

Virginia – Ten year retroactive limitations placed on addback exceptions

April 7, 2014

In brief

Signed on April 1, 2014, S.B. 5001 enacts Virginia's budget bill, which includes limitations on the state's subject to tax and unrelated party addback exceptions. The subject to tax exception is generally limited to the 'portion of income' received by the related member. The unrelated party exception is generally limited to the 'portion of income' derived from license agreements that are comparable to third party agreements.

Both limitations are retroactive to taxable years beginning on and after January 1, 2004.

In detail

Intangible expense addback

Under current law, for taxable years beginning on and after January 1, 2004, Virginia requires taxpayers to add back intangible expenses and costs paid to a related member to the extent such expenses and costs were deducted in computing federal taxable income for Virginia purposes.

Subject to tax exception limited to the portion of income received by related member

Under current law, Virginia provides an addback exception to the extent the income received by the related member is "subject to a 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."

Applicable for tax years beginning on and after January 1, 2004, S.B. 5001 provides that the subject to tax exception is limited and applies 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."

Unrelated party addback exception limited to the portion of income received

Under current law, Virginia generally provides an addback exception to the extent the

related member derives at least one-third of its gross revenues from the licensing of intangible property to parties that are not related members.

Applicable for tax years beginning on and after January 1, 2004, S.B. 5001 provides that the unrelated member addback exception is limited and applies only to the *portion of such income* derived from "licensing agreements for which the rates and terms are comparable to the rates and terms of agreements that the related member has actually entered into with unrelated entities."

The takeaway

This is just the latest chapter in a long saga dating back to the enactment of Virginia's royalty

addback provisions in 2004. Unlike other states, Virginia's subject to tax exception lacked language limiting the exception "to the extent" tax was actually paid to other states. This lead many taxpayers to take the position that if intangible expenses and costs were subject to tax in at least one other state that no addback would be required in Virginia.

The Department of Taxation previously sought legislative changes in 2010 and 2013 to add the "to the extent" language *and* to make the change declarative of existing law, i.e., to make it retroactive to 2004. Both previous attempts were defeated after

business community objections to making the legislation retroactive. More recently, the issue has been the subject of litigation in the Kohl's case currently before the Circuit Court of the City of Richmond, where a decision is expected this year.

The Department's latest effort to legislate a solution to its 2004 statutory drafting differs from past efforts in that it was accomplished entirely through the Budget Bill, instead of standalone legislation as in the past. The language was included in the 'caboose' budget bill, which amends the current budget for the biennium that ends June 30, 2014.

The budget for the next biennium, ending June 30, 2016, is still under negotiation and probably will not be enacted for several more weeks.

It is expected that the business community will strongly object to the provisions and perhaps attempt to repeal the changes in the upcoming 2015-2016 budget. Moreover, it is possible that the Kohl's case could provide a forum to argue the constitutionality of a 10-year retroactivity provision.

Let's talk

If you have questions about the retroactive law change to Virginia's addback exceptions, please contact:

State and Local Tax Services

Tim Winks
Managing Director, *Tyson's Corner*
+1 (703) 918-3541
tim.winks@us.pwc.com

Steve Arluna
Partner, *Tyson's Corner*
+1 (703) 918-1521
steve.arluna@us.pwc.com

Robert Porcelli
Principal, *Tyson's Corner*
+1 (703) 918-6793
robert.m.porcelli@us.pwc.com