

# Rulings of the Tax Commissioner

**Document Number:** 05-28  
**Tax Type:** Corporation Income Tax  
**Brief:** Distorted Virginia taxable income; Nexus  
**Description:**  
**Topics:** Accounting Periods and Methods; Assessment  
**Date Issued:** 03/07/2005

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March 7, 2005

Re: § 58.1-1821 Application: Corporation Income Tax

Dear \*\*\*\*\*:

This will reply to your letter in which you seek correction of the corporate, income assessments issued to your client, \*\*\*\*\* for the taxable years ended December 31, 1994 and 1995. I apologize for the delay in the Department's response.

## FACTS

The Taxpayer was audited by the Department and several adjustments were made. The Taxpayer has contested two of these adjustments, which are addressed separately below.

## DETERMINATION

### Intangible Holding Company

\*\*\*\*\* ("IHC") was incorporated in \*\*\*\*\* ("State A") in 1988. It is 100% owned by the Taxpayer and files as part of the Taxpayer's consolidated group for federal income tax purposes. IHC loaned funds to the Taxpayer and several of the Taxpayer's affiliates and accrued interest income during the taxable years at issue. The Taxpayer and its affiliates deducted the amounts accrued by IHC as interest expense.

The auditor determined that IHC lacked economic substance, and the intercompany loan distorted Virginia taxable income. As a result, the auditor consolidated the federal taxable income of IHC with the Taxpayer. The Taxpayer contests this adjustment, asserting that IHC has no nexus with Virginia and the transactions between the Taxpayer and IHC are at arm's length rates. The Taxpayer also argues that Virginia lacks the authority to adjust the federal taxable income of the Taxpayer.

Although Virginia utilizes federal taxable income as the starting point in computing Virginia taxable income and generally respects the corporate structure of taxpayers, *Va. Code* § 58.1-446 provides, in pertinent part:

When any corporation liable to taxation under this chapter by agreement or otherwise conducts the business of such corporation in such manner as either directly or indirectly to benefit the members or stockholders of the corporation . . . by either buying or selling its products or the goods or commodities in which it deals at more or less than a fair price which might be obtained therefore, or when such a corporation . . . acquires and disposes of the products, goods or commodities of another corporation in such manner as to create a loss or improper taxable income, and such other corporation . . . is controlled by the corporation liable to taxation under this chapter, the Department . . . may for the purpose determine the amount which shall be deemed to be the Virginia taxable income of the business of such corporation for the taxable year.

In case it appears to the Department that any arrangements exist in such a manner as improperly to reflect the business done or the Virginia taxable income earned from business done in this Commonwealth, the Department may, in such manner as it may determine, equitably adjust the tax.

[Emphasis added.]

The Virginia Supreme Court's opinion in *Commonwealth v. General Electric Company*, 236 Va. 54, 372 S.E.2d 599 (1988) upheld the Department's authority to adjust equitably the tax of a corporation pursuant to *Va. Code* § 58.1-446 (or its predecessor) where two or more commonly owned corporations structure an arrangement in such a manner as to reflect improperly, inaccurately, or incorrectly the business done in Virginia or the Virginia taxable income. Generally, the

Department will exercise its authority if it finds that a transaction, or a party to a transaction, lacks economic substance or transactions between the parties are not at arm's length.

The Taxpayer argues that, because IHC does not have nexus with Virginia, the Department lacks the authority to impose income tax on IHC under Public Law 86-272, codified at 15 U.S.C. §§ 381-384, and the Due Process Clause of the United States Constitution. However, where an arrangement between two or more commonly owned corporations results in the improper reflection of income in Virginia, the Department is authorized under *Va. Code* § 58.1-446 to adjust the tax "in such manner as it may determine." As such, the Department may determine that income of an affiliate; be deemed Virginia income even if the affiliate does not have nexus with Virginia. See Public Document ("P.D.") 96-346 (11/25/96).

The Virginia Supreme Court's decision in *General Electric* supports the Department's policy. In *General Electric*, the issue involved the creation of a Domestic International Sales Corporation ("DISC") that permitted General Electric to transfer income in the form of commissions to a wholly owned subsidiary at less than arm's length business standards.

