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"SLICING A SHADOW"[1] WEST VIRGINIA STYLE

by Dale W. Steager, Esq.

Summary

During the past three years, the West Virginia Legislature made numerous changes in the state's corporation net income tax, some of which also affect the state's business franchise tax. Many, but not all, of these changes first apply to taxable years beginning after December 31, 2008. The impetus for the major changes was the desire by the Legislature to minimize actions taken by some corporations to minimize their state tax liabilities, which actions had the effect of shifting income to jurisdictions in which they either were not subject to tax or paid a lower rate of tax. The side effect of these changes is to increase the complexity of the law and the filing requirements for even an affiliated group of small corporations engaged in multistate business activity that heretofore filed consolidated federal and state income tax returns.

Overall, these changes:

- Broaden the definition of "business income" to include all income that may be constitutionally apportioned.
- Broaden the definition of "corporation" so that it specifically includes corporate activity through limited liability companies and other pass-through entities.
- Change how corporate distributive share from limited liability companies and other pass-through entities is treated for taxable years beginning after December 31, 2008.
- Prohibit the filing of a consolidated West Virginia corporation net income tax return.
- Require corporations engaged in a unitary business with one or more other corporations to compute their respective corporation net income tax and business franchise tax

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Dale W. Steager practices in the area of state and local taxation in the Charleston, West Virginia, office of Spilman Thomas & Battle, PLLC. Prior to joining the firm in 2005, he served for over 28 years as General Counsel of the West Virginia Department of Revenue and the State Tax Department.

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[1] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 192 (1983).

liabilities based on a combined report filed with the annual return for taxable years beginning after December 31, 2008.

- Require add-back of intangible expenses and interest expenses paid to a related person for taxable years beginning after December 31, 2008, unless an exception applies.

- Require captive real estate investment trusts and regulated investment companies, except qualified regulated investment companies, to add-back to federal taxable income the dividends paid deduction claimed for federal income tax purposes for a taxable year beginning after December 31, 2008.

Background

The West Virginia Legislature began making significant changes in the state's corporation net income tax ("WVCNIT"), when it adopted forced combined reporting in 2007. *See* SB 749 (2007). The combined reporting regime adopted is largely based on the model combined reporting statute prepared by the Multistate Tax Commission. Although SB 749 took effect upon its passage, most changes made by the bill were deferred to taxable years beginning after December 31, 2008, including the combined reporting requirement. However, some changes did apply to taxable years beginning on or after March 10, 2007.[2] Technical corrections were made in 2008 (*see* SB 680) and again in 2009 (*see* SB 540). One significant change in 2008 was to flip the default requirement for combined reports from worldwide combination to water's-edge combination. Worldwide combination is now something that may be elected or required by the Tax Commissioner.

Additional legislation was enacted in 2008 and amended in 2009 that provides for the taxation of certain real estate investment trusts and regulated investment companies. *See* W. Va. Code § 11-24-4b (2008; 2009). The 2009 legislation also requires add-back of intangible expenses and interest expenses deducted for federal income tax purposes when the expense is paid to a related party, unless one of the narrow exceptions to add-back applies. *See* W. Va. Code § 11-24-4b(c) and (d), as added by SB 540 (2009). All of the 2009 changes and many of the changes enacted in 2007 and 2008 apply to taxable years beginning after December 31, 2008.

In late June, the Tax Commissioner filed for public comment a proposed legislative rule, W. Va. C.S.R. § 110-24-1, *et seq*., implementing combined reporting in the context of the WVCNIT. This proposed rule was amended by the Tax Commissioner based on public comments received and will be acted upon by the Legislature during its 2010 regular session. While this proposed legislative rule has no effect until its promulgation is authorized by the Legislature, it nevertheless is helpful to both taxpayers and tax practitioners as they begin complying with the requirements of forced combination, which also applied to the business franchise tax. This article discusses these various changes.

[2] W. Va. Code § 11-10-5p, which applies to the corporation net income tax, provides that "[a]ny amendment to any tax administered under this article shall first apply to a particular taxpayer for taxable years beginning on or after the effective date of the act of the Legislature containing such amendment, as determined under article six, section thirty of the constitution of this state, unless the language of the act provides a controlling internal effective date provision."

Discussion

1. Definition of *Business Income* Expanded

One change enacted in 2007 that applies to taxable years beginning after March 10, 2007, is the amendment to the definition of "business income." Business income now includes all income that can be apportioned under the United States Constitution. The amended definition of business income reads:

> *Business income.* -- The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property or the rendering of services in connection therewith constitute integral parts of the taxpayer's regular trade or business operations and includes all income which is apportionable under the Constitution of the United States.

W. Va. Code § 11-24-3a(1). "Nonbusiness income" continues to mean "all income other than business income." W. Va. Code § 11-24-3a(22).

While the scope of the prior law definition of business income has not been litigated in West Virginia, in states where it has been litigated the court's decision often turned on whether the definition contained one test for business income – the transaction test – or included a second test, known as the functional test. The Tax Commissioner's legislative rules for the WVCNIT, promulgated prior to amendment of the definition of business income, supported a single test – the transactional test. *See* W. Va. C.S.R. § 110-24-3a.1 (defining business income) and § 110-24-7 (providing examples for allocation and apportionment of income). The 2007 amendment clearly adds the functional test to the definition of business income. It also adds some new uncertainty by extending the definition to include "all income which is apportionable under the Constitution of the United States." While the true import of this additionally language remains to be seen, the United States Supreme Court has rejected the idea that all of a corporation's income is apportionable. *See Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 US 768, 784 (1992) (holding that investment income, as distinguished from operational income, is not subject to apportionment).

2. Corporate Partner Distributive Share

As a general rule, when a corporation's business activities take place in West Virginia and in one or more other states, including foreign countries, the corporation's nonbusiness income must be allocated, as provided in W. Va. Code § 11-24-7(d)(1) through (4), and its business income must be apportioned, as provided in W. Va. Code § 11-24-7(e).[3] One exception to this general rule has been the treatment of a corporate partner's distributive share. Since 1988, a corporate partner's distributive share has been treated as income subject to allocation, as provided in W.

[3] Motor carriers and financial organizations are authorized to use the special methods of apportionment provided for them in W. Va. Code §§ 11-24-7a and 11-24-7b, respectively.

Va. Code § 11-24-7(d)(5), and the corporate partner's proportionate share of the property, payroll and sales factors of the partnership were not included in the corporation's property, payroll and sales factors.[4] This method of taxing corporate partner distributive share is not allowed for taxable years beginning after December 31, 2008. *See* W. Va. Code § 11-24-7(d)(5)(C). Instead, the distributive share will be treated as any other item of income, loss, expense or deduction of the corporation and the corporation's proportionate share of the partnership's property, payroll and sales factors will be included in the corporation's factors, unless the corporation's interest in the partnership is an investment, in which case, the distributive share is subject to the nonbusiness income allocation rules. When the corporation is engaged in a unitary business with one or more corporations, a determination needs to be made about whether the partnership interest is part of the unitary business activity, or is a discrete business of the corporation, or is an investment. *See* definitions of "corporation" and "unitary business," *infra*.

3. Definition of *Corporation* Expanded

The 2007 legislation also amended and expanded the definition of "corporation." It clarifies that the business of a partnership indirectly or directly owned by a corporation is the business of the corporation to the extent of its ownership interest. Minor changes in the definition were made in 2008. As amended, the definition reads:

> *Corporation.* -- The term "corporation" means any corporation as defined by the laws of this state or organization of any kind treated as a corporation for tax purposes under the laws of this state, wherever located, which if it were doing business in this state would be subject to the tax imposed by this article. The business conducted by a partnership which is directly or indirectly held by a corporation shall be considered the business of the corporation to the extent of the corporation's distributive share of the partnership income, inclusive of guaranteed payments to the extent prescribed by regulation. The term "corporation" includes a joint-stock company and any association or other organization which is taxable as a corporation under the federal income tax law.

W. Va. Code § 11-24-3a(7).[5]

4. Consolidated Returns Not Allowed

Corporations that filed a consolidate federal income tax return could previously elect to file a consolidated WVCNIT return, for taxable years that began before January 1, 2009. This election was binding for subsequent years and could not be changed without the consent of the Tax Commissioner. *See* W. Va. Code § 11-24-13a(a). However, the filing of a consolidated WVCNIT return is no longer allowed for taxable years beginning after December 31, 2008. *See*

[4] As used here, "partnership" includes other business entities treated like a partnership for federal income tax purposes for the taxable year.

