urges the Court to look to Kohl's returns in other states in order to apply the exception to Virginia's add-back statute. Once again, Kohl's overlooks explicit language in the statute.

Virginia's statute only requires a company to add back to its calculation of Virginia taxable income any intangible expenses paid to a "related member." *Va. Code § 58.1-402(B)(8)(a).* Thus, the entire scope of the add-back statute is limited to the amounts received by the "related member." The statute then provides an exception for:

> any portion of the intangible expenses and costs if…
> (1) The **corresponding item of income received by the related member** is subject to a tax…imposed by Virginia, another state, or a foreign government.

Va. Code § 58.1-402(b)(8)(a)(1) (emphasis added). [6]

It is the "corresponding item of income received by the related member" that must be taxed in order for the exception to apply. Nothing in the plain language of the statute suggests that Kohl's can look to its own tax returns in other states to trigger the exception. If the General Assembly intended to apply the exception to situations where the taxpayer's intangible expenses are taxed in another state, it would have said so in the statute. Thus, for purposes of the add-back statute, the tax returns that Kohl's itself filed in other states are completely irrelevant.

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[6] Notably, Kohl's argument leads to results that are logically impossible. The exception applies when royalty income is "subject to a tax…imposed **by Virginia**...." *§ 58.1-402(b)(8)(a)(1)(emphasis added).* Because it includes taxes paid in Virginia, the only way to make sense of the exception is to apply it exclusively to the related member's income taxes. A related member might pay taxes on royalty income in the Commonwealth, so it makes sense to include "a tax…imposed by Virginia" in the exception. Under Kohl's reading, however, in which one could consider taxes paid by the taxpayer, the exception would allow for the illogical claim that a taxpayer need not pay any tax on its royalty expenses in Virginia **because it pays tax on those royalties in Virginia**. The statute cannot be read in a way that leads to such nonsensical results.

Kohl's argument in this regard also ignores – once again – the role that apportionment plays in determining state income tax. Kohl's may have to comply with the add-back statutes enacted by some of Virginia's sister states, but that does not mean Kohl's is actually taxed on all of the income it adds back to its calculation of taxable income in those states. Because of the apportionment process, Kohl's is only taxed on those intangible expenses in proportion to its business operations in each particular state. The fact that Kohl's may have to add back its intangible expenses in more than one state does not mean that Kohl's is taxed on the same income twice. It only means that multiple states have closed the IHC loophole and stopped companies like Kohl's from avoiding tax on income that was earned in those states.

For the same reason, Kohl's argument regarding taxes paid in the "Combined Reporting States" is misleading. Kohl's points out that when filing tax returns in the Combined Reporting States, it included Kohl's Illinois as a member of the combined group. What Kohl's does not address, however, is whether Kohl's Illinois actually paid tax on its royalty income in those states. The Combined Reporting States still go through the apportionment process for each entity included in the combined return.

Thus, the mere inclusion of a related member's royalty income on a combined tax return does not mean that such income is subject to tax.

In fact, this case illustrates this principle. Citing to Alaska as an example, Kohl's avers that Kohl's Illinois' royalty income was included in the combined return filed by Kohl's and suggests that Kohl's Illinois' income was therefore subject to tax in Alaska. *Opening Brief, pp. 31-33.* Ironically, Kohl's argument is belied by its own 2009 Alaska tax return. *SJA146-170.* As shown in the "Alaska Combined Apportionment Detail Summary", Kohl's Illinois did not have any property, payroll or sales in Alaska. *SJA160*. Thus, Kohl's Illinois' apportionment factors in Alaska were zero. *Id.* Because Kohl's Illinois had no operations in Alaska or income apportioned to Alaska, it was illegal for Alaska to impose an income tax on Kohl's Illinois' income. *Container Corp., 463 U.S. at 164.* In fact, the only entity identified in the return as having any nexus with Alaska is Kohl's itself. *SJA148.* Accordingly, the royalty income received by Kohl's Illinois was not subject to an income tax imposed by Alaska.

To the extent that the Department determined that Kohl's Illinois paid tax on any portion of the intangible expense income it received from Kohl's in any state, the Department excluded that portion of Kohl's intangible

expenses from the add-back requirement under the Virginia statute Therefore, the Department correctly calculated the amount of the add-back.

CONCLUSION

In 2009, Kohl's Illinois paid income tax on less than 1% of the royalty income it received from its affiliate, Kohl's. There is no better illustration for why the General Assembly enacted Virginia's add-back statute than Kohl's exploitation of the IHC loophole in this very case. The circuit court properly rejected Kohl's reading of the add-back statute and granted summary judgment in favor of the Department. This Court should affirm the Circuit Court's decision.

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CERTIFICATE OF SERVICE

In compliance with Rule 5:26, I hereby certify that on January 3, 2017, the correct number of true and accurate copies of this Opening Brief were hand-filed with the Supreme Court of Virginia and an electronic copy filed via VACES in PDF format, and an electronic copy via email in PDF format was served upon counsel for the appellant:

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