ALABAMA TAX TRIBUNAL

PFIZER, INC.,	§	
Taxpayer,	§	DOCKET NO. BIT. 18-236-JP
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE	§	

OPINION AND PRELIMINARY ORDER REGARDING APPLICATION OF ALABAMA'S ADD-BACK STATUTE

Following a corporate income tax audit of years 2007 through 2012, the Alabama Department of Revenue reduced the amount of net operating losses claimed by Pfizer, Inc. ("Taxpayer"). The reduction resulted from the Revenue Department's disallowance of deductions claimed by the Taxpayer concerning interest payments that it made to related business entities. The Revenue Department added back the deducted amounts to the Taxpayer's taxable income pursuant to Ala. Code § 40-18-35(b), which is known as Alabama's "add-back statute." The Taxpayer appealed the disallowance of these deductions to the Alabama Tax Tribunal, arguing that its payments to related entities are excepted from the add-back statute pursuant to the statute's subject-to-tax provision. The Taxpayer also raised other arguments in its Notice of Appeal, including constitutional challenges, but has limited its non-constitutional arguments to payments that it made during 2012 to one entity in Ireland. The Taxpayer's constitutional challenges are preserved for review in circuit court.

<u>Question Presented</u>

If an Alabama corporate taxpayer pays interest or intangibles expenses to a related member and deducts those expenses for Alabama income tax purposes, Alabama's add-back statute requires the taxpayer to add back those expenses to its taxable income, unless those payments meet an exception. Here, the Taxpayer argues that its interest payment to a related member in Ireland should be excepted from add-back because the payment was subject to a tax on the related member's net income in that country. The question is whether that interest payment by the Taxpayer was "attributed to" Ireland despite being deducted by the Ireland entity on its own return after the Ireland entity paid the interest to affiliates in Luxembourg.

Facts

The Taxpayer requests the Tax Tribunal to rule on a specific legal question that is at issue in this appeal concerning the subject-to-tax exception to Alabama's add-back statute. As noted, the question involves the Taxpayer's deduction of interest that it paid to related entities. To narrow the issue on appeal, the Taxpayer stated the following:

> Pfizer filed a Notice of Appeal with the Tax Tribunal regarding the Department's disallowance of certain interest and royalty expenses pursuant to the Add-Back Statute. Specifically, there were forty-one (41) related party transactions totaling approximately $1.564B that were disallowed on audit.
>
> … The Department issued a revised audit calculation allowing the deduction of interest in five (5) more transactions and increasing the related party expense deduction allowed by approximately $651M. While Pfizer does not agree that the Department should disallow interest expenses in the remaining thirty-six (36) transactions, Pfizer is willing to accept the Department's adjustments in all but one transaction - solely for this audit period - to narrow the issues for the Tribunal in this appeal. The one material transaction before this Tribunal is an interest amount

> of approximately $658M which Pfizer deducted and paid to its related affiliate in Ireland, PTI.

Additionally, the Taxpayer states that Pfizer Transactions Ireland ("PTI") filed a 2012 tax return in Ireland and reported the $658 million in interest that PTI received from the Taxpayer as income on that return. A copy of the Ireland return shows "Sales/Receipts/Turnover" of $682,823,783, which the Taxpayer states includes its $658 million payment. A Profit and Loss Account that PTI apparently included with its Ireland return reported "'interest receivable' (income)" of $877,769,973 and "Interest payable" of $877,698,047, for a "Trading (profit)" of $71,926. After subtracting administrative expenses of $61,926, PTI listed a profit of $10,000. The Taxpayer acknowledged that PTI paid interest to affiliates in Luxembourg in 2012 and that those payments were deducted by PTI on its 2012 Ireland return. Those payments apparently were reflected in the "Interest payable" amount of $877,698,047 on PTI's Profit and Loss Account. Specifically, the Taxpayer stated that "Ireland allowed PTI to take a deduction against this interest income from [the Taxpayer] for interest expense that PTI incurred to Luxembourg affiliates."

