

## Where's the Beef? Virginia Circuit Court Allows Wendy's to Claim Exception to Addback for Royalties Paid to Affiliate

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Authors: [Donald M. Griswold](#), [Walter Nagel](#), [Jeremy Abrams](#)

A new opportunity may exist for franchisors to claim an exception to Virginia's royalty addback statute based on a recent Circuit Court decision.

In *Wendy's International Inc. v. Virginia Dep't of Taxation*, decided March 29, the Circuit Court of the City of Richmond held that Wendy's qualified for the "unrelated party" addback exception for royalties paid to a related party, even though the related party did not directly license IP to the unrelated licensees, and granted Wendy's motion for summary judgment. The Wendy's decision means that a Virginia taxpayer can qualify for the "unrelated party" addback exception if the related member receiving the payments indirectly licenses its intangible property through sublicenses between the taxpayer and unrelated franchisees.

Virginia Code § 58.1-402(B)(8)(a) requires taxpayers to add back to federal taxable income the amount of any intangible expenses 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 that such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes. The statute provides an exception, however, where 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. Virginia Code § 58.1-402(B)(8)(a)(2).

Wendy's formed Scioto Insurance Company (SIC), which in turn formed Oldemark LLC (Oldemark), a disregarded entity that owns the Wendy's trademarks and trade names. Oldemark licensed the IP to Wendy's and allowed Wendy's to sublicense the IP to related and unrelated franchisees for a royalty of 3 percent of gross sales of Wendy's restaurants. Wendy's granted sublicenses to restaurants owned by related and unrelated companies to use the IP for 4

percent of the restaurants' gross sales. Wendy's then paid to Oldemark the 3 percent royalty received from all restaurants pursuant to Wendy's agreement with Oldemark. On its returns for the years in issue, Wendy's added back 100 percent of the royalties paid to Oldemark that were deducted on its federal return. Wendy's later requested a refund of the amount of royalties it had previously added back. More than one-third of the fees paid to Wendy's under sublicenses, and subsequently paid by Wendy's to Oldemark, were from unrelated franchisees.

The issue in *Wendy's* was whether the "unrelated party" addback exception is limited to situations in which a related member directly licenses intangible property to an unrelated member (the Department's contention), or whether the exception also applies where there is only an indirect connection between the related member and unrelated member licensing the intangible property. The court found the statutory language unambiguous, and determined that the word "derives," based on its common meaning, did not infer that a related member, like Oldemark, must receive royalties from direct licenses of intangible property to unrelated parties for the exception to apply. Accordingly, the court held that no direct connection between the related member and the unrelated licensee is required. "Thus, Wendy's is entitled to the exception because Oldemark derives at least one-third of its gross revenues from unrelated franchises as a result of Wendy's pass through to Oldemark of the same proportion of royalties paid to Wendy's by related and unrelated members."

## **Reed Smith's Observations**

The Circuit Court's decision in the *Wendy's* case opens up potential refund opportunities for all taxpayers that have been complying with Virginia's intangible expense addback rule with respect to payments for intangible property, when the property is ultimately used in significant part by unrelated persons. In particular, the decision creates refund opportunities for businesses that license their intangible property to third-party franchisees through a central franchising entity that files Virginia corporate income tax returns, and has been complying with Virginia's intangible expense addback rules.

## **About This Reed Smith State Tax Alert**

For more information on the *Wendy's* case, or to discuss the potential implications of the *Wendy's* decision on pending Virginia audits, or for assistance in filing refund claims, please



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