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LEGAL ALERT

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Where's the "Beef"? Sublicensing Qualifies for Virginia Addback Exception

On March 29, 2012, the Circuit Court of the City of Richmond held that an exception to Virginia's related party addback statute applied to licensing arrangements that included a sublicensor. *Wendy's International, Inc. v. Virginia Department of Revenue*, No. CL09-3757 (Va. Cir. Ct. 2012). This decision is one of only a handful throughout the United States addressing the application of an exception to state "addback" statutes that requires the denial of deductions of intangible expenses paid to a related party.

Background

For purposes of calculating Virginia taxable income, Virginia law requires taxpayers to make certain adjustments to federal taxable income. Va. Code Ann. § 58.1-402.A. In 2004, the Virginia legislature passed House Bill 5018, Sp. Sess. 1 (2004), which included an addback provision for intangible expenses and costs paid to related members that were excluded from federal taxable income. Specifically, Virginia's addback statute provides, in relevant part:

> [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.

Va. Code Ann. § 58.1-402.B.8.a. The addback statute was intended to eliminate the tax benefit a taxpayer received from paying a related party for the use of intangible property (such as trade names or patents), except in those circumstances where the taxpayer qualified for an exception.

Under Virginia law, there are three statutory exceptions to the general requirement that intangible expenses paid to a related member must be added back. The first two exceptions provide that: (1) the related member is subject to a tax based on income in another state or foreign treaty country; and (2) the related member directly or indirectly paid the expense to an unrelated member, and the transaction between the related members did not have as its principal purpose the avoidance of Virginia corporate income tax. The third exception to the addback statute—the exception at issue in *Wendy's*—provided that:

> 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[.]

Va. Code Ann. § 58.1-402.B.8.a.(2). This exception allows taxpayers to retain deductions with respect to intangible payments made to related parties that are primarily engaged in third-party licensing transactions.

Sutherland Observations: The Virginia addback exception at issue in *Wendy's* is unique. While other states' addback statutes provide exceptions for payments made to related parties that are on arm's length terms, no other state requires a specified percentage of third-party transactions.

Circuit Court Decision

Wendy's, a national restaurant chain, formed an insurance company that in turn formed another company, Oldemark LLC, to hold Wendy's trademarks and trade names. Oldemark LLC was disregarded for Virginia tax purposes. Wendy's paid royalties to Oldemark for use of its trademarks and trade names. Pursuant to its agreement with Oldemark, Wendy's was also authorized to sublicense the trademarks and trade names to related and unrelated companies operating Wendy's franchises.

Related and unrelated sublicensees paid royalties to Wendy's at a rate of **4%**, and Wendy's, in turn, paid Oldemark royalties at a rate of **3%**. It was undisputed that at least one-third of Oldemark's gross revenues, through Wendy's, originated from unrelated franchises. The Virginia Department of Taxation claimed that the exception in Va. Code Ann. § 58.1-402.B.8.a.(2) requires a related member to **directly** license intangible property to an unrelated member. Thus, the Department disallowed Wendy's claim that it qualified for the exception because all of Oldemark's royalties were directly received from a related party.

The court looked to the plain language of the addback exception and, more specifically, the term "derives." That term, the court explained, "does not infer that Oldemark receive the royalties from direct licensing activities in order for Wendy's to qualify for the exception to the addback." Under the court's reasoning, had the legislature intended to narrow the scope of the exception to only direct licensing arrangements with unrelated members, it would have done so explicitly. Because at least one-third of Oldemark's gross revenues, through Wendy's, were derived from unrelated franchises, the court held that Wendy's met the requirements of the addback exception and granted Wendy's motion for summary judgment.

Sutherland Observations: Numerous other states have addback exceptions that contain a "directly or indirectly" requirement. Even though the Virginia exception did not explicitly contain these words, the court inferred "directly or indirectly" as part of the intent of the addback exception. The inclusion of "indirectly" in other states' addback exceptions will provide an additional basis for a broad interpretation of an exception.

Sutherland Observations: The facts of this case did not implicate the addback exception contained in Va. Code Ann. § 58.1-402.B.8.a.(1), which applies if the related member is subject to a tax in another state or foreign treaty county. The application of this "subject to tax" exception is being debated (i.e., whether it applies on a post-apportionment or preapportionment basis) and will likely be litigated.

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