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Is Virginia's Addback Statute Exception Susceptible to Challenge?

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In 2004 Virginia joined what are now 21 states and enacted an addback statute. This law disallows deductions for intangible and some interest expenses paid by Virginia corporate taxpayers to related parties. Like the other states, Virginia provides a few exceptions from its addback statute. One is the subject to tax exception. If the related party that receives the royalty or intangible payment from the Virginia taxpayer is subject to tax in another state or foreign country, the Virginia taxpayer may deduct its royalty expense or other intangible expense.

Recent rulings by the Virginia Department of Taxation limit the applicability of the subject to tax exception to a postapportionment basis. That is, the department's rulings reduce the amount of the exception to correspond to the amount of the related party's royalty income or other intangible income that is apportioned to each state in which that party pays an income tax.

This article examines the possibility that the department's interpretation may run afoul of Virginia's rules of statutory interpretation. Further, the article considers whether Virginia's subject to tax exception could constitute a constitutionally impermissible tax on extraterritorial income or otherwise violate the external consistency test of the fair apportionment requirement to the U.S. Supreme Court's dormant commerce clause test.

Virginia's Subject to Tax Exception

Under Internal Revenue Code section 162, a taxpayer is entitled to deduct ordinary and necessary business expenses, including royalty payments, to arrive at federal taxable income. Like most states, Virginia's calculation of state taxable income starts with federal taxable income.[1] Among other modifications to federal taxable income, Virginia requires that intangible expenses directly or indirectly paid, accrued, or incurred to one or more related parties be added back to federal taxable income for purposes of arriving at Virginia taxable income.[2]

Virginia's statute provides that the "addition shall not be required for any portion of the intangible expenses" if:

> 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 Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government.[3]

Draft regulations[4] that were originally issued by the department in May 2008 but have not been formally published in the *Virginia Register of Regulations* as required by Virginia's Administrative Process Act, adopt the postapportionment limitation on the subject to tax exception set forth in the department's rulings. The draft regulations also provide an additional limitation not set forth in the statute. According to the draft regulations, the inclusion of the intangible payment in another state's combined or consolidated return filed by, or that includes, the related-party recipient of the payment does not qualify for the subject to tax exception.

In Virginia a taxing statute is construed to give effect to the legislative intent from the plain language of the statute, unless the statutory language is ambiguous or applying the plain language would lead to an absurdity.[5] If the language of a statute is clear and unambiguous, regulations issued by the

[1]Va. Code section 58.1-402.A.
[2]Va. Code section 58.1-402.B.8.
[3]Va. Code section 58.1-402.B.8.a.(1).
[4]23 VAC 10-120-103 (exposure draft).
[5]*Virginia Cellular LLC v. Virginia Department of Taxation*, 276 Va. 486, 490, 666 S.E. 2d 374, 376 (2008). (For the decision, see *Doc 2008-19785* or *2008 STT 181-18*.)

department that are inconsistent with or conflict with the plain language will not be sustained.[6]

If Virginia's addback statute or its subject to tax exception is found to be ambiguous, the legislative intent should be determined based on the reasons that caused the Virginia General Assembly to enact the statute.[7]

Department of Taxation Rulings

In a series of rulings, the department is interpreting the subject to tax exception as applicable on a postapportionment, not preapportionment, basis. If a related-party recipient of royalty income that was paid by a Virginia corporate taxpayer files a tax return only in State A and the recipient's apportionment factor in State A is 5 percent, then the department will allow the taxpayer to deduct 5 percent of the royalty payment.[8]

If Virginia's addback statute or its subject to tax exception is found to be ambiguous, the legislative intent should be determined based on the reasons that caused the Virginia General Assembly to enact it.

