State & Local Tax Alert

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Virginia Court Clarifies Scope of Related Party Addback Safe Harbor Exception

On February 3, 2016, the Circuit Court of the City of Richmond ruled that the safe harbor exception from the Virginia corporation income tax related party addback for certain corporate expenses was limited in applicability to the portion of intangible expenses that was not only subject to tax in another state, but on which tax was actually imposed.[1] Granting summary judgment in favor of the Virginia Department of Taxation, the Circuit Court noted that the original purpose of the legislation was to "close corporate loopholes" and ensure that income attributable to Virginia was appropriately taxed.

Background

For tax years beginning on or after January 1, 2004, taxpayers subject to the Virginia corporation income tax are required to add back intangible expenses paid to a related member to the extent such expenses were deducted by the taxpayer in calculating federal taxable income for Virginia income tax purposes.[2] Like many states that have a similar addback, Virginia allows taxpayers to claim an exception from the addback in several instances, including situations where the expense added back is subject to tax in another jurisdiction. The original "subject to tax" exception from this addback excluded a taxpayer from adding back intangible expenses to the extent that income received by the related party was "subject to 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."[3]

During its 2014 session, the Virginia General Assembly amended the "subject to tax" exception to conform to legislation in other jurisdictions that more narrowly construed this exception. The amendment was retroactively effective to tax years beginning on or after January 1, 2004.[4] The retroactive amendment modified the exception so that it only applies to the portion of intangible income received by a related member that has been

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Contact details

Gary Rosen
McLean
T 703.637.4070
E gary.rosen@us.gt.com

Guinevere Seaward
McLean
T 703.637.4133
E guinevere.seaward@us.gt.com

Nick Caputi
Philadelphia
T 215.814.1763
E nick.caputi@us.gt.com

Jamie C. Yesnowitz
Washington, DC
T 202.521.1504
E jamie.yesnowitz@us.gt.com

Chuck Jones
Chicago
T 312.602.8517
E chuck.jones@us.gt.com

Lori Stolly
Cincinnati
T 513.345.4540
E lori.stolly@us.gt.com

Priya D. Nair
Washington, DC
T 202.521.1546
E priya.nair@us.gt.com

www.GrantThornton.com/SALT

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[1] *Kohl's Department Stores Inc. v. Virginia Department of Taxation*, City of Richmond Circuit Court, Case No. CL 12-1774, Feb. 3, 2016.
[2] VA. CODE ANN. § 58.1-402(B)(8) (prior version).
[3] VA. CODE ANN. § 58.1-402(B)(8)(1) (prior version).
[4] H.B. 5001, 2014 Special Session I, § 3-5.11 (effective Jan. 1, 2004). Because the provisions in the bill simply funded Virginia through June 30, 2014 (the end of the state's 2013 fiscal year), rather

"attributed to a state or foreign government in which the related member has sufficient nexus to be subject to such taxes."[5]

In the first reported challenge to the interpretation of the amended "subject to tax" addback exception, the taxpayer, Kohl's Department Stores of Virginia (Kohl's Virginia) was audited by the Department for the tax years ending January 31, 2005; January 31, 2007; January 31, 2008; and January 31, 2009. Upon closing the audit, various modifications were made by the Department, including a complete disallowance of the related party addback exception for royalty payments made by Kohl's Virginia to Kohl's Department Stores of Illinois (Kohl's Illinois), an affiliate of Kohl's Virginia. Prior to the amendment, Kohl's Virginia, and several similarly situated Virginia taxpayers, interpreted the exception as applying on an unapportioned basis. As a result, Kohl's Virginia took the position that its royalties paid to its affiliate were "subject to tax" in another state and therefore, should not be added back into its income reportable to Virginia.