[5] Prior to amendment in 2007, the definition of "corporation" included only the last sentence of the current definition.

W. Va. Code § 11-24-13a(a)(2) (general rule on filing of consolidated return) and (c)(6) (consolidated return of financial organizations).

Interestingly, subsection 11-24-13a(e) provides that the Tax Commissioner may require any person or corporation to make and file a separate return or to make and file a composite, unitary, consolidated or combined return, as the case may be, in order to clearly reflect the taxable income of such corporations. The Tax Commissioner has not provided guidance on how this provision will be construed or applied by the Commissioner in the case of taxable years beginning after December 31, 2008.

5. *Combined Group* Defined

The term "combined group" was first defined for purposes of the WVCNIT in 2007 and amended in 2009. As amended, the definition reads:

> *Combined group.* -- The term "combined group" means the group of all persons whose income and apportionment factors are required to be taken into account pursuant to subsection (j) or (k), section thirteen-a of this article in determining the taxpayer's share of the net business income or loss apportionable to this state.

W. Va. Code § 11-24-3a(4). Subsection 11-24-13a(j) requires the filing of a combined report for taxable years beginning after December 31, 2008, while subsection 11-24-13a(k) gives the Tax Commissioner discretionary authority to require the filing of a combined report when one is not filed pursuant to subsection 11-24-13a(k), when the Commissioner believes that two or more corporations are engaged in a unitary business.

6. *Unitary Business* Defined

The definition of "unitary business" was added to the WVCNIT in 2007 and subsequently amended. As amended, the definition reads:

> "Unitary business" means a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. For purposes of this article and article twenty-three of this chapter, any business conducted by a partnership shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or the percentage of its distributive or any other share of partnership income. A business conducted directly or indirectly by one corporation through its direct or indirect interest in a partnership is unitary with that portion of a business conducted by one or more other corporations through their direct or indirect interest in a

> partnership if there is a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts and the corporations are members of the same commonly controlled group.

W. Va. Code § 11-24-3a (43)[6]

A problem with this definition is that its meaning is subject to debate and because it first becomes important for many taxpayers for taxable years beginning after December 31, 2008, there has been no West Virginia administrative or judicial case law development of this concept.

So when are the separate parts of a single business entity or of a commonly controlled group of business entities sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts that they constitute a unitary business for purposes of the WVCNIT?

The Tax Commissioner's proposed legislative rule fleshes out the meaning of "common ownership" for purposes of combined reporting. *See*, proposed legislative rule W. Va. C.S.R. § 110-24-3.2.3 (defining "commonly owned" and "common ownership"). In general, when more than 50% of the common stock or voting power of a corporation is directly or indirectly owned by another corporation, the two corporations will be engaged in a unitary business only if the other requirements of the unitary business definition are satisfied. Simply put, common ownership is not sufficient by itself to find that two corporations are engaged in a unitary business even if the second is wholly owned by first.

The proposed rule also makes it clear that in computing and apportioning the business income of the combined group engaged in a unitary business, West Virginia follows the decision of the California Board of Equalization in *Appeal of Joyce, Inc.*[7], which does not disregard the separate identities of members of the combined group.[8] This means, for example, that the throw-out rule, *see* discussion *infra*, is applied on a corporation by corporation basis rather than on a combined group basis, and that the nexus rules in Public Law 86-272[9] are also applied to each member of the group rather than to the combined group as a whole.

Other aspects of the definition of unitary business are also fleshed out in proposed legislative rule W. Va. C.S.R. § 110-24-13a.3. These rules recognize that a corporation may be engaged in one or more unitary businesses as well as in business activity that is not party of any unitary business. W. Va. C.S.R. § 110-24-13a.3.a.1. through 110-24-13a.3.a.3. read:

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[6] As enacted in 2007, the definition of "unitary business" included only the first sentence of this definition. The amendment in 2008 added the last two sentences to the definition.

[7] *Appeal of Joyce, Inc*., 66 SBE 069, 1966 WL 1411 (Cal. St. Bd. Eq.) (Nov. 23, 1966).

[8] The statutory basis for this rule is found in W. Va. Code § 11-24-13c(a).

[9] Codified as 15 USC §§ 381-384.

> 13a.3.a.1. A corporation subject to taxation may be engaged in more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by a formula which takes into consideration the in-state and out-of-state factors which relate to the respective trade or business subject to apportionment.
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> 13a.3.a.2. In addition, a corporation may be engaged in a single trade or business in combination with another commonly owned and controlled corporation or corporations. In such cases, it is necessary to determine the total business income of all such corporations attributable to the single trade or business. The combined income of the single trade or business is then apportioned by formula which takes into consideration the in-state and out-of-state factors of each corporation which relate to that single trade or business.
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> 13a.3.a.3. When business segments of a single corporation or the business activities of more than one corporation constitute a single trade or business, such single trade or business is said to constitute a "unitary business."

However, the proposed legislative rule includes a presumption that a corporation with two or more operating divisions is a unitary business even if the divisions are not in the same line of business or are not steps in a vertical process. Proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.a.12.H. reads:

> 13a.3.a.12.H. *No divisional segregation or separation for purposes of determining unitary group member status, income or attributes.* The determining factor in designation of a unitary activity is the character of the activity engaged in and not the organizational structure of the business components engaging in the activity. If a corporation or other entity is organized into divisions or other functional units or business segments not constituting separate legal entities, the corporation or entity so organized shall, as a whole, be presumed to be the unitary member if it is engaged in unitary business activity. However, if the corporation is engaged in more than one trade or business, then the determination of income attributable to each separate trade or business, authorized under subparagraph 13a.3.a.1 shall be made, and the determination of income attributable to each separate trade or business engaged in with another commonly owned and controlled corporation or corporations authorized under subparagraph 13a.3.a.2 shall be made. No operations, income or apportionment factor attributes of any such division, functional unit or business segment shall otherwise be subtracted, segregated or separated from those of the combined group.

Functional Integration. A key criteria to finding that two or more corporations are engaged in a unitary business is whether the corporations are functionally integrated. The concept of function integration is explained in proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.a.4., as follows:

13a.3.a.4. A unitary business exists when the operations of the business segments of a corporation or group of commonly owned and controlled corporations contribute to or depend on each other in such a way as to result in functional integration between such segments. Functional integration refers to transfers between or pooling among business segments of such items as products or services, technical information, marketing information, distribution systems, purchasing and intangibles (such as patents, copyrights, formulas, processes, trade secrets, and the like) in a manner which substantially affects the segments' business operations related to such activities as development, manufacture, production, extraction, distribution or sale of its products or services.

In general, whether two or more corporations are functionally integrated is a case-by-case determination. Evidence of functionally integrating factors and a description of those factors is set forth in proposed legislative rule W. Va. C.S.R. § 110-24-13a.3a.5 and 6, which read as follows:

13a.3.a.5. *Evidence of functionally integrating factors*. -- The determination of whether or not the operations of business segments are functionally integrated will turn on the facts and circumstances of the case. Several factors may evidence that the operations of business segments are functionally integrated. A non-exclusive list of such factors is found below. Generally, several functionally integrating factors will exist in a unitary business, although a unitary business may exist as a result of few factors or even one factor, if the factor or factors involved are particularly significant. In determining whether a unitary business exists factors should not be examined in isolation. Instead, it should be determined whether the factors which are present, in combination, result in a functionally integrated business. In addition, the presence or absence of any one factor or any particular factors is not necessarily determinative as to whether a unitary business exists, although absence of all of the factors described in this subsection will generally result in a finding that a unitary business does not exist.

13a.3.a.6. *Functionally integrating factors.* -- A non-exclusive listing of factors to be considered in determining whether business segments are functionally integrated appears below.