The department's rulings are suspect because they fail to address some fundamental issues of statutory construction. Rather, the department relies on its role helping to draft the statute, case law it claims entitles its interpretation to "great weight,"[9] and the rule that every part or word of a statute is presumed to have meaning.[10] However, only the department's interpretations embodied in validly issued regulations are entitled to any weight, and the case law relied on by the department dealt with departmental interpretations set forth in regulations, not rulings.[11] An interpretation in a published ruling is entitled to no weight or deference, only to judicial notice.[12]

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The department strains to construe the "portion of the intangible expenses" are not added back if the "corresponding item of income" is subject to an income tax to include "after the related member apportions that item of income." Rather than giving meaning to "portion" and "corresponding item," the department arguably is inserting additional words into the statute. In doing so, it could be narrowing the statutory "subject to tax" exception, and its interpretation may suffer the same fate as its costs of performance interpretation suffered in *General Motors*.

The rulings are also silent on the question of the external consistency test of the commerce clause fair apportionment requirement. Further, they do not consider whether Virginia's subject to tax exception (and addback statute) result in the taxation of extraterritorial values in light of some other Virginia tax policies. Thus, the department's rulings should not be the final word on the proper interpretation of Virginia's addback statute and its subject to tax exception.

VFJ Ventures

The department may believe its position is supported by the Alabama Court of Civil Appeals' decision in *Surtees v. VFJ Ventures Inc.*[13] However, different statutory language and underlying tax policies in Virginia compared to Alabama may provide better support to taxpayers challenging Virginia's subject to tax exception.

In *VFJ Ventures, Inc.*, the Alabama appellate court reversed an Alabama circuit court and upheld Alabama's version of the subject to tax exception to Alabama's intangible and interest expense addback

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[6]*General Motors Corp. v. Commonwealth*, 268 Va. 289, 293, 602 S.E. 2d 123, 125 (2004) (for the decision, see *Doc 2004-18598* or *2004 STT 184-26*); *Virginia Cellular LLC*, 666 S.E. 2d at 378; *Ruling of Commissioner*, P.D. 09-96 (June 11, 2009) (royalites).

[7]*Ambrogi v. Koontz*, 224 Va. 381, 297 S.E. 2d 660 (Va. 1982).

[8]*See Ruling of Commissioner, P.D. 07-153* (Oct. 2, 2007) (patent and trademark royalties); *Ruling of Commissioner, P.D. 07-217* (Dec. 20, 2007) (royalties); *Ruling of Commissioner, P.D. 09-49* (Apr. 27, 2009) (royalties); *Ruling of Commissioner*, P.D. 09-67 (May 13, 2009) (royalities and factoring fees); and *Ruling of Commissioner, P.D. 09-68* (May 13, 2009) (factoring fees).

[9]*See Ruling of Commissioner, P.D. 09-68; but see General Motors Corp.*, 602 S.E. 2d at 125.

[10]*Raven Red Ash Coal Corp. v. Henry Absher*, 153 Va. 332, 149 S.E. 541 (1929).

[11]Va. Code section 58.1-205.2 (Department regulations will be sustained unless unreasonable or plainly inconsistent with the statute); *General Motors Corp.*, 602 S.E. 2d at 125.

[12]Va. Code section 58.1-205.3. This means that the department's rulings at most are treated as facts and, in general, judicial notice only precludes a taxpayer from introducing contrary evidence as to the fact that the ruling setting forth a postapportionment interpretation by the department was issued.

[13]No. 2060478 (Ala. Civ. App., Feb. 8, 2008), *aff'd*, No. 1070718 (Ala., Sept. 19, 2008), *cert. denied,* 77 U.S.L.W. 3594 (Apr. 27, 2009). (For the Court of Civil Appeals decision, see *Doc 2008-20200* or *2008 STT 185-8*.)

statute. The related parties in *VFJ Ventures* were intangible holding companies (IHCOs) domiciled in Delaware, where their royalty income was not subject to income tax. The IHCOs licensed trademarks to various affiliates and third parties, including VFJ Ventures, a related Alabama taxpayer. The IHCOs filed North Carolina income tax returns and apportioned 2.8783 percent and 3.9415 percent, respectively, of their income to North Carolina and paid income taxes on their North Carolina apportioned income.