The interest expenses that the Taxpayer paid to PTI in 2012 were deducted by the Taxpayer on its 2012 U.S. corporate income tax return. Alabama's corporate income tax is based on a taxpayer's "taxable income." *See* Ala. Code § 40-18-31(a). And Alabama's starting point in determining "taxable income" is "federal taxable income," pursuant to Ala. Code § 40-18-33. Therefore, the Taxpayer's federal deduction of its interest payments to PTI was incorporated into its 2012 Alabama corporate income tax return. As noted, though, the Revenue Department added the amount of the Taxpayer's deduction relating to PTI back to the Taxpayer's taxable income. (This ruling by the Tax Tribunal concerning the Taxpayer's question of law is based on the facts as presented by the Taxpayer.)

Law

Alabama's add-back statute was adopted in 2001 as Act 2001-1088 (4th Special Session) and was codified in Ala. Code § 40-18-35(b). In 2003, the Revenue Department adopted an administrative rule concerning the statute. *See* Ala. Admin. Code r. 810-3-35-.02, effective August 1, 2003; revised effective July 7, 2006. Following the decision of the Alabama Court of Civil Appeals in *Surtees v. VFJ Ventures, Inc.*, 8 So.3d 950 (Ala.Civ.App. 2008), the legislature amended the add-back statute in Act 2008-543. For purposes of this appeal to the Tax Tribunal, Alabama's add-back statute reads as follows:

> (b) Restrictions on the deductibility of certain intangible expenses and interest expenses with a related member.
>
> (1) 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. For purposes of this section, subject to a tax based on or

measured by the related member's net income means 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. Any portion of an item of income that is not attributed to the taxing jurisdiction, as determined by that jurisdiction's allocation and apportionment methodology or other sourcing methodology, is not included in income for purposes of a tax on net income and, therefore, shall not be considered subject to a tax. That portion of an item of income which is attributed to a taxing jurisdiction having a tax on net income shall be considered subject to a tax even if no actual taxes are paid on such item of income in the taxing jurisdiction by reason of deductions or otherwise.

(2) The corporation shall make the adjustments required in subdivision (1) unless the corporation establishes that the adjustments are unreasonable, or the corporation and the Commissioner of Revenue agree in writing to the application or use of alternative adjustments and computations. Nothing in this section shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(3) The adjustments required in subdivision (1) shall not apply to that portion of interest expenses and costs and intangible expenses and costs if the corporation can establish that the transaction giving rise to the interest expenses and costs or the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any Alabama tax and the related member is not primarily engaged in the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, or in the financing of related entities. If the transaction giving rise to the interest expenses and costs or intangible expenses and costs, as the case may be, has a substantial business purpose and economic substance and contains terms and conditions comparable to a similar arm's length transaction between unrelated parties, the transaction will be presumed to not have as its principal purpose tax avoidance, subject to rebuttal by the Commissioner of the Department of Revenue.

(4) The adjustments required in subdivision (b)(1) shall not apply to that portion of interest expenses and costs and intangible expenses and costs that the corporation can establish was paid, accrued or incurred, directly or indirectly, by the related member during the same taxable year to a person that is not a related member.

> (5) Nothing in this section shall require a corporation to add to its taxable income more than once any amount of interest expenses and costs or intangible expenses and costs that the corporation pays, accrues or incurs to a related member described in subdivision (1).
>
> (6) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under this chapter.
>
> (7) This subsection shall not limit the deduction of the interest portion of rent paid under lease agreements described in subsection (a)(9).

Ala. Code § 40-18-35(b).

<u>Analysis</u>

The Taxpayer argues that the facts concerning its transaction with PTI met the express wording of the add-back statute's subject-to-tax exception, as amended, and thus that the Taxpayer was not required to add its interest payment to PTI back to taxable income. The Taxpayer is correct.

