Not All Intercompany Transactions Are Created Equal

by Brian Strahle

For any group of affiliated entities, intercompany transactions, such as intercompany purchases, loans, licensing, services, and management, are a way of life. Even though those transactions are a part of normal business operations, they have created problems and opportunities in states that have not adopted combined reporting. States have sought to disallow the deduction of related-party expenses under the presumption that the transactions were not entered into with business purpose or economic substance, or that they distorted the true reflection of income earned in the state.

It could be argued that taxpayers abused the positive effect of "true" intercompany transactions by using special purpose entities such as sales companies, finance companies, and the infamous intangible holding company to shift income from one entity to another or from one state to another. The use of those types of entities and transactions exploded in the 1990s. Since then, states have worked to end that perceived abuse by enacting related-party expense addback legislation or adopting combined reporting. As a result, the ability to use intercompany transactions to shift income has become very difficult.

Taxpayers argue that economic substance and business purpose other than tax savings have always been integral parts of any state tax planning (even in the 1990s). However, taxpayers today approach state tax planning in terms of focusing on the business objective first, and then seeking to implement that objective in a tax-efficient manner. Some practitioners refer to that as business alignment planning. I like to describe it as not putting the cart before the horse.

Several factors can cause a state to add back intercompany expenses or force an affiliated group of entities to file a combined return, such as:

- lack of economic substance and business purpose for the transactions or structure;
- no evidence of expecting or receiving a return of cash or of any effort to repay an intercompany loan;
- a circular flow of funds between entities;
- holding intangibles and never licensing them to a third party;
- a parent company retaining control of intangible property and maintaining the benefits and burdens of ownership;
- assets transferred within the group, with charge-back to the transferring entity;
- motivation for restructuring a transaction;
- related-party transactions not at fair market value; and
- income not accurately reflected in state because of intercompany transactions.

Despite those factors, companies can have legitimate, deductible intercompany transactions. Recent rulings in Virginia show how affiliated groups may be successful and what procedures should be followed.

Subject-to-Tax Exclusion

In Ruling 13-165, a group of entities filed a combined return in which the taxpayer paid royalties to three affiliated entities. On its tax return, the taxpayer listed one state in which the affiliated entities filed income tax returns and claimed an exception for all the royalty and interest deductions on the grounds that they were subject to tax in another state. Under audit, the Virginia Department of Taxation limited the amount claimed as an exception to the affiliates' royalty income apportioned to the state in which the affiliate paid tax and increased the corresponding net addback of royalties and interest. The taxpayer appealed the assessment on various grounds.

Virginia Code section 58.1-402 B 8 provides that if excluded from federal taxable income, the following will be added back:

> The 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 indirect transactions with one or more members to the extent that such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes.

The statute provides several exceptions to the general rule that an addback is required. The exception relevant to Ruling 13-165 states:

> This addition shall not be required for *any portion of the intangible expenses* and costs if one of 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, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government.
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> [Emphasis in original.]

The taxpayer argued that the plain meaning of the Virginia statute entitled it to exclude 100 percent of its royalty payments from the addback. The exclusion to the addback should be based on the gross amount of payments that the taxpayer made to its affiliates, because the gross amount is shown on another state's tax return (pre-apportionment). The taxpayer argued that the statute does not require the gross amount to be 100 percent apportioned to the other state to allow a deduction for the entire amount of intangible expenses. If the gross amount is included in the tax base before apportionment, that meets the subject-to-tax requirement.

The taxpayers in rulings 13-165, 07-153, and 13-140 believe the department's interpretation is incorrect, and they are not alone.

The department argued that the statute limits the exclusion to the amount of the income related to the portion of the intangible expense that is part of another state's taxable income (post-apportionment). In other words, the income has to be in the apportioned tax base to meet the subject-to-tax requirement. The department relied on *Raven Red Ash Coal Corp. v. Absher*, 149 S.E. 541 (Va. 1929), as support for its argument that "every part of a statute must be presumed to have some meaning and not be treated as meaningless unless absolutely necessary." It also relied on Ruling 07-153 2007-22791, in which the department determined that the statutory language did not support an all-or-nothing exclusion. The department believes the subject-to-tax test must be satisfied for each item of the affiliates' income that corresponds to the taxpayer's royalty expenses. Hence, one portion of the royalty expense may escape addback, while the rest may not.

The department also stated that it played a primary role in drafting the addback legislation enacted in the 2004 General Assembly. It said its interpretation is not an announcement of a change in policy or interpretation, but a reflection of the original intent.

The taxpayers in rulings 13-165, 07-153, and 13-140 believe the department's interpretation is incorrect, and they are not alone. In fact, the taxpayers in *Kohl's Department Stores Inc. v. Virginia Department of Taxation*, No. 760CL 12-1774 (Va. Cir. Ct. 2012), are challenging the department's policy and position in court. Taxpayers who have paid tax as a result of the department's rulings may consider filing a protective claim under Virginia Code section 58.1-1824.

Valid Business Purpose Exclusion

In Ruling 13-165, the taxpayer argued that it should be allowed to exclude its royalties and factoring fees from the addback requirement because the intercompany transactions had a valid business purpose other than the avoidance or reduction of tax. The taxpayer argued that its affiliates were not sham or shell companies.

Virginia Code section 58.1-402(B)(8) does not provide an exception to the addback requirement based on the economic substance of the related entities. However, section 58.1-402(A)(8)(b) provides an exclusion for the addback when the intangible intercompany expenses were incurred through a valid business purpose other than the avoidance or reduction of tax. Based on that provision, the taxpayer had an opportunity to obtain the exclusion it sought; however, it did not follow the procedures required to claim the business purpose exclusion.