Richmond Circuit Court Rules Safe Harbor Exception Does Not Apply

Appealing the assessment, Kohl's Virginia argued that the royalties paid to Kohl's Illinois were included in the taxable income computation in Illinois, and were thus subject to tax. Under this reasoning, because the amounts were taxable in another state, Kohl's Virginia argued it had rightfully excluded the entire amount paid to its affiliate in computing Virginia taxable income. The Department maintained that, historically, the exception applied only to the extent that the taxpayer actually paid the tax on a post-apportioned basis. It was the intention of the Commonwealth, in retroactively amending the legislation, to identify only the portion of intangible expenses paid to an affiliate where a tax was imposed on the affiliate's receipts and provide a safe harbor from double taxation.

Granting summary judgment in favor of the Department and disallowing the entire addback exception, the Circuit Court stated that "to fall within the safe harbor exception, the intangible expense paid to a related member must not only be subject to a tax in another state, but that tax must actually be imposed." The Court further reasoned that the Virginia General Assembly had amended the addback provisions in order to prevent taxpayers taking the safe harbor exception when the expenses paid to related members were not actually taxed.

Commentary

Interestingly, the Circuit Court cited *Surtees v. VFJ Ventures Inc.*,[6] an Alabama case relied upon by the Department that similarly held a taxpayer did not qualify for an exception to the addback statute. Unlike Virginia's "plain language" legislation, however, Alabama explicitly limits the exception to the extent an affiliate paid tax on the royalty payments, and has done so since its original enactment.[7]

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than including the budget for an entire fiscal period, the bill was referred to as the budget bill "caboose."

[5] VA. CODE ANN. § 58.1-402(B)(8)(1) (current version).

[6] 8 So. 3d 950 (Ala. Civ. App. 2008).

[7] *See* ALA. CODE § 40-18-35(b)(1) ("Subject to tax" means that the receipt of 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 Circuit Court's decision lends judicial validation to the Department's longstanding interpretation of the application of related party addback exceptions,[8] and the Department's motivation in requesting that the Virginia legislation retroactively amend this provision. Of particular importance is the fact that this case did not address the issue of whether the retroactive amendment was valid, as both parties stipulated to remove this issue from consideration. The ten-year period of retroactivity poses equitable and potentially constitutional concerns, as this length of time markedly exceeds the one-year period that Justice O'Connor deemed acceptable for a retroactive statute in her concurring opinion in *United States v. Carlton.*[9] It is possible that other taxpayers in a similar position may challenge the legislation in the future by attacking the period of retroactivity.

The Circuit Court's interpretation raises another potential constitutional argument, specifically with respect to the application of the dormant Commerce Clause. When a company files in both Virginia and a state in which mandatory unitary combined reports between affiliates are required (such as Illinois), payments to affiliates generally are eliminated and thus, not technically subject to tax. Therefore, the Department disallows the safe harbor when an affiliate only files in unitary combined states, because the receipts are not subject to tax under this ruling. This could implicate the dormant Commerce Clause,[10] calling into question the treatment of a taxpayer under the tests governing fair apportionment and external consistency.[11]

Constitutional concerns notwithstanding, the Circuit Court's decision to apply the "subject to tax" exception on a post-apportioned basis serves to substantially limit the ability of corporate taxpayers to utilize an important and frequently used exception to the Virginia related party addback. Taxpayers that have intercompany transactions with affiliates resulting in expenses that are subject to the Virginia addback rules should determine the extent of their potential exposure in light of this decision.

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[8] The Department's policy in this area was first stated in Ruling of Commissioner, P.D. 07-153, Virginia Department of Taxation, Oct. 2, 2007.

[9] 512 U.S. 26, 37-38 (1994) (O'Connor, J., concurring) (stating that "[t]he government interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose . . . A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise . . . serious constitutional questions.").

[10] The "dormant" Commerce Clause prevents state from passing legislation that discriminates against interstate commerce. *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 754 (1967).

[11] The operation of the related party addback rule may serve to substantially increase a taxpayer's taxable income, potentially resulting in taxation on an unfair portion based on the services provided, thus ignoring the "reasonable sense of how income is generated." See *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983).