



SALT Alert!



SALT Alert! 2017-23: Virginia: State Supreme Court Issues Ruling on Applicability of “Subject to Tax” Exception

On August 31, 2017, the Supreme Court of Virginia ruled partially in favor of the Department of Taxation and partially in the taxpayer’s favor in a case addressing the application of the “subject to tax” exception to the state’s related party addback statute.

Background

Under Virginia law, certain types of intangibles expenses paid to related parties that are deducted for federal income tax purposes are required to be added back in determining a corporation’s Virginia taxable income. The addback is not required if the taxpayer qualifies for one of the statutory exceptions to the addback rules. The taxpayer at issue argued that none of its royalties were required to be added back because the affiliate to whom it paid royalties was subject to tax on its royalty income in certain states. In the taxpayer’s view, if the royalties were included in the computation of taxable income in another state, then it qualified for the so-called “subject to tax” exception to the addback requirement. The Department, however, asserted that the exception applied only to the amount of the affiliate’s royalty income actually taxed in other states, as evidenced by apportionment percentages shown on the tax returns filed in those states. In other words, it was the Department’s view that the subject to tax exception applied on a post-apportionment basis, while the taxpayer argued that the exception applied on a pre-apportionment basis. After a circuit court ruled in the Department’s favor, the taxpayer appealed.

Virginia Supreme Court’s Decision

The “subject to tax” exception applies when 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 . . . another state.*” In the court’s view, it was unclear from this language whether the exception applied on a pre- or post-apportionment basis. Because the statute was ambiguous, the court looked to the legislative intent behind the enactment of the addback statute and observed that it was intended to close certain corporate loopholes. Under a pre-apportionment interpretation, a corporation could avoid the application of the addback statute by paying royalties to a related member in a state where the related member had insignificant apportionment. This result, the court determined, would resurrect the loophole the statute was designed to close. Because the statute was ambiguous, the Commissioner’s interpretation was also entitled to deference where, as here, it was a reasonable interpretation of the law. As such, the court concluded that the “subject to tax” exception

applies on a post-apportionment basis and only to the extent that the royalties are actually taxed by another state.

The court next addressed the taxpayer's alternative argument that the Department erred in calculating the amount of the subject to tax exception. The Department had allowed a partial exception for the royalties that were apportioned and taxed on the separate returns filed by the taxpayer's affiliate. However, the taxpayer argued that the exception should have been greater because it paid tax on some of the royalty income through being included in a combined report with its affiliate or because it was required to add the royalties back in certain separate return states. The court agreed with the taxpayer. This statute required only that the "item of income received by the related member"—in this case, the royalties—be taxed by another state. It did not mandate that the entity paying tax on the "item of income" be the related member to whom the payments were made. Thus, the court concluded that the exception applies to the extent that the royalties are **actually taxed** in separate return states (by virtue of the related member being subject to tax), combined return states, or in states with addback rules (by virtue of the taxpayer adding the expense back to federal taxable income).

Next steps

What is interesting (and confusing) about the court's holding is that it acknowledged, but did not specifically address, retroactive amendments to Virginia law that added limitations to the subject to tax exception to more closely align with the Department's interpretation.

Specifically, under the amended law, for tax years beginning on and after January 1, 2004, the "subject to tax" exception "shall be limited and apply only to the portion of such income received by the related member, which portion is attributed to a state or foreign government in which the related member has sufficient nexus to be subject to such taxes." Because the decision addressed the exception pre-amendment and the amendment was retroactive to 2004, the court's holding must be read in light of the revised law. Although the court considered royalties included in a combined return to be subject to tax, it is not clear how that holding applies given the revised law.

Three justices dissented, in part because the plain language of the statute did not contain an apportionment mechanism and the multiple bills proposed to add one indicated that this was not a clarification of existing law. For more information on [Kohl's Department Stores, Inc. v. Virginia Department of Taxation](#), please contact [Diana Smith](#) at 703-286-8214.