VFJ Ventures did not add back its related-party royalty payments to the IHCOs. Rather, on its Alabama tax return, VFJ Ventures claimed that the entire royalty payments qualified for the subject to tax exception from Alabama's statute because of the IHCO's North Carolina income tax payments.

Alabama's exception defined subject to tax to mean "that the receipt of the 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."[14] Although the IHCOs "reported and included" their royalty income on North Carolina corporate income tax returns and paid North Carolina income tax, the court interpreted Alabama's exception to apply on a postapportionment basis. The court reasoned that this interpretation was consistent with legislative intent. According to the court, it was an unreasonable interpretation and would negate operation of the addback statute if an Alabama taxpayer could fully deduct its intangible or interest expenses paid to a related party if that party had only to establish nominal nexus in another state and pay some income tax.[15]

The court also upheld Alabama's addback statute and its subject to tax exception against the taxpayer's constitutional challenges. On appeal, the taxpayer contended that Alabama's statute violated the commerce clause of the U.S. Constitution. Under the U.S. Supreme Court's dormant commerce clause test, a state tax is upheld only if it has a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state.[16]

First, the Alabama court rejected the taxpayer's contention that the addback statute is tantamount to a tax on the out-of-state recipients of the intangible income that the taxpayer argued did not have a substantial nexus with Alabama. Even if it was a tax on those licensors, the court further reasoned that the assertion of income taxing jurisdiction over a corporation that did not have a physical presence in Alabama was supported by the continuing trend of case law from other state courts in favor of economic presence nexus.[17]

In *Amerada Hess Corp. v. Director, Div. of Taxation*,[18] New Jersey's addback of federal windfall profit tax expenses that were related to oil production outside New Jersey, but that were attributable to apportionable business income of the unitary business conducted partly in New Jersey, was upheld by the U.S. Supreme Court. Thus, the disallowance of an expense deduction is justified if the expense is related to income that could be or is taxed by the state. Otherwise, disallowance of an expense deduction that is not attributable to income that could be taxed by the state is actually tantamount to the taxation of extraterritorial value.[19] Thus, although a state may do indirectly what it may also do directly, as ruled in *Amerada Hess*, it may not do indirectly what it may not do directly, as the Court ruled in *Hunt-Wesson*.

As seen below, the distinction of *Hunt-Wesson* from *Amerada Hess* is significant for Virginia's addback statute and subject to tax exception in light of long-standing Virginia tax policies.

> ***The distinction of* Hunt-Wesson *from* Amerada Hess *is significant for Virginia's addback statute and subject to tax exception.***

Next, the court summarily rejected the taxpayer's argument that the subject to tax exception, as limited by a postapportionment application, was not

[14]Ala. Code section 40-18-35(b)(1).

[15]The court also rejected the taxpayer's argument, and the trial court's judgment, that the trademark royalties were deductible under Alabama's "unreasonable" exception. The trial court had found the IHCOs were formed pursuant to legitimate business purposes and their licensing transactions had economic substance. As such, the trial court believed it was unreasonable to require addback and that exception applied (Ala. Code section 40-18-35(b)(2)). According to the appellate court, Alabama's addback statute was not intended to address only sham transactions.

[16]*Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

[17]*See, e.g., Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E. 2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); *Geoffrey, Inc. v. Commissioner of Revenue*, 899 N.E. 2d 87 (Mass. 2009), *cert. denied*.

[18]490 U.S. 66 (1989).

[19]*Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000) (disallowance of interest expense deduction attributable to nontaxable nonbusiness income allocable outside the state was unconstitutional). (For the decision, see *Doc 2000-5169* or *2000 STT 36-58*.)

fairly apportioned. A state tax must be internally consistent — if applied by every state, there would be no multiple taxation. Also, a state tax must be externally consistent — the state tax reflects a reasonable sense of how income is generated.[20] The taxpayer did not argue that the subject to tax exception was not internally consistent, and the court believed that the limitation was externally consistent. According to the court, there was external consistency because the added back royalty payments were apportioned to Alabama using the taxpayer's Alabama apportionment factor. Further, the court simply stated that the taxpayer made no evidentiary showing that the addback statute resulted in taxation out of proportion to the taxpayer's activities in Alabama.

