

Rulings of the Tax Commissioner

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Tax Type: Corporation Income Tax
Brief Description: Royalties; Exception to the add-back; Inter-company transaction
Topics: Federal Conformity; Out of State Tax Credits; Royalties; Subtractions and Exclusions
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December 19, 2013

Re: § 58.1-1821 Application: Corporate Income Tax

Dear *****:

This will reply to your letter in which you seek correction of the corporate income tax assessments issued to the ***** (the "Taxpayer") for the taxable years ended January 28, 2007, February 3, 2008, February 3, 2009 and January 31, 2010. I apologize for the delay in responding to your appeal.

FACTS

For the taxable years at issue, the Taxpayer paid royalties to ***** (the "IHC"), an affiliated company for the use of intangible assets. The Taxpayer filed Schedule 500AB with its 2006 through 2009 Virginia corporate income tax returns listing six states in which IHC filed income tax returns. IHC reported the royalties paid by the Taxpayer, and the amount of tax paid based on or measured by net income on the returns. The Taxpayer claimed an exception for 100% of the royalties deducted on its federal income tax returns on the grounds that they were subject to tax in another state.

On audit, the Department limited the amount claimed as an exception to the add-back by reducing it to correspond to the amount of the IHC's royalty income apportioned to each state in which the affiliates paid tax and increased the corresponding net add-back of royalties. The Taxpayer appeals the assessments, 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 and the intercompany transaction had a valid business purpose.

DETERMINATION

Subject to Tax Exception

Virginia Code § 58.1-402 B 8 provides that there shall be added back to the extent excluded from federal taxable income:

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 *Code* 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 corresponds 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 Taxpayer paid royalties to IHC. The auditor reduced the royalty add-back exception to the portion of the Taxpayer's royalties paid to IHC that corresponds to the portion of IHC's income subjected to tax in other states.

Further, 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 would 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 these 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 distortion of the business done in Virginia is not of sufficient magnitude to require an equitable adjustment under *Va. Code* § 58.1-446.

Valid Business Purpose Exception

Virginia Code § 58.1-402 A 8 b provides an exclusion for the add back when the intangible intercompany expenses were incurred through a valid business purpose other than the avoidance or reduction of tax. The statute establishes the specific procedures to follow to claim this exclusion.

In order to apply to the Tax Commissioner for relief based upon the existence of a valid business purpose, 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 taxable year. A taxpayer may then petition the Tax Commissioner to consider evidence relating to any transactions between it and related members that resulted in its taxable income being increased. The Tax Commissioner may permit the taxpayer to file an amended return if the application demonstrates by clear and convincing evidence that the transactions resulting in such increase in taxable income had a valid business purpose other than the avoidance or reduction of the tax. A questionnaire that provides an example of the type of information a taxpayer must provide to the Department to demonstrate a valid business purpose is enclosed.

If the Tax Commissioner grants the application, the taxpayer may file an amended return that excludes the addition related to the specific transaction or transactions identified in the Tax Commissioner's response. The amended return must be filed

within one year of the Tax Commissioner's response.

The Taxpayer's request was not made in accordance with the procedure for claiming the business purpose exclusion from the addition for intangible and interest expenses paid related entities pursuant to *Va. Code* § 58.1-402 B 8 b. As such, the Taxpayer's request to exclude the add back of the royalties and factor fees on the basis that they were incurred for a valid business purpose cannot be considered.

I will, however, withhold additional collection actions for 30 days from the date of this letter to allow the Taxpayer to comply with the procedures in *Va. Code* § 58.1-402 B 8 b or remit payment for the assessment. If the Virginia income tax returns reporting the addition, along with all taxes, penalties and interest due for the taxable year are not received within the allotted time, a revised bill, with interest accrued to date, will be sent to the Taxpayer and collection action will resume.

CONCLUSION

Based on the foregoing, the auditor's adjustments are correct and the assessments are upheld. A revised bill, with interest accrued to date, will be sent to the Taxpayer. No additional interest will accrue provided the outstanding balance is paid within 30 days from the date of the revised bill. The Taxpayer should remit its payment to: Virginia Department of Taxation, 600 East Main Street, 23rd Floor, Richmond, Virginia 23219, Attention: *****. If you have any questions concerning payment of the assessment, you may contact ***** at *****.

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 regarding this determination, you may contact ***** in the Office of Tax Policy, Appeals and Rulings, at *****.

Sincerely,

Craig M. Burns
Tax Commissioner

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