13a.3.a.6.A. The existence or non-existence of the following factors will assist in the determination of whether "unity of operations" exits with respect to an affiliated group. The existence or non-existence of any one factor, by itself, is normally not determinative of whether the element has or has not been satisfied. Nor is this list a limitation on the factors that may be considered in determining whether unity of operations exists:

13a.3.a.6.A.1. Common or centralized purchasing;
13a.3.a.6.A.2. Common or centralized advertising;

13a.3.a.6.A.3. Common or centralized employees, including sales force;
13a.3.a.6.A.4. Common or centralized accounting;
13a.3.a.6.A.5. Common or centralized legal support;
13a.3.a.6.A.6. Common or centralized retirement plan;
13a.3.a.6.A.7. Common or centralized insurance coverage;
13a.3.a.6.A.8. Common or centralized marketing;
13a.3.a.6.A.9. Common or centralized cash management;
13a.3.a.6.A.10. Common or centralized research and development;
13a.3.a.6.A.11. Common or centralized offices;
13a.3.a.6.A.12. Common or centralized manufacturing facilities;
13a.3.a.6.A.13. Common, centralized or intercompany financing;
13a.3.a.6.A.14. Common or centralized computer systems and support;
13a.3.a.6.A.15. Common or centralized management;
13a.3.a.6.A.16. Common or centralized labor relations;
13a.3.a.6.A.17. Common or centralized pension plans;
13a.3.a.6.A.18. Common or centralized personnel recruitment;
13a.3.a.6.A.19. Intercompany sales, exchanges, or transfers;
13a.3.a.6.A.20. Common, centralized or intercompany transfer or pooling of technical information;
13a.3.a.6.A.21. Common or centralized distribution system, including but not limited to common or centralized transportation facilities, or common or centralized warehousing facilities, or common or centralized order fulfillment systems, inventory control systems or other distribution systems or subsystems, or any combination thereof.

Intercompany Sales. The relevance of intercompany sales, exchanges or transfers in the unitary business analysis is discussed in proposed legislative rule W. Va. C.S.R. § 110-24-133.3.a.7. However, the absence of intercompany sales does not preclude finding that the corporations are functionally integrated. The proposed rule reads:

13a.3.a.7. *Intercompany sales, exchanges, or transfers*.

13a.3.a.7.A. Sales, exchanges, or transfers (hereinafter "sales") of products, services, intangibles or the like between business segments are important indicia of functional integration. The significance of intercompany sales will be a function of both the character of the items sold and percentage of total sales or purchases represented by the intercompany sales. Intercompany sales at a given level take on greater significance if there is a limited sales or purchasing market for such items or if valuable trade name or other intangibles are associated with such sales, or both.

13a.3.a.7.B. The fact that intercompany sales are at a readily determinable market price does not negate the importance of such sales as a functionally integrating factor, because such sales generally represent an assured market for the seller and a guaranteed source of supply for the purchaser.

13a.3.a.7.C. As the percentage of intercompany sales to the total sales of the selling segment increases or as the percentage of intercompany purchases of the purchasing segment's total purchases increases, the more important such purchases and sales become as a unitary factor. For purposes of this subdivision, where goods, services, or intangibles are transferred without charge, percentages of cost (or cost of goods sold) may be used in lieu of percentage of sales or purchases. For purposes of this subdivision, management stewardship activities are not considered an intercompany sale or transfer of services. Generally, intercompany sales or purchases in excess of 10% will be considered a significant, although not necessarily determinative, unitary factor. Sales of less than 10% become relatively less significant as the percentage of sales declines, but a small percentage of sales may nevertheless be considered significant if the sales represent goods or services which are particularly important to the purchaser's operations.

13a.3.a.7.C.1. *Example*. - Business segments A and B are commonly owned and controlled. Segment A grows citrus and other fruit. Segment B manufactures soft drinks. A sells to B oils extracted from the skin of a special variety of fruit for use in 8's soft drinks. This oil is not significantly available from other sources. The sales represent only a small portion of A's total sales and B's total purchases. The unusual flavor produced by the oil is a major factor in the character of the soft drink. Consumer taste tests demonstrate a strong preference for the soft drink with this oil as an ingredient. The intercompany sales between A and B would be considered a significant unitary factor.

13a.3.a.7.D. Sales, exchanges or transfers between business segments may be disregarded where intercompany sales are used as a device to assert unitary combination for tax avoidance purposes.

13a.3.a.7.D.1. *Example*: Company A is a West Virginia corporation with operations in West Virginia and other states. These operations are non unitary with sister corporations B and D, which operate entirely outside of West Virginia. B and C have had significant net operating losses for many years. A's property, payroll and sales factors apportion 90% of A's net income to West Virginia.

A enters into a fraudulent collusive tax avoidance scheme with its sister corporations to cause A to sell to B and C office supplies valued at less than $500 that are simply purchased and resold by A. A. B and C are not in the office supply business, and office supplies have nothing to do with A. B or C's regular business operations, except as simple consumable items used in their respective offices.

B and C each sell 2 used office computers to A which would have otherwise been sold for salvage value. A, B and C are not in the computer business, and computers have nothing to do with A, B or C's regular business operations, except as simple consumable items used in their respective offices. A does not use the computers, and sells them less than 1 week after receiving them for salvage value.

A, B and C falsely assert that they are unitary businesses by reason of the intercompany sales. Because B and C have no operations in West Virginia and no nexus with West Virginia, and because of the dilutive effect of the inclusion of B's and C's denominator numbers in A's property, payroll and sales factors for A's combined unitary tax return, A now apportions less than 30% of A's income to West Virginia, thereby decreasing taxable income for West Virginia tax purposes.

Common Marketing. Common marketing of goods and services can be evidence of functional integration. The relevancy of common marketing in the unitary business analysis is explained in proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.a.8, which reads:

13a.3.a.8. *Common marketing*.

13a.3.a.8.A. When business segments share substantial common marketing features, such features can be an important characteristic of functional integration when such marketing results in significant mutual advantage. For this purpose, common marketing exists when a substantial portion of the business segments' products, services, intangibles, or the like are distributed or sold to a common customer, or the business segments use a common trade name or other common identification and such common identification is a significant factor in purchasers' decisions to purchase the respective products or services.

13a.3.a.8.A.1. *Example*. - Business segments A and B are commonly owned and controlled. A manufactures small tools and garden implements. B manufactures auto replacement parts and accessories. Both A and B jointly sell a substantial portion of both segment's total production to various hardware store chains, which then sell both product lines to the public. As a result of such common sales, both segments are able to obtain preference on shelf space and greater merchant participation in product promotion of each segment. Such common sales would be considered a functionally integrating factor.

13a.3.a.8.A.2. *Example*. - Commonly owned and controlled segments A, B, and C manufacture furniture, carpeting, and household appliances, respectively. All three product lines are sold under the name "Alpha" which is a nationally recognized trade name. A, B and C jointly participate in advertising to portray the "Alpha" name as a symbol of quality and value. Based on consumer studies, the "Alpha" name is a significant factor in the consumer's decision to

purchase the respective products. The common use of the trade name "Alpha" would be considered a functionally integrating factor.

13a.3.a.8.B. Common use of an advertising agency does not constitute common marketing, absent circumstances described above. In addition, shared use of a commonly owned and controlled business segment which provides advertising services is not common marketing described by this subparagraph, absent circumstances described above.

Pooling of Technical Information. The pooling of technical information can be evidence of functional integration. The relevance of common, centralized or intercompany transfers or pooling of technical information in the unitary business analysis is explained in proposed legislative rule W. Va. C.S.R. § 13a.3.a.9 as follows:

13a.3.a.9. *Common, centralized or intercompany transfer or pooling of technical information.* -- Evidence of functional integration may be indicated by transfers or pooling of technical information, know-how, or research and development, if such transfer or pooling represents a significant economy of scale or the information shared is particularly important to the segments' operations.

Common Distribution or Purchasing. Common distribution of goods or common purchasing of goods and services can be evidence of functional integration. The relevance of a common distribution system or common purchasing in the unitary business analysis is explained in proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.a.10 and 11 as follows:

13a.3.a.10. *Common distribution system*. -- Business segments may demonstrate evidence of functional integration by use of a common distribution system, under which inventory control and accounting, storage, trafficking and transportation are controlled through a common network.

13a.3.a.11. *Common purchasing*. -- Evidence of functional integration may be indicated by common purchasing of substantial quantities of products, services intangibles, or the like from the same source, where such purchasing results in a significant economy of scale, or where such products, services, intangibles, or the like are not readily available from other sources and are particularly important to each segment's operations or sales.