Finally, the Alabama court rejected the taxpayer's argument that the addback statute discriminated against interstate commerce.

Virginia Tax Policies

One of Virginia's long-standing administrative tax policies is that an out-of-state business has nexus with Virginia only if it has positive Virginia apportionment factors — property, payroll, or sales.[21] That policy is also confirmed by Virginia tax regulations.[22] One reason for the policy is to provide clarity regarding the members of an affiliated group of corporations that can be included in a Virginia consolidated return. Only those members of an affiliated group of corporations that are subject to Virginia income tax are eligible to be included in a Virginia consolidated return.[23] The department has historically removed any affiliate from the return that does not have a physical presence in Virginia (that is, positive apportionment factors).[24] One purpose underlying Virginia's policy is to prevent or minimize the inclusion of loss companies in the Virginia consolidated return.

Moreover, the licensor of intangible property to a Virginia corporate taxpayer would likely not have a positive Virginia sales factor. Its intangible receipts are most likely sourced outside Virginia based on the greater proportion of its costs of performance being outside Virginia.[25]

Thus, an important justification for the addback statutes under *Hunt-Wesson* that arguably may exist for Alabama and possibly other states does not exist for Virginia's statute. For other material reasons, the department should be loath to argue that it could assert taxing jurisdiction over an out-of-state licensor of intangible property that has no positive apportionment factors with Virginia, at least one that is also engaged in ongoing and substantive business activities. By doing so, the department risks opening a door it does not want opened — introducing the potential to include loss affiliates having no Virginia apportionment factors into a Virginia consolidated return. However, the department's policy of not asserting nexus over an out-of-state corporation that does not have positive Virginia apportionment factors may imperil the department's interpretation of the subject to tax exception.

Is the 'Subject to Tax' Exception an Impermissible Tax?

The department's application of the subject to tax exception may suffer from significant flaws. First, the department's interpretation may not be supported by the rules of statutory interpretation applied by Virginia courts to Virginia tax statutes. In fact, the department's position in its draft regulation that inclusion of the intangible income in another state's combined or consolidated return does not qualify the payment for the subject to tax exception is nowhere to be found in the statute. Second, given the Virginia tax policy discussed above, Virginia's entire addback statute seems highly susceptible to a constitutional challenge under a *Hunt-Wesson* rationale.

Finally, Virginia's subject to tax exception may not be externally consistent. The department's rulings that apply the subject to tax exception on a postapportionment basis do not address the external consistency test. The department does not explain why, so this may be an oversight or an intentional tactic. Although a fuzzy concept that has not always been a fruitful area of challenge for taxpayers, a particular fact pattern may bear fruit.

External consistency requires a rational relationship between the income attributed to Virginia by the addback statute and the intrastate values of the enterprise.[26] A state tax regime must reflect a "reasonable sense of how income is generated."[27] "External consistency . . . looks . . . to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that

[20] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

[21] *Ruling of Commissioner, P.D. 92-238* (Nov. 16, 1992); *Ruling of Commissioner, P.D. 09-44* (Apr. 27, 2009); *Ruling of Commissioner, P.D. 09-81* (May 26, 2009).

[22] 23 VAC 10-120-20.

[23] Va. Code section 58.1-442; 23 VAC 10-120-322.B.

[24] *Ruling of Commissioner, P.D. 92-238; Ruling of Commissioner, P.D. 94-228* (July 25, 1994).

[25] 23 VAC 10-120-230; *Ruling of Commissioner, P.D. 02-52* (Apr. 16, 2002).