According to the department, a taxpayer must file its Virginia income tax return reporting the addition in accordance with the statute and remit all taxes, penalties, and interest due for the tax year. A taxpayer may then petition the tax commissioner to consider evidence regarding any transactions between it and related members that increased its taxable income. The commissioner may let the taxpayer file an amended return if the petition demonstrates by clear and convincing evidence that the transactions resulting in the increase had a valid business purpose other than the avoidance or reduction of tax. If the commissioner grants the petition, the taxpayer may file an amended return that excludes the addition related to the transactions identified in the commissioner's response. The amended return must be filed within one year of the commissioner's response. Taxpayers who believe they can meet the business purpose exclusion should follow the procedures to avoid being disqualified.

Conduit Exception (Directly and Indirectly)

Virginia Code section 58.1-402(B)(8)(a)(2) provides that the addback will not be required if:

> 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 transaction giving rise to the expenses and costs between the

> corporation and the related member was made at rates and terms comparable to the rates and terms of agreements that the related member has entered into with parties who are not related members for the licensing of intangible property.

That provision is known as the conduit exception. Taxpayers have been successful in meeting that exception if the related member received the royalties directly or indirectly.

For example, the taxpayer in Ruling 13-165 provided documentation showing that the rates the affiliates charged the taxpayer were similar to the rates charged to unrelated third parties and that more than one-third of the affiliates' income was derived from unrelated third parties. The affiliate in Ruling 13-165 received the royalties directly from unrelated third parties.

In *Wendy's International Inc. v. Virginia Dept. of Taxation*, CL09-3757 (Va. Cir. Ct. 2012), the taxpayer was able to meet the conduit exception when the affiliate received the royalties indirectly. A subsidiary of Wendy's owned and licensed the trademarks and trade names to Wendy's. Wendy's later sublicensed the intellectual property to related and unrelated franchisees. Wendy's also granted sublicenses to restaurants owned by related and unrelated companies. Wendy's received royalties from the related and unrelated parties and then paid the royalties to the subsidiary that owned the trademarks and trade names. On its Virginia return, Wendy's added back 100 percent of the royalties it paid to its subsidiary. It then filed an amended return to obtain a refund of the royalties it added back based on the fact that more than one-third of the fees paid to Wendy's under sublicenses, and subsequently paid by Wendy's to its subsidiary, were from unrelated franchisees.

The issue was whether the word "derives" requires the related entity to engage directly in licensing to unrelated parties. The subsidiary that owned the trademarks and trade names did not directly license to unrelated parties. It had agreements only with Wendy's, a related party, and Wendy's had agreements with unrelated parties.

The court concluded:

> The use of the word "derives" does not imply that the General Assembly intended only that the related entity actually engage directly in licensing to unrelated parties. In other words, "derives," based on its common meaning, does not infer that the related entity receive the royalties from direct licensing in order for Wendy's to qualify for the exception to the add back.

As a result of Wendy's passthrough of royalties paid to it by related and unrelated members, the direct and indirect recipients of those royalties from Wendy's received at least one-third of their gross revenues from the licensing of intangible property to unrelated parties.

Therefore, taxpayers with similar arrangements or fact patterns should determine if they can meet the conduit exception, either directly or indirectly.

Cost Reimbursement?

Generally, intercompany transactions should be conducted at arm's length. However, some transactions are simple cost reimbursements with no profit built in. In those situations, the question of deductibility arises.

In Ruling 13-140, the department said the transactions were deductible because intercompany profit was not incorporated into the overall management fee charged by the parent. In its decision, the department relied on Ruling 97-132, in which it recognized that the taxpayer had to either hire an outside firm to perform the essential corporate services or develop its own in-house capability. It also stated that a cost reimbursement arrangement between related parties, without any intercompany profit, could not be characterized as distorting Virginia taxable income.

According to Ruling 97-290, if a profit percentage is added to the cost reimbursement fee, the department will look at whether the recipient of the fee has economic substance and whether the fee is at fair market value.

The Virginia Supreme Court[1] has upheld the department's authority to equitably adjust a corporation's tax when two commonly owned corporations structure an arrangement to improperly, inaccurately, or incorrectly reflect the business done in Virginia or the Virginia taxable income. Generally, the department will exercise its authority if it finds that a transaction, or a party to a transaction, lacks economic substance or that transactions between the parties are not at arm's length.

According to Ruling 97-290, if a profit percentage is added to the cost reimbursement fee, the department will look at whether the recipient of the fee has economic substance and whether the fee is at FMV. In Ruling 13-140, the taxpayer provided several independent transfer pricing studies demonstrating

[1] *Commonwealth v. General Electric Co.*, 372 S.E.2 599 (1988).

that the rates charged for the services were reasonable when compared with arm's-length transactions between unrelated third parties. The department agreed.

Conclusion

Those department rulings provide insight regarding how a taxpayer may be able to deduct its related-party expenses in Virginia. Even though each state has its own rules, the principles from the rulings may be helpful when dealing with addback legislation in another state.

Taxpayers should review each state's rules for guidance, but some general guidelines are to:

- understand the intercompany transactions and why they exist (that is, transactions may not be settled regularly, leading to substantial balances and ambiguity);
- understand the tax and business risks associated with each intercompany account and transaction;
- have a strong business purpose and economic substance for the legal entity structure and intercompany transactions;
- keep related-party transactions at arm's length or FMV; and
- complete analyses to confirm that state taxable income is a reasonable reflection of income.

Perhaps the most important strategy is to determine whether any restructuring of entities or transactions can be completed to meet specific state exceptions to addback legislation. Analyzing intercompany transactions may provide opportunities to reduce tax, exposure, or a company's reserve and effective tax rate under FASB Interpretation No. 48. ☆

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