Centralized Management. Centralized management is a critical element of functional integration. However, centralized management entails more than the involvement a parent corporation would ordinarily have in the business of its subsidiaries.[10] The concept of centralized management in the unitary business analysis is discussed in proposed legislative rule W. Va. C.S.R. § 11-24-13a.3.a.12. as follows:

[10] *See, for example, F. W. Woolworth Co. v Taxation and Revenue Department of New Mexico*, 458 U.S. 354 (1982).

13a.3.a.12. *Centralized management.*

13a.3.a.12.A. Centralization of management exists when directors, officers and/or management employees jointly participate in management decisions which significantly affect the respective business segments. Transfer of officers or management employees between business segments may also provide evidence of centralization of management.

13a.3.a.12.B. The mere presence of centralized management may support a finding that the operations of commonly owned and controlled business segments are unitary.

13a.3.a.12.C. Centralization of management is more significant as a unitary factor when business segments are engaged in the same general line of business or constitute steps in a vertically integrated enterprise than in other business contexts, because of the opportunity the respective segments have in making use through such central management of readily transferable knowledge and expertise of the operations of the other segment, and developing coordination between the business segments.

However, factors such as the provision of common legal services, accounting service, tax administration service and financial reporting services will generally be accorded little weight in determining whether business segments are functionally integrated. *See* proposed legislative rule W. Va. C.S.R. § 110-24-13a.12.D.

Unitary Business Presumption. The presence of a unitary business is presumptively shown when the segments are in the same general line of business or are steps in a vertical process. Proposed legislative rule W. Va. C.S.R. § 110-24-13a.3a.12.E reads:

13a.3.a.12.E. The presence of a unitary business will be presumptively shown by the presence of the following:

13a.3.a.12.E.1. *Same general line of business*: There is a strong presumption that a corporation or a commonly owned and controlled group of corporations is engaged in a unitary business when its activities are in the same general line. For example, a corporation which operates a chain of retail grocery stores will almost always be engaged in a unitary business.

13a.3.a.12.E.2. *Steps in a vertical process*: A corporation or a commonly owned or controlled group of corporations is almost always engaged in a unitary business when its various divisions or segments are engaged in different steps in a vertically structured enterprise. For example, a corporation which explores for and mines copper ores; concentrates, smelts and refines the copper ores; fabricates the refined copper into consumer products and distributes such products (whether by intercompany fee or purchase, or without charge) is engaged in a unitary business, regardless of the fact that the various steps in the process are operated

substantially independently of each other with only general supervision from the corporation's executive offices.

No Unitary Business Presumption. However, business segments that are not in the same general line of business or are not steps in a vertical process are presumptively engaged in separate businesses, unless there is a determination that the respective segments are functionally integrated. Proposed legislative rule W. Va. C.S.R. § 110-24-13a.12.F reads:

> 13a.3.a.12.F. Business segments which are neither in the same general line of business nor steps in a vertical process are presumptively engaged in separate businesses, absent a determination that the respective segments are functionally integrated.
>
> 13a.3.a.12.F.1. In the event that a business segment is functionally integrated with a second business segment and the second business segment is functionally integrated with a third business segment, the first, second and third business segments constitute a unitary business notwithstanding the fact that the first and third business segments are not functionally integrated with each other. The preceding sentence shall not apply where the second business segment's functional integration is not substantial viewed from the perspective of either the first or third business segment.
>
> 13a.3.a.12.F.1.1. *Example*. -- Business segments A, B, and C are commonly owned and controlled. A is an architectural firm. B is a construction company which builds office and apartment buildings. C is a manufacturer of finished steel. A provides architectural services to B, representing half of the total architectural services it provides. C designs, fabricates, and sells the superstructures used in the construction of B's office and apartment buildings. The steel superstructures constitute 20% of B's construction purchases. A and C have no intercompany sales, common marketing, pooling of technical knowledge, common distribution system or common purchases. Nevertheless, A, B, and C constitute a unitary business because B is functionally integrated with both A and C.
>
> 13a.3.a.12.F.1.2. *Example*. -- Business segments A, B, and C are commonly owned and controlled. A is in the business of oil exploration, extraction and refining. B is a charter air transportation company. C produces motion pictures. A and C have no intercompany sales, common marketing, pooling of technical knowledge, or common distribution system. A uses B's service for transporting oil executives, engineers and geologists to remote oil exploration and drilling sites. C uses B's services for flying movie executives and actors to movie locations and business meetings. A and C's common purchases are limited to the transportation services provided by B. A's use of B's service constitute 20% of B's total charter sales. C's use of B's service constitutes 40% of B's total charter sales. However, B's service represents less than a hundredth of a percent of A's total purchases and only two tenths of a percent of C's total

purchases. Despite the fact that B is functionally integrated with both A and C, A, B, and C do not constitute a unitary business.

Burden of Proof. Whether the taxpayer asserts that business segments are, or are not, unitary, the burden of proof is on the taxpayer. *See* proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.a.12.G. The proposed rule goes on to provide that failure by the taxpayer to produce requested evidence which lies within the control of the taxpayer gives rise to a presumption that the evidence would be unfavorable if provided. Additionally, when the Tax Commissioner asserts that business segments are, or are not unitary, the burden of proof is also on the taxpayer to show by the preponderance of the evidence that the Tax Commissioner is wrong. The Tax Commissioner has no burden of proof.

Acquired Corporation. The general rule is that acquisition of an ongoing business corporation does not create instant unity, unless the unitary business relationship existed before the acquisition. Proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.b.1. reads:

> 13a.3.b. *Establishment of unity for acquired entities and newly formed entities.*
>
> 13a.3.b.1. *Newly Acquired Corporations*. When a corporation that is a member of a unitary group acquires another corporation, a presumption exists against a finding of a unitary relationship during the first reporting period unless a unitary relationship already existed at the time of the acquisition. The presumption may be rebutted by proving that the corporations are unitary. If such presumption is rebutted, then the corporations shall be considered unitary as of the date of acquisition, unless the evidence shows that unity was established as of another date.
>
> 13a.3.b.1.A. In the next succeeding reporting period after the first reporting period subsequent to an acquisition whereby a corporation that is a member of a unitary group acquires another corporation, and for all reporting periods thereafter, a presumption of a unitary relationship exists. The presumption may be rebutted by proving that the corporations are not unitary.

Newly Formed Corporation. The general rule is that when a member of a unitary group forms a new corporation, there is a presumption that the new corporation is a member of the unitary group from the date it is formed. Proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.b.2. reads:

> 13a.3.b.2. *Newly-Formed Corporations or entities*. When a corporation that is a member of a unitary group forms another corporation, a presumption exists in favor of finding unity between the two corporations or entities as of the date of formation. Any party may rebut such presumption by proving that the corporations or entities are not unitary or became unitary at a later date.
>
> 13a.3.b.2.A. For purposes of this rule, a newly formed corporation or entity includes but is not limited to: a corporate reorganization whereby a corporate

divestiture, split-up or split off occurs, or one or more new subsidiaries is formed, or one or more new subsidiaries is acquired and substantially all of the assets and operations of an existing division or operation are placed into or under the administrative or operational responsibility of the acquired entity, or a partnership is created or formed, or an existing corporation changes its form of doing business from one organizational structure to one or more new organizational structures or merges several subsidiary entities into an existing or newly formed entity.

Computation of Unitary Business Income When Composition of Combined Group Changes During Tax Year. The proposed legislative rule also provides reporting guidance when the composition of a combined group changes during the tax year either because a new corporation is added or a corporation ceased to be a member of the combined group. Proposed W. Va. C.S.R. § 110-24-13a.3.b.3 reads:

13a.3.b.3. Unitary members compute their liability relating to a year when a member is added to or departs from the unitary group as follows:

13a.3.b.3.A. If a corporation becomes a member of a unitary group during the group's common accounting period, or ceases to be a member during the period, the other members shall take into account the appropriate portion of the part year member's income and the property, payroll, sales attributes of the part-year member in computing their tax liabilities.

13a.3.b.3.A.1. part-year unitary member computes its liability as follows:

13a.3.b.3.A.1.1 business income attributable to the portion of the year during which the part-year unitary member was a unitary group member is combined with business income of the other unitary group members for the same portion of the year, and the total income is apportioned to West Virginia on a combined apportionment basis; and

13a.3.b.3.A.1.2 business income attributable to the portion of the year during which the part-year unitary member was not a unitary member is apportioned to West Virginia on the basis of the part year member's separate property, payroll, and sales attributes for the part of the year during which the part-year unitary member was not a unitary member. The corporation is required to file a separate return for this portion of its income.