The Court's decision upheld the Department's authority to consolidate the DISK even though the DISC did not engage in business in Virginia, was not qualified to do business in Virginia, and had no assets, property, employees or offices in Virginia. Accordingly, the Department does have the authority to tax the income of a foreign corporation in lieu of established nexus rules under the principles set forth in *General Electric*.

The Taxpayer also contends the auditor's adjustments are erroneous because they are inconsistent with Internal Revenue Code ("IRC") § 482 and the Taxpayer's federal taxable income. The Taxpayer argues that Virginia's conformity to federal definitions under *Va. Code* § 58.1-301 require the use of federal taxable income as the starting point for determining Virginia taxable income. *Virginia Code* § 58.1-446, however, grants the Department authority to adjust the tax "in such manner as it may determine." In fact, the Department has set forth a number of remedies in Title 23 of the Virginia Administrative Code ("VAC") 10-120-363, including, but not limited to, income reattribution, expense reattribution and consolidated income. All these methods essentially adjust the federal taxable income of a taxpayer.

Finally, the Taxpayer asserts the transactions between the Taxpayer and IHC were conducted at arm's length, and the consolidation of IHC with the Taxpayer is contrary to the provisions of the Title 23 VAC 10-120-364 E. This regulation sets forth an example of an arrangement that would not create an improper reflection of income. Specifically, Title 23 VAC 10-120-364 E states:

D Corporation, a wholly owned subsidiary of P, is a 'financial corporation' not subject to State A income taxation under State A Corporation Income Tax Code § 1902(b)(8). P is subject to Virginia income tax. D leases an office for its exclusive use in State A where it has a staff adequate to conduct all of its business affairs. D has substantial intangible assets which are loaned or otherwise made available to other group members for a consideration determined pursuant to the safe harbor provision of subdivision E 3 of 23 VAC 10-120-361. All of D's assets are located in State A, and all of its business activities, including all day-to-day decision making, are conducted by its own officers and employees in State A. D received its intangible assets from P in a transaction under Internal Revenue Code § 351. In this instance, the group's income from business done in Virginia is not distorted due to the intragroup lending transactions. This conclusion is not changed by the mere fact that one or more officers or directors of D may reside in Virginia, or may be employed by an affiliate of D doing business in Virginia.

The information provided to the Department contradicts the Taxpayer's assertions. The financial information provided shows that IHC reported no expenses for any office, no office assets, and no payroll for staff. Further, all the directors of IHC are officers of the Taxpayer and employed primarily in Virginia. While it is not known how much time these directors spent conducting the business of IHC, there is no record of them traveling to State A to attend to the business. IHC did report other deductions on its federal income tax return for the 1994 and 1995 taxable years, but has failed to provide documentation as the nature of these deductions. Also, IHC made a substantial charitable contribution to a nonprofit foundation established by the Taxpayer and located in Virginia. Based on these facts, I cannot conclude that IHC is a discrete, separate business enterprise with its own employees, office space, and

books and records as provided under Title 23 VAC 10-120361 E 3.

Further, IHC was formed in 1988 and held substantial capital in the form of cash and marketable securities by the beginning of 1994. The information provided shows that the Taxpayer made several large contributions to capital in 1989 and 1990. The Taxpayer transferred assets to IHC in a tax-free transaction. If the Taxpayer had been dealing with an unrelated third party, it would not transfer assets without consideration, and then agree to pay interest for the use of funds generated by these same assets. Had the assets been transferred to an unrelated third party for their fair market value, the gain realized by the Taxpayer would have been subject to tax by Virginia. Because IHC is a wholly owned subsidiary, the Taxpayer never lost the ability to control the subject assets, the rate or terms of the loan agreements, or the unrestricted use of the assets. The Taxpayer is essentially free to undo the transactions with IHC at any time.

IHC loaned funds to the Taxpayer and other Taxpayer affiliates. The rate of interest in the notes is stated to be equal to "110% of the short term applicable rate under IRC §1274(d)." The Taxpayer has provided no evidence to document the loans (e.g., copies of notes, loan application forms, approval procedures). Absent such documentation, the Department cannot conclude that the transactions between IHC and the Taxpayer are conducted on an arm's length basis.

*Virginia Code* § 58.1-205 provides that in any proceeding relating to the interpretation of the tax laws of the Commonwealth of Virginia, an "assessment of a tax by the Department shall be deemed *prima facie* correct." The burden of proof is on the Taxpayer to show that an assessment is in error. Because the Taxpayer has not provided the requested information regarding the intercompany loans, the adjustment of tax based on the intercompany loans is correct.

