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External Multistate Tax Alert
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Virginia Supreme Court addresses "Subject-to-Tax" Addback Exception

Overview

Recently, the Virginia Supreme Court ("the Court") ruled in a 4-3 decision in *Kohl's Department Stores, Inc. v. Virginia Department of Taxation*[1] in which it considered the subject-to-tax exception of Virginia's related party intangible expense add back statute. In sum, the majority held that the subject-to-tax exception applies only to the extent that the royalty payments were actually taxed by another state (*i.e.,* on a post–apportionment basis); and that the subject-to-tax exception applies as long as royalties are actually taxed regardless of *which* entity paid the tax (*i.e.,* even if paid by an affiliate, as part of a combined filing or statutory add back). The Court remanded the case back to the Circuit Court for further proceedings.

This Tax Alert summarizes the factual background of the case, the lower court and Virginia Supreme Court decisions, and provides taxpayer considerations.

Background

Kohl's Department Stores, Inc. ("Kohl's") paid royalties to an affiliated corporation that lacked nexus-creating activities in Virginia during the tax years ending January 31, 2009 and January 30, 2010.[2] The royalties were included as income in each of the affiliate's state tax returns, and apportioned to and taxed by such states. Kohl's took the position that for Virginia tax purposes 100% of these royalty payments qualified for the subject-to-tax exception to the add back statute, and thus did not add them back to federal taxable income in determining their Virginia taxable income.[3]

As do many other states, Virginia's tax laws include a statutory provision that requires corporations to add back certain "intangible expenses and costs" to their federal taxable income. Virginia's statute provides, in pertinent part:

> There shall be added to the extent excluded from federal taxable income:
>
> > 8. a. . . . [T]he amount of any intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes.[4]

Virginia provides an exception to this provision such that the addition:

> [S]hall not be required for any portion of the intangible expenses and costs if . . . the following applies:
>
> > (1) 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 [or] another state . . . .[5]

The Department audited Kohl's returns for both of the tax years at issue, with the auditor allowing only a "partial exception" to the add back statute corresponding to the amount of the royalties "actually taxed" in states requiring separate returns by the affiliated corporation - i.e., on a post-apportionment basis. The auditor required that any untaxed portion be added back to Kohl's taxable income. The Department then issued a Notice of Assessment to Kohl's for the taxable years.[6]

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[1] Case No. 160681 (Va. Aug. 31, 2017). The Virginia Supreme Court's opinion is available here.
[2] *Id.* at 1.
[3] *Id.* at 3.
[4] Va. Code Ann. § 58.1-402(B)(8)(a).
[5] *Id. at (1).*
[6] Case No. 160681 at 4.

Kohl's appealed to the Tax Commissioner, requesting corrections. The Tax Commissioner upheld the assessments and Kohl's then filed suit in the Circuit Court of the City of Richmond (the "Circuit Court").

The lower court ruling

Kohl's primary argument was that all of the royalty payments should fall within the subject-to-tax exception because they were included in taxable income by the affiliated corporation on another state's return, regardless of whether they were actually taxed by another state (i.e., the pre-apportionment amount).[7] The Department counter argued that only the portion of the royalty payments that was actually taxed by other states (i.e., the post-apportionment amount) qualifies for the exception.

The Circuit Court issued an opinion holding that "to fall within the [subject-to-tax] exception, the intangible expenses paid to a related member must not only be subject to a tax in another state, but that tax must actually be imposed."[8]

Kohl's alternatively argued that even if the exception only covers the amount that was actually taxed, the Department's calculation of that amount was incorrect. The Circuit Court's opinion did not address Kohl's alternative argument.[9]

Virginia Supreme Court decision

Taxpayer's primary argument

The Virginia Supreme Court began its review of the Circuit Court's decision by examining the plain language of *Va. Code Ann. § 58.1-402(B)(8)*. The Court found the statute's language ambiguous, holding that "…looking only at the plain language of the statute, it is doubtful and uncertain whether the General Assembly intended the subject-to-tax exception to apply on a pre- or post-apportionment basis."[10] The Court noted that the phrase "subject to a tax" is not defined by the Virginia Tax Code.[11]