Holding Companies. A passive holding company is not automatically excluded from being part of the combined group engaged in unitary business. The rules, presumptions and tests provided in the proposed legislative rule for determining when a unitary business exists also apply to passive holding companies. Proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.c reads:

13a.3.c. *Holding Companies*. The test for a unitary business established by this rule applies in determining whether a holding company is included or excluded

> from a unitary business. A passive parent holding company that directly or indirectly controls one or more operating company subsidiaries engaged in a unitary business shall be deemed to be engaged in a unitary business and includable in a combined report with the subsidiary or subsidiaries. An intermediate passive holding company shall be deemed to be engaged in a unitary business with the parent and subsidiary or subsidiaries and includable in a combined report with them.

Statutes of Limitation. Because the West Virginia combined reporting requirements recognize and preserve the separate identities of the members of the corporations that comprise the unitary group, the applicable statutes of limitations on issuance of deficiency assessments and on filing claims for refund or credit apply separately to each member of the combined group engaged in a unitary business. Proposed legislative rule W. Va. C.S.R. § 110-24-13a.3.d reads:

> 13a.3.d. *Statute of limitations*. If the statute of limitations applicable to refund claims and assessments is open with respect to a particular member of the combined group, the statute of limitations is open with respect to that particular Taxpayer notwithstanding the fact that the statute of limitations may have expired for one or more other members of the combined group.
>
> 13a.3.d.1. The statute of limitations applicable to refund claims and assessments for members of a combined reporting group which have filed their tax return based on a fiscalized reporting period matched to the accounting period of a principal member, shall be the statute of limitations determined and calculated based on the fiscalized accounting period.
>
> 13a.3.d.2. If a return is filed pursuant to a combined report, the Tax Commissioner may examine and audit that return, and collect any deficiency from a combined group member for whom the statute of limitations for assessments has not expired, even if the statute of limitations for other members which filed pursuant to the same combined report has expired. Any deficiency assessed pursuant to such audit or examination will not cause a reopening of the statute of limitations for those other members for which the statute of limitations has expired who filed pursuant to the same combined report.

7. Combined Reporting Required

For tax years beginning after December 31, 2008, any taxable corporation[11] engaged in a unitary business with one or more other corporations must file with its annual WVCNIT return a combined report, which includes the income, determined under section 11-24-13c or section 11-24-13d, and the allocation and apportionment of income provisions of the WVCNIT, of all corporations that are members of the unitary business, and such other information as required by the Tax Commissioner. *See* W. Va. Code § 11-24-13a(j). However, the income of an insurance company, the allocation or apportionment of income related thereto and the apportionment

[11] "Taxable corporation" means a corporation required to file an annual WVCNIT return.

factors of an insurance company are not to be included in a combined report, unless inclusion is specifically required by the Tax Commissioner. *See* W. Va. Code § 11-24-13a(j).

This combined reporting requirement applies to both the WVCNIT and to the West Virginia business franchise tax (WVBFT). *See* W. Va. Code § 11-24-13a(e) and (j). Consequently, the combined report will be used to compute both the taxable income and the taxable capital of taxable members of the combined group. *See* discussion of the WVBFT, *infra*.

8. Combined Reporting at Commissioner's Discretion

For taxable years beginning after December 31, 2008, the Tax Commissioner may require the combined report to include the income and associated apportionment factors of any person that is not included in the combined report under subsection 11-24-13(j), who is a member of a unitary business, in order to reflect proper apportionment of income of the entire unitary businesses. *See* W. Va. Code § 11-24-13a(k)(1).

Additionally, if the Tax Commissioner determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included in a combined report pursuant to subsection 11-24-13a(j) represents an avoidance or evasion of tax by the taxpayer, the Tax Commissioner may, on a case-by-case basis, require all or any part of the income and associated apportionment factors be included in the taxpayer's combined report. *See* W. Va. Code § 11-24-13a(k)(2).

With respect to inclusion of associated apportionment factors pursuant to section 11-24-13a, the Tax Commissioner may require the exclusion of any one or more of the factors, the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state, or the employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income. *See* W. Va. Code § 11-24-13a(k)(3).

9. Combined Report Not a Combined Return.

The combined report required by W. Va. Code § 11-24-13a(j) is not the same thing as a combined return. Rather, a combined report is one or more schedules used to compute the business income of the combined group from unitary business activity and used to compute the capital of those corporations for purposes of the business franchise tax. However, a diversified multistate or multinational corporation could be a member of two or more different unitary businesses or have business income that is not derived from any unitary business. The statutory combined report requirements contemplate that for a taxable member of the combined group, the combined report will include more than the business income from the combined group's unitary business. The combined report will include information regarding all of the taxable member's various business and nonbusiness activities. While each individual corporation will know this information, the member of the combined group that prepares the combined report may not have all of that information for every member of the combined group. Moreover, the statute does not specify which member of the combined group is required to prepare the combined report. Presumably, it will be prepared by the corporation that directly or indirectly owns more than

50% of the stock or voting power of the other members of the combined group. A taxpayer member of each combined group doing a unitary business in West Virginia is required to file the combined report with its annual WVCNIT return. The combined report includes all corporations that are part of the combined group even though the corporation is not subject to WVCNIT, because the corporation has no or insufficient taxable nexus with West Virginia, or it is exempt from tax under Public Law 86-272, because it only engages in protected activities in West Virginia. However, the combined report will not include an insurance company, unless the Tax Commissioner expressly requires that a particular insurance company be included in the combined report. *See* W. Va. Code § 11-24-13a(j).

Because a corporation may no longer elect to file a consolidated WVCNIT return, each taxable member of the combined group engaged in a unitary business in West Virginia is required to file on a separate corporation basis, unless the taxable members of the combined group elect to file a combined return under W. Va. Code § 11-24-13e. *See* discussion of section 11-24-13e, *infra.*

Included in the various business incomes will be the corporation's distributive share of business incomes of partnerships, limited liability companies and other entities taxed like a partnership for federal income tax purposes, when the partnership activity is a component of the unitary business and the distributive share is subject to apportionment. Not clear in the statute, or in the Tax Commissioner's proposed legislative rule, is how a corporate partnership interest is treated when the partnership is engaged in unitary business activity with some members of the combined group, but as to one or more members of the combined group, the corporate interest in the partnership is an investment interest. In this event, the investment income is treated as nonbusiness income subject to allocation as provided in W. Va. Code § 11-24-7(d)(1) through (4).

10. Determination of Taxable Income or Loss Using Combined Report

The use of a combined report does not disregard the separate identities of the members of the combined group. *See* W. Va. Code § 11-24-13c(a). Each taxpayer member of the combined group is responsible for WVCNIT based on its taxable income or loss apportioned or allocated to this state, which includes, in addition to other types of income, the taxpayer member's apportioned share of business income of the combined group, where business income of the combined group is computed as a summation of the individual net business incomes of all members of the combined group. *See* W. Va. Code § 11-24-13c. A member's net business income from the unitary business is determined by removing all but unitary business income, expense and loss from that member's total federal taxable income, as provided in section 11-24-13c and section 11-24-13d.

11. Components of Income Subject to Tax; Application of Tax Credits and Post-apportionment Deductions

As previously noted, each taxpayer member is responsible for WVCNIT based on its taxable income or loss apportioned or allocated to West Virginia, which includes:

(1) Its share of any business income apportionable to West Virginia for each of the combined groups of which it is a member, as determined under subsection 11-24-13c(c);

(2) Its share of any business income apportionable to West Virginia of a distinct business activity conducted within and without West Virginia wholly by the taxpayer member, determined under the applicable apportionment methodology;[12]

(3) Its income from a business conducted wholly by the taxpayer member entirely within West Virginia;

(4) Its income sourced to West Virginia from the sale or exchange of capital assets, and from involuntary conversions, as determined under subsection 11-24-13d;

(5) Its nonbusiness income or loss allocable to West Virginia, determined under the provisions for allocation of nonbusiness income set forth in section 11-24-7(d);

(6) Its income or loss allocated or apportioned in an earlier year, required to be taken into account as West Virginia source income during the income year, other than a net operating loss; and

(7) Its net operating loss carryover.