[26] *Container*, 463 U.S. at 180-181.

[27] *Id.* at 169.

portion of value that is fairly attributable to economic activity within the taxing State."[28]

Virginia's subject to tax exception may not be externally consistent.

The intrastate values of the enterprise being taxed by Virginia under its addback statute are measured by the Virginia taxpayer's apportionment factors — its Virginia economic activity. It seems that the flaw in Virginia's subject to tax exception, as interpreted by the department, is that the licensee's Virginia tax deduction is limited to the extent of economic activity of its licensor that occurs in some states (those requiring or permitting a combined or consolidated return) or that is not taxed by other states (those requiring separate company tax returns). Virginia increases the values that it seeks to tax by limiting a tax deduction precisely by the extent of economic activity occurring in other states that Virginia has no right, at least under its own tax policies, to tax.

Also, Virginia increases the intrastate values of the Virginia licensee that it seeks to tax equal to the economic activity (licensing) that Virginia's own policies do not permit it to tax directly. The licensor has no positive Virginia apportionment factors, and thus no Virginia economic activity. It is also questionable that income unrelated to any Virginia economic activity could have any rational relationship to Virginia. Virginia's economic justification seems largely absent.[29]

Hunt-Wesson shows that Virginia's subject to tax exception, and possibly its entire addback statute, may be constitutionally impermissible. In *Hunt-Wesson*, California's interest expense offset statute was challenged under the external consistency prong of the fair apportionment requirement. The statute limited a California taxpayer's interest expense deduction by disallowing an interest expense deduction to the extent of the taxpayer's interest and dividend income allocated to another state. The parties conceded that the interest and dividend income allocable to other states was nontaxable income and bore no rational relationship to California. According to the U.S. Supreme Court:

> California's rule measures the amount of additional unitary income that becomes subject to its taxation (through reducing the deduction) by precisely the amount of nonunitary income that the taxpayer has received. And for that reason, that which California calls a deduction limitation would seem, in fact, to amount to an impermissible tax.[30]

Likewise, Virginia's subject to tax exception limits a deduction of a Virginia taxpayer by precisely the amount of income that Virginia, under its long-standing tax policies, rulings, and regulations, cannot tax. Thus, by reducing a deduction, Virginia is doing indirectly what it cannot do directly.

Virginia, like California in *Hunt-Wesson*, could still justify its deduction limitation by showing that the "limit actually reflected the portion of the expense properly related to [nontaxable] income." In that circumstance, " . . . the limit would not, in fact, be a tax on [nontaxable] income. Rather, it would merely be a proper allocation of the deduction."[31] Reasonable efforts to allocate deductions between taxable and nontaxable income are upheld by the Court.[32] *Bartow County* is cited by the department in one of its rulings[33], but the department does not explain why its interpretation of the subject to tax exception is a "reasonable effort to allocate a deduction." In *Hunt-Wesson*, California failed to justify that its interest expense offset statute was a reasonable allocation of a deduction, because the statute, like Virginia's, relied on unreasonable assumptions. As such, a "state tax code that unrealistically assumes . . . is a code that fails to 'actually reflect a reasonable sense of how income is generated,' . . . and in doing so assesses a tax upon constitutionally protected [nontaxable] income."[34]

The department's postapportionment application of the subject to tax exception is based on at least three unreasonable or unrealistic assumptions.

The department's postapportionment application of the subject to tax exception is based on at least three unreasonable or unrealistic assumptions. First, the statute assumes a bad motive of the related parties in all instances. In *VFJ Ventures*, the court rejected the notion that Alabama's statute was targeted at sham transactions. After rightfully noting that the Alabama Department of Revenue, like

[28]*Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

[29]*Jefferson Lines*.

[30]*Hunt-Wesson*, 528 U.S. at 464-465.

[31]*Hunt-Wesson* 528 U.S. at 465.

[32]*First National Bank of Atlanta v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583 (1985).