As quoted, if a corporation deducts (for income tax purposes) interest expense that it paid to a related member, the corporation is not required to add that expense amount back to its taxable income "to the extent the corporation shows … that the corresponding item of income was in the same taxable year: … b.[s]ubject 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." (The other exceptions to add-back are not at issue in this appeal.) Here, the Taxpayer asserts that PTI was a "resident" of Ireland during the year in issue, pursuant to an income-tax treaty that was in force between Ireland and the United States. The Revenue

Department did not dispute those assertions.

Instead, the dispute concerns whether the interest expense paid to PTI was "subject to a tax based on or measured by [PTI's] net income" in Ireland. Act 2001-1088, § 1, p. 13, lines 20-24, defined that phrase to mean "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." The 2008 Act clarified the phrases "included in income for purposes of a tax on net income" and "subject to a tax," as follows:

> Any portion of an item of income that is not attributed to the taxing jurisdiction, as determined by that jurisdiction's allocation and apportionment methodology or other sourcing methodology, is not "included in income for purposes of a tax on net income" and, therefore, shall not be considered "subject to a tax." That portion of an item of income which is attributed to a taxing jurisdiction having a tax on net income shall be considered subject to a tax even if no actual taxes are paid on such item of income in the taxing jurisdiction by reason of deductions or otherwise.

Act 2008-543, § 1, p. 13, line 24 - page 14, line 8.

The Taxpayer paid $658 million in interest to PTI during 2012. According to the PTI return provided by the Taxpayer, PTI reported the interest income on its 2012 Ireland return on Line 2.31 as "Sales/Receipts/Turnover" (p. B-12) as part of a combined total of $682 million, and on a Profit and Loss Account as part of "interest receivable" of $877 million. After the deduction by PTI of interest payable (which included PTI's payments to Luxembourg affiliates) and expenses, that account showed

PTI's profit to be $10,000.00. As provided by the Taxpayer, Ireland's Taxes Consolidation Act, 1997, § 26(1), requires that "a company shall be chargeable to corporation tax on all its profits wherever arising." And § 4(1) of the Act states that "'profits' means income and chargeable gains." Further, the "amount of tax chargeable" takes into account allowances & deductions against income and profits or gains. (§ 959A)

Therefore, PTI "reported and included in income" its interest income from the Taxpayer "for purposes of a tax on net income …" Ala. Code § 40-18-35(b)(1). And the return filed by PTI in Ireland was not a combined or consolidated return.

This finding is consistent not only with the facts and with the original language of the subject-to-tax exception, but also with the clarifications added in 2008. In addition to reporting the interest income that PTI received from the Taxpayer, PTI deducted an almost equal amount of interest income that it paid to Luxembourg affiliates. Nevertheless, the interest income that PTI received from the Taxpayer "shall be considered subject to a tax even if no actual taxes are paid on such item of income in the taxing jurisdiction by reason of deductions or otherwise." Act 2008-543, §1 (clarifying the subject-to-tax exception). That is the fact situation here.

In its briefs, the Revenue Department primarily relies upon the *VFJ* decision in support of its position that the subject-to-tax exception does not apply here. In fact, the Revenue Department claims that the Taxpayer is asserting that the language of the add-back statute upon which *VFJ* was based was implicitly repealed by the 2008 Act.

But the Taxpayer has made no such argument. Instead, the Taxpayer contends that *VFJ* supports the Taxpayer's position because all of PTI's interest income from the Taxpayer was sourced to Ireland and, therefore, was subject to tax there.

