

DRAFT FORM — NOT FOR FILING

This draft form has been updated to include the most recent changes effective for Tax Year 2026 Virginia returns. If legislative changes or issues arise, we will post a new version of this draft form.

Please continue to monitor tax.virginia.gov/early-release-forms for future drafts of this form. Once forms are final, we will post them on our website at tax.virginia.gov/forms.

2026 Instructions for Schedule 500AB

Schedule of Related Entity Add Backs and Exceptions

Corporations are required to add back certain deductions taken on the federal return for interest, royalties, and other expenses related to intangible property such as trademarks and patents. A related entity is allowed a subtraction to the extent that any payments it received have been added back to the income of another corporation.

Corporations should report all payments made and then identify any exceptions which apply to the payments in the tables provided. The exceptions for interest and royalties differ and need to be reported separately on the form.

Intangible Expenses Paid to Related Entities

A corporation that directly or indirectly claims a deduction for payments to a related entity in connection with trademarks, patents and similar intangible property must add back the deduction on its Virginia income tax return. The addition is required for 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 (Va. Code § 58.1-402(B) (8)(a)).

Related entities include a stockholder and a partnership, limited liability company, estate, trust, and corporation owned by a stockholder when at least 50% of the value of the taxpayer's outstanding stock is owned, directly or indirectly, or beneficially by the stockholder or family. For further details, see the definitions of "related entity" and "related member" in Va. Code § 58.1-302.

The statute defines "intangible property" as "patents, patent applications, trade names, trademarks, service marks, copyrights, and similar types of intangible assets." The statute further defines the intangible expenses and costs that must be added back as follows:

- i. Expenses, losses, and costs for, related to or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, lease, transfer, or any other disposition of intangible property to the extent that such amounts are allowed as deductions or costs in determining taxable income;
- ii. Losses related to or incurred in connection directly or indirectly with factoring transactions or discounting transactions;
- iii. Royalty patent, technical, and copyright fees;
- iv. Licensing fees; and
- v. Other similar expenses and costs.

Intangible Expenses Add Back Exceptions

Exception 1

The corporation may exclude from the addition an item of intangible expense when 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 foreign government that has entered into a comprehensive tax treaty with the United States government.

An intangible expense payment may not be excluded from the addition unless the receipt of the payment, and its inclusion in the related member's taxable income or capital, results in a non-trivial increase in tax liability (or reduction of an operating loss) after consideration of all of the deductions, credits, exemptions, and other tax policies and preferences affecting the tax liability of the related member. The actual return filed with the other state(s) will be examined for the impact or the payments on the related member's tax liability. Pro forma separate returns and tax accruals by the affiliated group are not acceptable for this purpose.

Example 1. If the payor and related member receiving the payments are included in a consolidated or combined return in the other jurisdiction, then the payor's deduction and corresponding item of income of the related member offset each other in the return filed on behalf of the related member, and the offsetting amounts do not materially affect the tax liability of the related member of the affiliated group.

Example 2. If the related member is subject to a capital tax in another jurisdiction that is measured by the number of authorized shares, then the receipt of the corresponding item or income does not materially affect the tax liability of the related member.

Example 3. If the related member is subject to a franchise tax with alternative measures (such as a minimum tax, net capital, net income, or other measure) and its actual tax liability for the taxable year is based on a measure other than net income or capital, then the receipt of the corresponding item of income does not materially affect the tax liability of the related member.

Exception 2

The corporation may exclude from the addition an item of intangible expense when 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. For example, Corporation A uses a trademark licensed from its affiliate to market popular beverages. The trademark was created in connection with the beverage products and is widely known and associated with beverage products. The licensing affiliate also licenses the trademark to unrelated businesses for use on toys, glasses, and incidentals other than beverage products. The royalty rates paid by the unrelated businesses do not qualify for this exception because the use of the trademark by Corporation A is not comparable to the use of the trademark by the unrelated businesses.