The Court next examined the history of Va. Code § 58.1-402(B)(8), in an attempt to determine the Legislature's intent in enacting the statute. The Court found that by enacting the add back statute, Virginia had "joined numerous states with legislation 'designed primarily to prevent the deduction of royalties and interest paid to related intangible holding companies.'"[12] Based on this history and giving due weight to the Department's interpretation of the statute, the Court found that "[u]nder a pre-apportionment interpretation, corporations could avoid the application of the add back statute by paying royalties to a related member in a state in which its apportionment factor is insignificant. This result would resurrect the loophole that the add back statute was designed to close."[13]

Therefore, the Court held that the subject-to-tax exception applied on a post-apportionment, rather than a pre-apportionment basis. That is to say that "the subject-to-tax exception applies only to the extent that the royalty payments were actually taxed by another state."[14]

Taxpayer's alternative argument

Kohl's also posited an alternative argument which was not addressed by the Circuit Court but which the Supreme Court then proceeded to take up.

The Department had allowed Kohl's a partial exception to the add back statute, to the extent that royalty payments had been apportioned and taxed in a separate return states. However, the royalty payments had also been included in combined filing states taxable income calculations, where the Kohl's affiliate to which the royalties were paid was

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[7] Kohl's Dep't Stores, Inc. v. Va. Dep't of Taxation, 91 Va. Cir. 499 (2016).
[8] *Id.* at 505.
[9] *Id.* at 504-06.
[10] Case No. 160681 at 5-7.
[11] *Id.* at 7.
[12] *Id.* at 9
[13] *Id.* at 10.
[14] *Id.* at 11.

included in the combined group.[15] Kohl's had also been required to add the royalties back to its taxable income for other states with add back provisions ("Addback States").[16]

Kohl's argued that, even if the subject-to-tax exception applied on a post-apportionment basis, the Department had erred in calculating the amount of the royalties that would fall within the exception. Kohl's contended that to the extent the royalties were apportioned to and taxed by all of the above states, they fall within the subject-to-tax exception.[17]

The Department countered that the Court can only look to the returns of Kohl's affiliate when determining whether the royalty payments were subject to a tax in another state. In other words "that for the royalty payments to fall within the subject-to-tax exception, the tax must have been paid by the related member."[18] The Department based this argument on the reasoning that the add back statute only applies to any intangible expenses paid to a "related member," and that the subject-to-tax exception only applies to "[t]he corresponding item of income received by the related member."[19]

The Court disagreed, holding that the statute "only requires that the 'item of income received by the related member' – in this case, the royalties – be taxed by another state. It does not require that that the related member be the entity that pays the tax on that 'item of income.'"[20]

Therefore, the Court held that to the extent the royalties were actually taxed by the separate return states, combined filing states, or Addback States, "they fall within the subject-to-tax exception regardless of which entity paid the tax."[21] The Court remanded the case back to Circuit Court "for a determination of what portion of the royalty payments was actually taxed by another state and, therefore, excepted from the add back statute."[22]

Taxpayer Considerations

Companies interested in this decision are strongly encouraged to discuss this decision and the potential implications with one of the contacts listed below.

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[15] *Id.*
[16] *Id.*
[17] *Id*.
[18] *Id*. at 12.
[19] Code § 58.1-402(B)(8)(1)
[20] Va. Code § 58.1-402(B)(8)(a).
[21] Case No. 160681 at 12.
[22] *Id*. at 13. A petition for rehearing has also been filed and is currently pending as of the date of this Alert.

Contacts:

If you have questions regarding this Virginia Supreme Court decision or other Virginia tax matters, please contact any of the following Deloitte Tax professionals:

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