

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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► SUBJECT

VIRGINIA RECENTLY ENACTED LEGISLATION THAT LIMITS THE APPLICATION OF TWO EXCEPTIONS TO ITS RELATED MEMBER INTANGIBLE EXPENSE ADD-BACK REQUIREMENT.

► SUMMARY

On April 1, 2014, Virginia Governor Terry McAuliffe signed H.B. 5001, 2014 Special Session I, which included two new limitations with respect to Virginia's related member intangible expense add-back requirement:

1. the subject to tax exception only applies to that portion of corresponding income that is attributed to a jurisdiction where the income receiving related member is subject to tax; and
2. the contracts with unrelated parties exception only applies where the related member actually has contracts with unrelated parties.

These provisions of H.B. 5001 are retroactive to taxable years beginning on or after January 1, 2004.

► DETAILS

Pre-H.B. 5001

Prior to the enactment of H.B. 5001, Va. Code § 58.1-402 required a corporate taxpayer to add back to taxable income federal income tax deductions for expenses directly or indirectly related to intangible property (e.g., trademarks and patents) that are paid to a related member. However, Va. Code § 58.1-402 did not require the add-back of the portion of such related-member intangible expenses if:

1. Subject to Tax Exception - "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;" or



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2. Unrelated Parties Exception - "The related member derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members" and the taxpayer's contracts with the related member are on terms comparable to the contracts the related member has with unrelated parties.

Corporate taxpayers had argued that the first exception allowed deduction of 100% of the related member intangible expenses where the related member is subject to tax in any state.¹ In addition, corporate taxpayers had argued that the second exception allowed deduction of 100% of the related member intangible expenses where the corporate taxpayer has intangible property licensing contracts with unrelated parties, regardless of whether the related member receiving the income from the corporate taxpayer has the contracts with unrelated parties.²

The New H.B. 5001 Limitations

One new limitation established in H.B. 5001 provides that the "subject to tax" exception 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." A second limitation enacted by H.B. 5001 provides that the "contracts with unrelated parties" exception is limited 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." These provisions of H.B. 5001 are retroactive to taxable years beginning on or after January 1, 2004, and presumably eliminate the arguments that corporate taxpayers had been asserting.

► BDO INSIGHTS

- A corporate taxpayer that took the position on a Virginia income tax return that 100% of its related member intangible expenses were deductible under the "subject to tax" exception or the "contracts with unrelated parties" exception may have, according to H.B. 5001, understated Virginia taxable income for open taxable years. A taxpayer in this situation should analyze the extent of any Virginia tax exposures. Virginia generally applies a three-year statute of limitations on assessments with respect to previously filed returns, and thus any exposure would generally be limited to three years.³
- A corporate taxpayer that took the position on a Virginia income tax return that 100% of its related member intangible expenses were deductible under the "subject to tax" exception or the "contracts with unrelated parties" exception may find a relative increase in future Virginia income tax liability if the new limitations under H.B. 5001 are followed. This increase in tax liability, along with any exposure related to previously filed tax returns open under the statute of limitations, should be considered by taxpayers for both tax and financial accounting purposes.

¹ See P.D. 09-67, Ruling of the Commissioner of the Virginia Department of Taxation (May 13, 2009).

² See P.D. 13-239, Ruling of the Commissioner of the Virginia Department of Taxation (Dec. 19, 2013) and P.D. 09-14, Ruling of the Commissioner of the Virginia Department of Taxation (Feb. 9, 2009).

³ Va. Code Ann. § 58.1-104. See Va. Code Ann. § 58.1-312.

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