Exception 3

The corporation may exclude from the addition an item of intangible expense when the corporation can establish to the satisfaction of the Tax Commissioner that the intangible expenses and costs meet both of the following:

- i. the related member during the same taxable year directly or indirectly paid, accrued or incurred this portion to a person who is not a related member and
- i. the transaction giving rise to the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any portion of any Virginia income tax due.

The portion of a payment to an unrelated party for which this exception is claimed cannot exceed the amount actually paid, accrued, or incurred to the related party. When a transaction results in significant tax savings, it is presumed that the savings were a principal purpose for the transaction even though the transaction may also serve other purposes. The taxpayer must show that the other purposes are specific to the aspects of the transaction that generated the tax savings, and that the other purposes are so important that the transaction would have occurred even if there were no tax savings. For example, a statement that the purpose of the transaction is to consolidate trademark functions is not sufficiently specific when tax savings are generated by transferring the functions to a related entity, and moving the functions to another state. The activities of the corporation and related entity will be examined to determine if they are consistent with the stated purposes for the transaction.

In the case of factoring transactions, the following items paid or incurred by the recipient of the receivables that are the subject of the factoring transaction may qualify for the exception:

- (i) interest paid by the recipient to an unrelated party, based on the percentage that the receivables and other intangible property transferred by the taxpayer are of the recipient's total assets; and
- (ii) discounts and losses incurred by the recipient upon the subsequent transfer of the same intangible property to an unrelated party.

Interest Expenses Paid to Related Entities

A corporation that directly or indirectly claims a deduction for interest paid to a related entity in connection with trademarks, patents, and similar intangible property must add back the deduction on its Virginia income tax return. The addition is required for "any interest expenses and costs directly or indirectly paid, accrued, or incurred to, one or more related members." See *Va. Code* § 58.1-402 (B)(9)(a).

Interest paid to a related entity is presumed to be related to intangible property if the corporation has incurred intangible expenses or costs to the same or any other related entity in the same year. It is not necessary to trace the source and

application of funds among the related entities. The focus of the inquiry is whether the reason that the corporation found it necessary or expedient to borrow funds from the related entity is in any way related to the fact that the corporation is incurring intangible expenses and costs.

Although the statute contains several exceptions, the definition of "interest expenses and costs" in *Va. Code* § 58.1-302 limits the addition to interest paid in connection to trademarks, patents and similar intangible property. The restrictive definition excludes all of the interest that might qualify for an exception. For more information visit the Department's website at www.tax.virginia.gov.

Completing the Form

Enter the corporation name, federal employer identification number, Virginia account number, and number of related entities in the space provided. Complete the related entity information for each related entity and indicate the amount of interest, royalties or other intangible expenses paid to each related entity on Lines 1(a)-3(a) and 1(b)-3(b) as appropriate. Complete the related entity information for the interest exception in Part I and exceptions 1-3 in Part II, Royalties and Other Intangible Property as appropriate.

Line Instructions

Lines 1(a)-3(a): Enter the amount of interest paid to the appropriate related entities shown on Lines 1-3. Enclose additional copies of the form or a separate schedule if more than 3 related entities.

Lines 1(b)-3(b): Enter the amount of royalties or other intangible expenses paid to related entities. Enclose additional forms or a schedule, if necessary.

Lines 4(a) and 4(b): Enter the total interest paid to related entities on Line 4(a) and the total royalties or other expenses on Line 4(b).

Line 5: Enter on Line 5 the amount of royalties and other intangible income qualifying for Exception 1 from Part II, Exception 1 (Subject to tax).

Line 6: Enter the amount of royalties and other intangible income qualifying for Exception 2 from Part II, Exception 2 (One-Third Revenue).

Line 7: Enter the amount of royalties and other intangible income qualifying for Exception 3 from Part II, Exception 3 (Conduit).

Line 8: Total exception amount. Add Lines 5, 6, and 7. Enter here and on Form 500, Question A.

Line 9: Compute the net addition amount for royalties and other intangibles. Subtract Line 8 from Line 4(b).

Line 10: Enter the taxable addition amount of interest and royalties. Add Lines 4(a) and 9. Enter the total on Schedule 500ADJ, Section A, Line 3.