



This Week in State Tax (TWIST)

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Virginia: Department of Taxation Addresses Application of Related Party Addback Rules

The Virginia Department of Taxation recently issued two policy documents (P.D. 24-18 and P.D. 24-26) addressing the state's related party expense disallowance rules. Both rulings discussed the application of the "subject-to-tax" exception taking into account the litigation in the Kohl's case. In both rulings, the Department of Taxation, on audit, reduced the claimed exception amount on the basis that the exception should be limited to the portion of the intangible expense payments that correspond to the portion of the taxpayers' affiliates' income subjected to tax in other states. The taxpayers contended that the plain language of the statute entitled them to exclude 100 percent of the royalties because all the royalty income was included in the affiliates' taxable income in another state. The Department disagreed and reminded the taxpayers that in the Kohl's case, the Virginia Supreme Court held that the subject-to-tax exception applies to the portion of royalties actually taxed by another state. In other words, the exception is calculated based on post-apportionment income, rather than pre-apportionment income. The Kohl's court also held that at the "statute only requires that the 'item of income received by the related member' . . . be taxed by another state. It does not require that the related member be the entity that pays the tax on that 'item of income.'" Further, in a subsequent court case also involving Kohl's, the Department of Taxation successfully argued that the subject-to-tax exception does not apply when royalty payments are eliminated as intercompany transactions in combined or consolidated reporting states. P.D. 24-26 also addressed the impact of New Jersey's "throw-out" rule on the calculation of the addback exception. The Department determined that when a state has a "throwout" or "throwback" rule, the amount of income eligible for the subject-to-tax exception must include all intercompany intangible income taxed in the state, including any additional income apportioned to, and taxed by, such state by operation of the throwout or throwback rule.

P.D. 24-18 also addressed a second important issue—whether certain types of expenses – merchandise buyer service fees and systems license fees – were subject to addback. Pursuant to Virginia Code § 58.1-302, five categories of expenses qualify as intangible expenses and costs. The first category ties the expense to the definition of "intangible property." The fourth category specifically lists licensing fees without regard to whether the fee is paid for intangible property. The Department concluded that the merchandise buyer fees were not a type of expense that was captured by the addback statute. However, the license fee, which was calculated based on a percentage of the taxpayer's sales, was paid to an affiliate for the use of certain trade secrets and other intangible property, including unique computer software application systems. In addition to use of the software, the taxpayer asserted that the fees were also paid for the service of maintaining and operating the systems. The Department disagreed, noting that a sample license agreement provided by the taxpayer stated that the affiliates employees developed and maintained the software. Further, the licensing fee structure was similar to those normally associated with intellectual assets specifically identified under the definition of intangible property under Virginia Code § 58.1-302. The Department concluded that the systems license fee expenses were subject to addback and would be eligible for the subject-to-tax exception. Please contact [Diana Smith](#) with questions.

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