Rulings of the Tax Commissioner

Document Number:	**13-226**
Tax Type:	**Corporation Income Tax**
Brief Description:	**Net add-back of royalties**
Topics:	**Appropriateness of Audit Methodology; Exemptions; Royalties; Taxable Transactions; Taxable Income**
Date Issued:	**12/17/2013**

December 17, 2013

Re: § 58.1-1821 Application: Corporate Income Tax

Dear *****:

This will reply to your letter in which you seek a refund corporate income tax paid by ***** (the "Taxpayer") for the taxable years ended December 31, 2006 and December 31, 2007. I apologize for the delay in responding to your appeal.

FACTS

For the taxable years at issue, three of the Taxpayer's affiliates paid royalties to ***** (IHC). The IHC filed income tax returns in five different states and claimed an exception for all of the royalty deductions on the grounds that they were subject to tax in another state.

The Taxpayer was audited for the taxable years at issue. The auditor made an adjustment limiting the amount claimed as an exception to the add-back by reducing it to correspond to the amount of the affiliate's royalty income apportioned to each state in which the affiliates paid tax and increased the corresponding net add-back of royalties.

The Taxpayer filed an appeal, contending that all the royalties qualify for an exception to the add-back because they were subject to tax based on or measured by net income imposed by other states. In the alternative, the Taxpayer asserts that the Department erroneously calculated the portion of the add-back attributed to the amount of intangible income subject to tax in New Jersey.

DETERMINATION

<u>Subject to Tax Exception</u>

Virginia Code § 58.1-402 B 8 provides several exceptions to the general rule that an add-back is required. The exception relevant to the Department's assessment of the Taxpayer 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. (Emphasis added.)

According to the Taxpayer, the plain meaning of the statute entitles it to exclude 100% of its royalty payments from the add-back. This interpretation, however, cannot be reconciled with the legislature's use of the limiting words "portion" and "corresponding item." When interpreting statutes "[a] fundamental rule of statutory construction requires that **every part** of a statute be presumed to have some meaning, and not be treated as meaningless unless absolutely necessary." *Raven Red Ash Coal Corporation v. Henry Absher*, 153 Va. 332, 149 S.E. 541 (1929). (Emphasis added).

In Public Document (P.D.) 07-153 (10/2/2007), the Department determined that parsing the statutory language of *Va. Code* § 58.1-402 B 8 shows that the exception is not all inclusive. When considering this statute in its totality, the exception does not apply to the gross amount of payments that a taxpayer made to an affiliate merely because the gross amount is shown on another state's tax return. Instead, the exception is limited to the portion of a taxpayer's royalty payments to its affiliate that correspond to the portion of the affiliate's income subjected to tax in other states, as evidenced by the apportionment percentages shown on the affiliate's tax returns filed with other states.

In this case, the three affiliates paid royalties to IHC. The auditor reduced the royalty add-back exception to the portion of the affiliates' royalties paid to IHC that corresponds to the portion of IHC's income subjected to tax in other states.

The statutory provision requiring the addition (and allowing exceptions) specifically states in *Va. Code* § 58.1-402 B 8 c that "[n]othing in subdivision B 8 shall be construed to limit or negate the Department's authority under § 58.1-446." The latter section authorizes an equitable adjustment when the Department finds that arrangements between affiliated corporations improperly reflect business done in Virginia. The quoted language clearly authorizes the Department to invoke *Va. Code* § 58.1-446 when it finds that allowing an exception would result in the taxpayer's income improperly reflecting the business done in Virginia.

If the Taxpayer qualified for the exception with respect to 100% of the addition for royalty expenses, the situation appears to be similar to that described in P.D. 05-29 (3/7/2005). In that case, the Tax Commissioner upheld an adjustment under *Va. Code* § 58.1-446 based upon consolidating the affiliated entities with the taxpayer or disallowing a deduction for amounts paid to the affiliated entity. Under such circumstances the Department may invoke *Va. Code* § 58.1-446 to make a similar adjustment to the extent that an addition is not made under *Va. Code* § 58.1-402 B 8. In this case, however, because the Taxpayer qualifies for only a portion of the requested exception, the Department has concluded that any improper reflection of the business done in Virginia is not of sufficient magnitude to require an equitable adjustment under *Va. Code* § 58.1-446.

<u>New Jersey Add-Back</u>

Under New Jersey statutes, IHC was required to file a return and pay income tax on an allocated portion of its royalty income for the taxable years at issue. The auditor calculated the allowable add-back resulting from tax paid to New Jersey by dividing the royalties allocated to New Jersey by the total royalties reported on the federal income tax return.

The Taxpayer disagrees with the auditor's methodology. According to the Taxpayer, IHC's New Jersey sales were determined by multiplying royalties received from related entities by those entities' respective sales factor. The tax rate was applied directly to these sales in order to determine IHC's New Jersey income tax. Because the New Jersey sales were treated as New Jersey taxable income, the Taxpayer believes the exclusion amount should be determined by multiplying IHC's royalty income by a ratio equal to IHC's New Jersey taxable income divided by IHC's federal taxable income.

Under New Jersey's taxing scheme, IHC is not granted any deductions for expenses similar to those granted for determining federal taxable income. In essence, New Jersey's tax is based on the gross receipts generated in New Jersey. The Department cannot agree with an approach under which gross receipts are compared to net income. Because the New Jersey tax is based on gross receipts, the ratio for determining royalties eligible for the exception must be based on gross receipts.

For purposes of determining the exception from the add back for taxes paid to New Jersey, the New Jersey apportionment percentage will be the intangible holding company's New Jersey taxable income divided by its total royalty income everywhere. Under this method, the exclusion amount would be determined by multiplying the Taxpayer's royalty deduction attributed to IHC by a ratio equal to IHC's royalties reported on the New Jersey return divided by IHC's total royalty income.

CONCLUSION

Based on the foregoing, the auditor's adjustments are correct and the Taxpayer's request for a refund corporate income tax is denied.

The *Code of Virginia* sections and public documents cited are available on-line at www.tax.virginia.gov in the Laws, Rules and Decisions section of the Department's web site. If you have any questions concerning payment of the assessment, you may contact ***** at *****.

Sincerely,

Craig M. Burns
Tax Commissioner

AR/1-4613914063.B