Net Operating Losses. If the West Virginia taxable income computed pursuant to W. Va. Code §§ 11-24-13c and 11-24-13d results in a loss for a taxpayer member of the combined group, that taxpayer member has a West Virginia net operating loss, subject to the net operating loss limitations, and carryover provisions of the WVCNIT.[13] This net operating loss is applied as a deduction in a prior or subsequent year only if that taxpayer has West Virginia source positive net income, whether or not the taxpayer is or was a member of a combined reporting group in the prior or subsequent year. However, net operating loss carry forwards that were earned during a tax year in which the taxpayer filed a consolidated WVCNIT return may be applied as a deduction from the West Virginia taxable income of any member of the taxpayer's controlled group until the net operating loss carryover is used or expires pursuant to the net operating loss provisions of the WVCNIT. *See* W. Va. Code § 11-24-13c(b)(1)(D).

Tax Credits. In general, no tax credit or post-apportionment deduction earned by one member of the combined group, but not fully used by or allowed to that member, may be used, in whole or in part, by another member of the combined group or applied, in whole or in part, against the

[12] The general apportionment method is the property factor plus the payroll factor plus two times the sales factor with the sum divided by four. W. Va. Code § 11-24-7(d). Motor carriers may generally apportion their business income from motor carrier operations using a single factor, mileage. W. Va. Code § 11-24-7a. Financial organizations apportion their business income using the special gross receipts factor provided in W. Va. Code § 11-24-7b.

[13] *See* W. Va. Code § 11-24-6(d) (net operating loss deduction).

total income of the combined group unless otherwise provided in the WVCNIT. *See* W. Va. Code § 11-24-13c(b)(2).

Additionally, a post-apportionment deduction carried over into a subsequent year as to the member that incurred it, and available as a deduction to that member in a subsequent year, must be considered in the computation of the income of that member in the subsequent year regardless of the composition of that income as apportioned, allocated or treated as wholly earned within West Virginia. W. Va. Code § 11-24-13c(b)(2).

However, unused and unexpired economic development tax credits that were earned during a tax year in which the taxpayer filed a consolidated WVCNIT return for a taxable year beginning before January 1, 2009, may, if otherwise allowed within the statutory limitations applicable to the tax credit, be used, in whole or in part, against the tax imposed by the WVCNIT on any member of the taxpayer's combined group to the extent the credits would have been allowed had the taxpayer continued to file a consolidated WVCNIT return. W. Va. Code § 11-24-13c(b)(2). However, because the ownership rules are different for purposes of filing a consolidated return than they are for purposes of filing a combined report, the credit will not be available to those taxable members of the combined group that were not included in the consolidated WVCNIT return. For purposes of this provision, the term "economic development tax credit" means, and is limited to, a tax credit asserted on a tax return under article 11-13C (business investment and jobs expansion tax credit), 11-13D (industrial expansion and revitalization tax credit), 11-13E (coal loading facilities tax credit), 11-13F (credit for reducing electric and natural gas utility rates for certain low-income residential customers), 11-13G (credit for reducing telephone rates for certain low-income residential customers), 11-13J (credit for neighborhood investment program), 11-13Q (economic opportunity tax credit), 11-13R (strategic research and development tax credit), 11-13S (manufacturing investment tax credit) or the West Virginia capital company act.

12. Determination of Taxpayer's Share of Business Income of Combined Group Apportionable to West Virginia

The taxpayer's share of the business income apportionable to West Virginia of each combined group of which it is a member is the product of:

(1) The business income of the combined group, determined under section 11-24-13d, *see* W. Va. Code § 11-24-13c(c)(1); and

(2) The taxpayer member's apportionment percentage, determined in accordance with the WVCNIT, including in the property, payroll and sales factor numerators the taxpayer's property, payroll and sales, respectively, associated with the combined group's unitary business in West Virginia and including in the denominator the property, payroll and sales of all members of the combined group, including the taxpayer, which property, payroll and sales are associated with the combined group's unitary business wherever located. *See* W. Va. Code § 11-24-13c(c)(2).

However, this statutory requirement needs to be modified when the combined group includes one or more members required to use one of the special apportionment methods provided in W.

Va. Code § 11-24-7a (motor carriers) or § 11-24-7b (financial organizations). The Tax Commissioner's proposed legislative rule, W. Va. C.S.R. § 110-24-7a (special apportionment rules), provides, in relevant part:

> 7a.1.a.1. In the absence of a method otherwise authorized or required by the Tax Commissioner, as described in section 7a.1.b of this rule, a special apportionment member shall report and file its tax based on designation of a combined reporting group limited to unitary group members who are required or permitted to use a special apportionment formula or method, and who do in fact use the same special apportionment formula or method as the special apportionment member. The income and the factors of a special apportionment member shall not be included in the combined reporting group comprised of the remainder of the unitary group that are not special apportionment members, that use an apportionment formula other than the apportionment formula of the particular special apportionment member.
>
> 7a.1.b. In lieu of the method described in paragraph 7a.1.a.1 of this rule, a special apportionment member may seek authorization of the Tax Commissioner to report and file its tax on a separate return basis, pursuant to such accounting and allocation and apportionment requirements as the Tax Commissioner may on a case by case basis prescribe.

It follows from the Tax Commissioner's proposed legislative rule that when a combined group consists of corporations that use different apportionment methods, the combined report will consist of separate schedules, one for corporation members that use the general method of apportionment, one schedule for financial organization members and a third schedule for corporation members that are motor carriers.

Elimination of Certain Transactions. As a general rule, when a combined report is prepared, transactions between members of the combined group are eliminated. *See* W. Va. Code § 11-24-13d(e). However, this requirement only applies to transactions that are part of the unitary business of members of the combined group. In the event that a transaction between members is not part of the unitary business, the add-back rules for intangible expenses and interest expenses paid, accrued or incurred, to a related person come into play. *See* discussion, *infra,* of these add-back requirements.

Treatment of Partnership Factors. The property, payroll and sales factors of a partnership are to be included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group in accordance with 11-24-13d and the denominator of which is the amount of the partnership's total unitary income. *See* W. Va. Code § 11-24-13c(c). While this directive is appropriate when a partnership is part of the unitary business, it is not appropriate when the partnership interest generates business income (or loss) that is not unitary business income (or loss) or the partnership generates nonbusiness income. Nor does it appear to be appropriate when the members of the unitary business use a special apportionment method.

Sales Factor Denominator Adjustment. The final point in this part is that when computing the denominator of the sales factor under W. Va. Code § 11-24-7(e)(10), sales of tangible personal property delivered or shipped to a state in which the corporation is not taxable[14] must be subtracted from the denominator of the sales factor as provided in subsection 11-24-7(e)(11)(B). Because the separate identities of each member of the combined group are not disregarded, the throw-out rule is applied on a member-by-member basis when computing the West Virginia denominator of the sales factor for the combined group. Application of this requirement in the context of combined reporting is explained in proposed legislative rule, W. Va. C.S.R. § 110-24-7.7.g.2.B. (application of throw-out rule when computing unitary group's sales factor denominator in combined report).

13. Determination of Business Income of Combined Group

The business income of a combined group is determined under W. Va. Code § 11-24-13d as follows:

> (1) From the total income of the combined group, determined under subsection 11-24-13d(b), taxpayer subtracts any income and adds any expense or loss, other than the business income, expense or loss of the combined group.
>
> (2) Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for WVCNIT purposes, as if the member were not consolidated for federal purposes, as provided in subsection 11-24-6(b) (modifications increasing federal taxable income), (c) (modifications decreasing federal taxable income), (d) (net operating loss deduction), (e) (special adjustment for air and water pollution control equipment expenditures), and (f) (allowance for certain government obligations and obligations secured by residential property); and section 11-24-6a (disallowance of deduction under IRC § 199). Additionally, federal taxable income must be increased by the amount of any intangible expense or interest expense paid to a related person. However, add-back is not required when the income and expense is eliminated when computing the business income of the combined group from a unitary business. This does not mean, however, that the combined group engaged in a unitary business is exempt from the intangible and interest expense add-back requirements. To the extent the intangible or interest expense is paid to a related person who is not a member of the combined group, or the intangible or interest expense is not income from unitary business in the hands of the related person, add-back is required, unless one of the limited exceptions to add-back applies. *See* discussion of the add-back requirements, *infra.*

[14]"Taxable in another state" is defined in W. Va. Code § 11-24-7(b) and means, "[f]or purposes of allocation and apportionment of net income under this section, a taxpayer is taxable in another state if: (1) In that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporation stock tax; or (2) That state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, that state does or does not subject the taxpayer to the tax."

