

Virginia - Franchise fee deduction supported by transfer pricing study and subject-to-tax addback exception limited

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In brief

The Virginia Tax Commissioner allowed a taxpayer's deduction for franchise fees paid when transfer pricing studies supported that such fees reflected arm's length transactions. Additionally, the taxpayer could claim a subject-to-tax addback exception only for its portion of royalty expenses relating to the recipient's income that was subject to tax *after apportionment*. Virginia taxpayers should note that the Department is currently in litigation regarding the subject-to-tax exception. Pending the outcome of the litigation, Virginia taxpayers should consider filing protective claims regarding income taxes paid for related party intangible and interest expenses when the subject-to-tax exception was anything less than a 100% exception. [[Virginia Public Document 13-140 \(7/19/2013\)](#)]

In detail

Facts

For tax years ending in 2005, 2007, 2008, and 2009, Taxpayer incurred two related party expenses paid to its parent (Parent): (1) franchise fees and (2) royalty expenses. On its Virginia corporate income tax returns, Taxpayer claimed a deduction for its franchise fee expenses, which the state disallowed on audit. Although Virginia requires the addback of related party royalties, Taxpayer claimed that 100% of its royalty expenses were exempt under Virginia's subject-to-tax exception. On audit, the state allowed Taxpayer a subject-to-

tax exception only to the extent such royalties were included in Parent's apportioned taxable income in other states. Taxpayer appealed the audit determinations to the Tax Commissioner.

Franchise fee deductions allowed when supported by transfer pricing studies

The Department of Taxation may 'equitably adjust the tax' of a taxpayer when arrangements exist that 'improperly reflect the business done' in Virginia.

The Commissioner viewed Taxpayer's franchise fees as management fees, the treatment of which Virginia has addressed

in prior rulings. The Commissioner recognized that, applying the Department's equitable adjustment powers, management fee deductions:

- have been *allowed* when no intercompany profit was created because a cost-reimbursement arrangement cannot be characterized as improperly reflecting Virginia income
- have been *disallowed* when a profit percentage provided to a related party without economic substance failed to reflect fair market value.

In this case, Taxpayer provided several independent transfer pricing studies demonstrating that Parent's service charges were reasonable when compared with arm's length transactions between unrelated parties. The Commissioner determined economic substance was clear and services were provided at fair market value and, therefore, allowed Taxpayer to deduct its franchise fees.

Royalty expense 'subject-to-tax' addback exception applies only to apportioned amount actually taxed

Virginia's related party addback rule generally provides an exception for *any portion* of the expense if the *corresponding* item of income received by the related member is 'subject-to-tax' in Virginia or another state's jurisdiction.

This decision raises the question of how to interpret whether an expense item is 'subject-to-tax.' Taxpayer asserted that 100% of Parent's royalty income was 'subject-to-tax' when Parent reported such income on state income tax returns, even though Parent's measure of tax was only on a certain apportioned percentage of such income. Accordingly, Taxpayer claimed that it could exempt 100% of its royalty expenses. The Department argued that an expense is 'subject-to-tax' only to the extent that it relates to apportioned income subject to state taxation.

The Commissioner asserted that this issue was resolved in Public Document 07-153 (10/2/07), which

allowed a subject-to-tax royalty exception equal to the related party's *apportioned* royalty income subject to state tax. Therefore, the Commissioner in this case found that the subject-to-tax-exception is limited to the amount of income that is apportioned to states where Parent is taxed, evidenced by the apportionment factors of actually filed tax returns with other states.

Valid business purpose not considered, statutory procedure not followed

Taxpayer argued it should be allowed to exclude its royalty expense from the addback requirement because the related intercompany transactions had a valid business purpose other than the avoidance or reduction of tax.

Virginia's Code establishes a specific procedure to be followed to claim the valid business purpose addback exclusion, which includes paying the tax on an original return and requesting a refund. The Taxpayer did not make the request in accordance with the statutory procedure, therefore Taxpayer's request to exclude the addback of intangible expenses on the claim that they were incurred for a valid business purpose was not considered by the Department.

The takeaway

This ruling affirms that related party management/franchise fees may be sustained on audit when supported by a transfer pricing study that evidences an arrangement between related parties that does not distort Virginia taxable income and is provided at fair

market value. Previous rulings held that intercompany service charges made at cost did not distort Virginia taxable income, so this ruling is important because it affirms that intercompany services that reflect arm's-length rates will be respected as well.

With regard to Virginia's royalty addback, the interpretation of the subject-to-tax safe harbor remains in flux. Despite the Department's assertions to the contrary, the subject-to-tax safe harbor does not expressly require apportionment. In fact, the Virginia statute lacks language contained in other states' addback statutes that apply the subject-to-tax exception 'to the extent' that the income is actually subject-to-tax in other states. Moreover, two separate efforts by the Department in recent years to add such language to the statute have been rejected by the General Assembly. The issue is currently in litigation in the Circuit Court for the City of Richmond in *Kohl's v. Commonwealth* and a hearing is expected later this year. Taxpayers applying the safe harbor on an apportioned basis may wish to consider submitting protective claims for refund for any open years pending the outcome of the *Kohl's* case.

Finally, the decision highlights the strict adherence to procedure regarding the state's business purpose exception. Taxpayers anticipating to claim such an exception should be aware of the procedural requirements and their risks and benefits.

Let's talk

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