The Taxpayer's point highlights the factual differences between *VFJ* and this appeal before the Tax Tribunal. In *VFJ*, the Taxpayer argued that it was entitled to a subject-to-tax exception of all the royalty amounts that it had paid to two related entities which filed corporate income tax returns in North Carolina for that same tax year (2001). However, on those North Carolina returns, the two related entities had apportioned - or sourced - slightly less than 3% and slightly less than 4%, respectively, of their royalty receipts to that state. The court in *VFJ* interpreted the subject-to-tax exception to apply on a post-apportionment basis, thus limiting VFJ's royalty-expense deduction in Alabama by the related entities' apportionment ratios in North Carolina. Here, all of PTI's interest income from the Taxpayer was sourced to Ireland. And instead of arguing that the 2008 Act repealed *VFJ*, the Taxpayer contends that the first sentence that was added by the Act confirmed the holding in *VFJ* regarding the exception being applied on a post-apportionment basis. Of course, the second sentence added by the 2008 Act was not at issue in *VFJ*.

Concerning the second sentence added by the 2008 Act, the Revenue Department claimed that it was relevant only to adjustments made after income was multiplied by a foreign jurisdiction's tax rate. That statement is incorrect, however, because of the fundamental rule that deductions are taken prior to applying a tax rate to taxable income. Here, on the Ireland return, the deductions taken by PTI occurred prior to the tax rate being applied to PTI's profit. In fact, it was the deductions that lowered PTI's profit to $10,000. The applicable tax rate then was applied to that profit. Alabama's statutes operate similarly. Section 40-18-2 imposes an income tax on "taxable income." Section 40-18-31 sets the tax rate for corporations at 6.5 percent of "taxable income." And § 40-18-33 states that "the term 'taxable income' means federal taxable income without the benefit of federal net operating losses plus the additions prescribed and less the deductions and adjustments allowed by this chapter and as allocated and apportioned to Alabama." Thus, Alabama allows for deductions to be taken before the tax rate is applied. In the Revenue Department's second brief, it stated that it was not attempting to address a "below the line" number on the returns concerning the second sentence of the 2008 Act, but instead "that the concept of 'net' income that is relevant for determining whether and to the extent that the receipt is 'included' is the calculated number on the return that is 'actually taxed.'" But the Revenue Department did not specify which "calculated number on the return" it was referencing.

The facts presented in this appeal fit squarely within the subject-to-tax exception to Alabama's add-back statute, as amended. The interest payment by the Taxpayer to PTI was attributed to Ireland according to that nation's sourcing methodology for purposes of Ireland's net income tax. Therefore, the interest income to PTI "shall be considered subject to a tax" even though no tax was paid by PTI on the income by reason of PTI's deduction of its own interest expenses. Ala. Code § 40-18-

35(b)(1). This ruling comports with well-established rules of statutory interpretation. *See*, *e.g. Blankenship v. Kennedy*, 320 So.3d 565, 567 (Ala. 2020):

> When interpreting a statute, this Court 'looks to the plain meaning of the words as written by the legislature.' *DeKalb Cty. LP Gas Co. v. Suburban Gas, Inc.*, 729 So. 2d 270, 275 (Ala. 1998). We do so because that is the only approach to statutory interpretation consistent with our constitutional role. 'To the end that the government of the State of Alabama may be a government of laws and not of individuals ... the judicial branch may not exercise the legislative or executive power.' Ala. Const. 1901, Art. III, § 42. Departing from the plain meaning of the text of a statute and substituting our own meaning would 'turn this Court into a legislative body, and doing that, of course, would be utterly inconsistent with the doctrine of separation of powers.' *DeKalb Cty. LP Gas Co.*, 729 So. 2d at 276.

Conclusion

The action of the Revenue Department to add the amount of the Taxpayer's interest payment to PTI back to the Taxpayer's taxable income is reversed. The Revenue Department is directed to recalculate the Taxpayer's net operating losses and carryforward amounts in accordance with this opinion and notify the Tax Tribunal of those amounts no later than **August 31, 2022**.

It is so ordered.

Entered July 28, 2022.

/s/ *Jeff Patterson*
JEFF PATTERSON
Chief Judge
Alabama Tax Tribunal

cc: Christopher R. Grissom, Esq.
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