(3) When a water's-edge combined report is prepared, the adjusted federal taxable income of each member of the combined group is the federal taxable income of the member, adjusted as required by the WVCNIT.

(4) When a worldwide combined report is prepared, the adjusted federal taxable income of each member of the combined group is then determined as follows:

(a) For any member incorporated in the United States, or included in a consolidated federal corporate income tax return, the income to be included in the total income of the combined group is the taxable income for the corporation after making allowable adjustments required by the WVCNIT. *See* W. Va. Code § 11-24-13d(b)(1).

(b) For any member of the combined group not included in the preceding subparagraph, the income to be included in the total income of the combined group is determined as follows:

(i) A profit and loss statement must be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(ii) Adjustments must be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements, except as modified by the WVCNIT or by a promulgated rule of the Tax Commissioner.

(iii) Adjustments must be made to the profit and loss statement to conform it to the tax accounting standards required by the WVCNIT.

(iv) Except as otherwise provided by rule of the Tax Commissioner, the profit and loss statement of each member of the combined group, and the apportionment factors related thereto, whether United States or foreign, must be translated into the currency in which the parent company maintains its books and records.

(v) Income apportioned to West Virginia must be expressed in United States dollars.

In lieu of the procedures set forth above for determining the adjusted federal taxable income of members included in a worldwide combined report, and subject to the determination of the Tax Commissioner that it reasonably approximates income as determined under the WVCNIT, any member not incorporated in the United States or included in a consolidated federal income tax return may determine its income on the basis of the consolidated profit and loss statement which includes the member and which is prepared for filing with the Securities and Exchange Commission by related corporations. *See* W. Va. Code § 11-24-13d(b)(3). If the member is not required to file with the Securities and Exchange Commission, the Tax Commissioner may allow

the use of the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor. If the above statements do not reasonably approximate income as determined under the WVCNIT, the Tax Commissioner may accept those statements with appropriate adjustments to approximate that income. *Ibid.*

Partnership income or loss. If a unitary business includes income from a partnership, then the income to be included in the total income of the combined group must be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income. *See* W. Va. Code § 11-24-13d(c).

Dividends. All dividends paid by one to another of the members of the combined group, to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report in the current or an earlier year, must be eliminated from the income of the recipient. *See* W. Va. Code § 11-24-13d(d). This elimination requirement does not apply to dividends received from members of the unitary business which are not a part of the combined group. *Ibid.*. However, all dividends paid by an insurance company directly or indirectly to a corporation that is part of a unitary business with the insurance company must be deducted or eliminated from the income of the recipient of the dividend, unless the Tax Commissioner specifically requires that they be included in the combined report. *Ibid.*

Intercompany transactions. Except as otherwise provided in a rule promulgated by the Tax Commissioner, unitary business income from an intercompany transaction between members of the same combined group must be deferred in a manner similar to that specified in 26 C.F.R. § 1.1502-13.[15] Upon the occurrence of any of the following events, deferred business income resulting from an intercompany transaction between members of a combined group must be restored to the income of the seller and must be apportioned as business income earned immediately before one of the following events:

(1) The object of a deferred intercompany transaction is:

   (a) Resold by the buyer to an entity that is not a member of the combined group;

   (b) Resold by the buyer to an entity that is a member of the combined group for use outside the unitary business in which the buyer and seller are engaged; or

   (c) Converted by the buyer to a use outside the unitary business in which the buyer and seller are engaged; or

(2) The buyer and seller are no longer members of the same combined group, regardless of whether the members remain unitary. *See* W. Va. Code § 11-24-13d(e).

Charitable expenses. A charitable expense incurred by a member of a combined group must, to the extent allowable as a deduction from unitary business income pursuant to IRC § 170, be subtracted first from the business income of the combined group, subject to the income

[15] This requirement does not apply to transactions between members of the combined group when the transaction between the members is not part of the unitary business activity.

limitations of § 170 applied to the entire unitary business income of the group, and any remaining amount must then be treated as a nonbusiness expense allocable to the member that incurred the expense, subject to the income limitations of § 170 applied to the nonbusiness income of that specific member. Any charitable deduction disallowed under the foregoing rule, but allowed as a carryover deduction in a subsequent year, must be treated as originally incurred in the subsequent year by the same member, and the rules of subsection 11-24-13d(f) apply in the subsequent year in determining the allowable deduction in that year. The Tax Commissioner's proposed legislative rule explains application of this requirement. *See* proposed legislative rule W. Va. C.S.R. § 110-24–13g (treatment of charitable expenses).

Gain (or Loss) From Disposition of Certain Assets. Gain or loss from the sale or exchange of capital assets, or property described by IRC § 1231(a)(3), or property subject to an involuntary conversion must be removed from the total separate net business income of each member of a combined group from unitary business activity and must be apportioned and allocated as follows:

(1) For each class of gain or loss (short term capital, long term capital, IRC § 1231, and involuntary conversions) all members' business gain and loss for the class must be combined without netting between classes and each class of net business gain or loss must be separately apportioned to each member using the member's apportionment percentage determined under subsection 11-24-13d(c). *See* W. Va. Code § 11-24-13d(g)(1).

(2) Each taxpayer member must then net its apportioned business gain or loss for all classes, including any such apportioned business gain and loss from other combined groups, against the taxpayer member's nonbusiness gain and loss for all classes allocated to West Virginia, using the rules of IRC § 1222 and § 1231, without regard to any of the taxpayer member's gains or losses from the sale or exchange of capital assets, IRC § 1231 property, and involuntary conversions which are nonbusiness items allocated to another state. See W. Va. Code § 11-24-13d(g)(2).

(3) Any resulting West Virginia source income or loss, if the loss is not subject to the limitations of IRC § 1211 of a taxpayer member produced by the application of the preceding rules must then be applied to all other West Virginia source income or loss of that member. *See* W. Va. Code § 11-24-13d(g)(3).

(4) Any resulting West Virginia source loss of a member that is subject to the limitations of IRC § 1211 must be carried over by that member and must be treated as West Virginia source short-term capital loss incurred by that member for the year for which the carryover applies. *See* W. Va. Code § 11-24-13d(g)(4).

No such adjustment is made if the property, at time of its disposition, was not used in the unitary business of the corporation.

Nonbusiness or exempt income expense. Any expense of one member of the unitary group which is directly or indirectly attributable to the nonbusiness or exempt income of another

member of the unitary group must be allocated to that other member as corresponding nonbusiness expense or exempt expense, as appropriate. W. Va. Code § 11-24-13d(h).

Mixed Apportionment Methods. If the members of the combined group do not all use the same apportionment method, then the steps outlined above must be applied separately to each subgroup of the combined group that uses the same method of apportionment.

14. Water's-Edge Combined Report Required Unless Worldwide Combined Reporting Elected

Water's-Edge Combined Report. Absent an election under W. Va. Code § 11-24-13f(b) to report based upon a worldwide unitary combined reporting basis, taxpayer members of a unitary group must determine each of their apportioned shares of the net business income or loss of the combined group on a water's-edge unitary combined reporting basis. In determining the WVCNIT and WVBFT due on a water's-edge unitary combined reporting basis, taxpayer members must take into account all or a portion of the income (capital in the cases of the WVBFT) and apportionment factors of only the following members otherwise included in the combined group pursuant to W. Va. Code § 11-24-13a:

(1) The entire income and apportionment factors of any member incorporated in the United States or formed under the laws of any state, the District of Columbia or any territory or possession of the United States;
(2) The entire income and apportionment factors of any member, regardless of the place incorporated or formed, if the average of its property, payroll and sales factors within the United States is 20% or more;

(3) The entire income and apportionment factors of any member which is a domestic international sales corporation as described in IRC §§ 991 to 994, inclusive; a foreign sales corporation as described in IRC §§ 921 to 927, inclusive; or any member which is an export trade corporation, as described in IRC §§ 970 to 971, inclusive;

(4) Any member of the combined group not described in paragraphs (1), (2) or (3), above, must include its business income which is effectively connected, or treated as effectively connected under the provisions of the Internal Revenue Code, with the conduct of a trade or business within the United States and, for that reason, subject to federal income tax;

(5) Any member that is a "controlled foreign corporation", as defined in IRC § 957, to the extent of the income of that member that is defined in IRC § 952 (Subpart F income) not excluding lower-tier subsidiaries' distributions of such income which were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that income. However, any item of income received by a controlled foreign corporation must be excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than ninety percent of the maximum rate of tax specified in IRC § 11, presently 35%;

(6) Any member that earns more than 20% of its income, directly or indirectly, from intangible property or service-related activities that are deductible against the business income of other members of the water's-edge group, to the extent of that income and the apportionment factors related thereto; and

(7) The entire income and apportionment factors of any member that is doing business in a tax haven, which is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria set forth in this definition of a tax haven, the activity of the member must be treated as not having been conducted in a tax haven. W. Va. Code § 11-24-13f(a).