Thus, to the extent that IHC does not appear to have valid economic substance and the intercompany transactions were not conducted at arm's length, the facts satisfy the Court's requirement in *Commonwealth v. General Electric Company* of (1) an arrangement (2) between two commonly owned corporations (3) in such a manner improperly, inaccurately, or incorrectly to reflect (4) the business done or the Virginia taxable income earned from business done in Virginia.

Accordingly, the auditor's adjustments, subject to some technical

corrections, to consolidate the accounts of IHC with the Taxpayer for the taxable years ended December 31, 1994 and 1995 are upheld.

Based on the information provided, IHC earned interest income from investments other than loans to related parties during the audit period. The sales factors for 1994 and 1995 have been adjusted accordingly. In addition, IHC had dividend income in 1995 that did not qualify in full for the special federal deduction. The remaining dividend income has been allocated to IHC's state of commercial domicile.

### Nexus

The Taxpayer incorporated \*\*\*\*\* ("Corporation A") in Virginia in 1984 and incurred start-up costs. Corporation A was formed to become a partner in a business venture with an unrelated third party. After some attempts to initiate the business, the Taxpayer and the unrelated party determined that market conditions were not right for the business venture. In 1994, the Taxpayer and the unrelated party agreed to terminate and abandon the business venture.

Under IRC § 195, a taxpayer can elect to amortize start-up costs beginning in the taxable year in which the active trade or business begins. Corporation A attempted to initiate business activities but never generated any revenue. Accordingly, the start-up costs were not amortized, and Corporation A took a deduction for the entire amount of the costs when the business venture was terminated.

The auditor disallowed this loss on the basis that Corporation A did not have nexus with Virginia because it lacked a positive apportionment factor. The Taxpayer contends that Corporation A has nexus because it was incorporated and domiciled in Virginia and had no activities outside of Virginia.

In general, a corporation that is commercially domiciled in Virginia will be subject to tax on its income and eligible to be included in a consolidated Virginia corporation income tax return. Under Title 23 VAC 10-120-140, the commercial domicile of a corporation is defined as the location of the principal office where "the business affairs of the corporation are normally directed or managed." This is usually a corporation's headquarters. The regulation goes on to state:

If the corporation has no office then the commercial domicile may be where the officers, directors and

shareholders regularly meet or where the principal officer or majority shareholder/officer conducts the affairs of the corporation, depending upon the facts and circumstances.

In this case, Corporation A has no office, employees, or tangible assets. The Taxpayer has provided evidence to show that Corporation A's affairs were primarily conducted by officers located at the Taxpayer's headquarters in Virginia. Pursuant to Title 23 VAC 10-120-140, Virginia is considered the commercial domicile of Corporation A for Virginia income tax purposes.

Under *Va. Code* § 58.1-406, every corporation that has income from business activity that is taxable by Virginia and another state must allocate and apportion its income. Typically, a corporation will not have nexus if there is insufficient business activity within Virginia to make any one or more of the applicable apportionment factors positive. See Public Document ("P.D.") 92-238 (11/16/92).

A corporation's nexus is only at issue if it is subject to corporation income tax in Virginia and in at least one other state. The documentation furnished indicates that Corporation A was registered and commercially domiciled in Virginia and was not subject to income tax in any other state besides Virginia. Therefore, Corporation A was correctly included in the Taxpayer's consolidated return for the 1994 and 1995 taxable years.

### Conclusion

The audit report has been revised in accordance with this determination. 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, 3600 West Broad Street, Suite 160, Richmond, Virginia 23230, Attention: \*\*\*\*\*. If you have any questions concerning payment of the assessment, you may contact \*\*\*\*\* at \*\*\*\*\*.

The *Code of Virginia* sections, Public Documents and regulations cited are available on-line in the Tax Policy Library section of the Department's web site, located at [www.policylibrary.tax.virginia.gov](http://www.policylibrary.tax.virginia.gov). If you have any questions regarding this determination, please contact \*\*\*\*\* in the Department's Office of Policy and Administration, Appeals and Rulings, at \*\*\*\*\*.

Sincerely,

Kenneth W. Thorson  
Tax Commissioner

AR/17465B