[33]*Ruling of Commissioner, P.D., 07-153.*

[34]*Hunt-Wesson*, 528 U.S. at 466, *citing Container*, 463 U.S. at 169.

any state taxing authority, was already vested with various discretionary authorities to challenge transactions and arrangements lacking business purpose or economic substance, the court held that Alabama's statute was intended to preclude any tax deduction for intangible payments between related parties, presumably regardless of motive. Nevertheless, the addback statutes in Alabama, Virginia, and some other states without question target a particular tax planning structure, whether the tax consequences achieved by it are incidental, substantive, or a sham. A naked holding company, however, is less likely to have economic activity measured by apportionment factors in states outside its domicile. Thus, the risk that an addback state is taxing economic activity that is not rationally related to the state may be less. However, that risk is heightened when the licensor is engaged in other substantive and continuous business activities in multiple states. That economic activity is unrelated to Virginia, yet the state limits a tax deduction to the extent that unrelated economic activity is not taxed or is included in a combined or consolidated tax return. Virginia's disallowing a deduction may amount to laying claim to taxing value that is unrelated to Virginia.

Second, the subject to tax exception, as it may be applied by the department based on its draft regulation, unreasonably assumes that the intercompany royalty income is not taxed when the licensor files a unitary combined report or a consolidated tax return in another state or states. The intercompany royalty income and expense are offset in combination or consolidation. For example:

> Assume ABC is a Virginia corporate taxpayer with $100 of gross income from its trade or business operations. ABC's parent corporation, P, does business in California and files a California tax return. P earns $100 of gross income from its trade or business activities. P also licenses valuable intellectual property to ABC and receives $20 of royalty income. P and ABC are engaged in a unitary business. P attaches a California combined report to its California tax return. P's income included in the combined report is $100 of trade or business income, plus $20 of royalty income. ABC's income included in the combined report is $100 of trade or business income, less a $20 royalty expense deduction. Thus, P's combined business income subject to apportionment by California is $200 ($120 plus $80).

The inclusion of ABC's income in the California combined report is not tantamount to California's taxation of ABC; rather, California is taxing P by reference to P's separate income and apportionment factors and by reference to ABC's income and apportionment factors that are unitary with P. P is the California taxpayer, not ABC.[35] After P apportions its combined income, including its royalty income and ABC's royalty expense, the portion attributed to California is included in the measure of tax by California.[36] Moreover, Virginia's interpretation disregards P's economic activity in California and other "unitary states." It is unreasonable to conclude that P's economic activity is taxed in some states, but not in others, simply based on the tax return filing options available or required. In short, P is filing a tax return and it is no less taxed if its income and apportionment factors are determined with reference to ABC, as if it filed a separate company tax return.

Virginia's subject to tax exception assumes P's economic activities occurring in other states are rationally related to Virginia. The department's interpretation makes P's economic activities or apportionment factors in other states determinative of ABC's Virginia tax deduction. But P has no activity in Virginia. At most, P's Virginia connection is a license on which Virginia cannot assert taxing jurisdiction under its own law and rules. However, ABC's tax deduction and Virginia tax liability will be determined based on economic activities having no connection whatsoever to Virginia. Thus, if P files a separate company tax return in other states because of its property, payroll, and sales in those separate return states, Virginia is going to limit ABC's tax deduction in relation to that activity.

Conclusion

Virginia's subject to tax exception should be viewed as having particular vulnerabilities that arguably may not apply to other states' addback statutes. Further, the Virginia department's rulings interpreting the Virginia subject to tax exception as applicable on a postapportionment basis do not address these vulnerabilities. Therefore, taxpayers should press forward and challenge the department's interpretation in appropriate circumstances. ✰

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[35] *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403, 1415 (Cal. App., 1st Dist. 2000). (For the decision, see *Doc 2000-25559* or *2000 STT 195-7*.)

[36] *Safeway Stores, Inc. v. Franchise Tax Board*, 3 Cal. 3d 745, 752 (1970).