The rules discussed above also apply to computation of the capital of the combined group for business franchise tax purposes. For that purpose, the word "capital" is substituted for the word "income." *See* W. Va. Code § 11-24-13f(c).

Worldwide Combined Reporting. An election to report West Virginia tax based on worldwide unitary combined reporting is effective only if the election is made on a timely filed original return for a tax year by every member of the unitary business subject to the WVCNIT. The Tax Commissioner is required to develop rules governing the impact, if any, on the scope or application of a worldwide unitary combined reporting election, including termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the taxpayer members and any other similar change. *See* W. Va. Code § 11-24-13f(b)(1).

The worldwide combination election constitutes consent to the reasonable production of documents and taking of depositions in accordance with the provisions of the West Virginia Tax Code. *See* W. Va. Code § 11-24-13f(b)(2).

Tax Commissioner's Discretion. In the discretion of the Tax Commissioner, a worldwide unitary combined reporting election may be disregarded, in part or in whole, and the income and apportionment factors of any member of the taxpayer's unitary group may be included in or excluded from the combined report without regard to the provisions of W. Va. Code § 11-24-13f, if any member of the unitary group fails to comply with any provision of the WVCNIT. *See* W. Va. Code § 11-24-13f(b)(3).

Even if the taxpayer's combined report is prepared on a water's-edge basis, the Tax Commissioner, in his or her discretion, may require the use of worldwide unitary combined reporting, in part or in whole, and the income and apportionment factors of any member of the taxpayer's unitary group may be included in or excluded from the worldwide combined report without regard to the provisions of W. Va. Code § 11-24-13f, if any member of the unitary group fails to comply with any provision of the WVCNIT, or if a person otherwise not included in the water's-edge combined group was availed of with a substantial objective of avoiding state income tax. *See* W. Va. Code § 11-24-13f(b)(4).

Election Binding for 10 Years. The election to file a worldwide combined report is binding for and applicable to the tax year in which the election is made and each of the ensuing 9 tax years. The election may be withdrawn, or reinstituted after withdrawal, prior to the expiration of the 10-year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law or policy. and then only with the written permission of the Tax Commissioner. *See* W. Va. Code § 11-24-13f(b)(5).

If the Tax Commissioner grants a withdrawal of a worldwide combined reporting election, the Commissioner must impose reasonable conditions necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10-year period, a taxpayer may withdraw from the worldwide unitary combined reporting election. Withdrawal must be made in writing within one year of the expiration of the election and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the worldwide unitary combined reporting election remains in place for an additional 10-year period, subject to the same conditions as applied to the original election. *See* W. Va. Code § 11-24-13f(b)(5).

15. Designation of Surety
Taxable Member Combined Return

As a filing convenience, and without changing the respective liability of the group members, the members of a combined reporting group may annually elect to designate one taxpayer member of the combined group to file a combined return, in the form and manner prescribed by the Tax Commissioner, in lieu of filing their own respective returns, provided the taxpayer designated to file the single return consents to act as surety with respect to the tax liability of all other taxpayers properly included in the combined report [return] and agrees to act as agent on behalf of those taxpayers for the year of the election for tax matters relating to the combined report [return] for that year. If for any reason the surety is unwilling or unable to perform its responsibilities, tax liability may be assessed against the taxpayer members. *See* W. Va. Code § 11-24-13g.

A combined group likely to elect one member to file a single [combined] return is a group of corporations that presently elects to file a consolidated federal and previously elected to file a consolidated WVCNIT return. The taxpayer designated to file the combined return will most likely be the common parent corporation. This single [combined] return filing will not include members of the affiliated group, as defined for purposes of filing a consolidated federal income tax return, that are not engaged in unitary business activity with the members of the affiliated group properly included in the single [combined] return. The filing of a combined return does not replace the requirement to file a combined report with that return. While the 2009 combined return is not yet available, it appears that the combined return will be prepared using the summation method rather than being prepared in a manner similar to the federal consolidated return.

After a combined report is prepared, there are two questions to be answered. First, does the combined report exclude a corporation or partnership that should be included in the combined

report? The second question is whether the combined report includes a corporation or partnership that should be excluded from the combined report.

16. Add-back of Intangible Expenses and Interest Expenses Paid to Related Person

For taxable years beginning after December 31, 2008, a corporation must add-back to federal taxable income intangible expenses and interest expenses otherwise deductible in computing federal taxable income when the expense is directly or indirectly paid, accrued or incurred in connection with one or more direct or indirect transactions with one or more related members, when computing its West Virginia taxable income. *See* W. Va. Code § 11-24-4b(c)(1) and (d)(1), unless an exemption applies, *see* discussion, *infra.*

These requirements are written to apply when the corporation and the related member are not engaged in a unitary business activity and when the intangible expense or interest expense is not attributable to the unitary business activity of the related members. W. Va. Code § 11-24-4b(c) and (d) do not explain how they apply when the payor and payee are members of a combined group that prepares a combined report under W. Va. Code § 11-24-13a(j) and the intangible expense or interest expense was incurred as part of the unitary business activity and the income to the payee is unitary business income. In general, transactions between members of a combined group are eliminated when the combined report is prepared and there should be no need to add-back an eliminated intangible expense or an eliminated interest expense of the corporation.

As is typically true of complex tax provisions such as these add-back requirements, it is helpful to understand the meaning of several key terms used in subsections 11-24-4b(c) and (d).

"Intangible expense" includes:

(1) 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 or any other disposition of intangible property to the extent those amounts are allowed as deductions or costs in determining taxable income before operating loss deductions and special deductions for the taxable year under the Internal Revenue Code;

(2) Amounts directly or indirectly allowed as deductions under IRC § 163 for purposes of determining taxable income under the Internal Revenue Code to the extent those expenses and costs are directly or indirectly for, related to or in connection with the expenses, losses and costs referenced in subdivision (A), above;

(3) Losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions;

(4) Royalty, patent, technical and copyright fees;

(5) Licensing fees; and

(6) Other similar expenses and costs. *See* W. Va. Code § 11-24-3a(18).

"Intangible property" includes patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets and similar types of intangible assets. *See* W. Va. Code § 11-24-3a(19).

"Interest expense" means amounts directly or indirectly allowed as deductions under IRC § 163 for purposes of determining federal taxable income. *See* W. Va. Code § 11-24-3a(20)

"Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is:

(1) A related entity, as defined in W. Va. Code § 11-24-3a(31)[16];

(2) A component member, as defined in IRC § 1563(b)[17];

[16] "Related entity" as used in the definition of "related member" means:

(A) A stockholder who is an individual or a member of the stockholder's family set forth in IRC § 318 if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50% of the value of the taxpayer's outstanding stock;

(B) A stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50% of the value of the taxpayer's outstanding stock; or

(C) A corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Internal Revenue Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50% of the value of the corporation's outstanding stock. The attribution rules of the Internal Revenue Code shall apply for purposes of determining whether the ownership requirements of this definition have been met. See W. Va. Code § 11-24-3a(31).

[17] "Component member" is defined in IRC § 1563(b) and means:

(1) *General rule*. – For purposes of this part, a corporation is a component member of a controlled group of corporations on a December 31 of any taxable year (and with respect to the taxable year which includes such December 31) if such corporation —

(A) is a member of such controlled group of corporations on the December 31 included in such year and is not treated as an excluded member under paragraph (2), or

(B) is not a member of such controlled group of corporations on the December 31 included in such year but is treated as an additional member under paragraph (3).

(2) *Excluded members*. – A corporation which is a member of a controlled group of corporations on December 31 of any taxable year shall be treated as an excluded member of such group for the taxable year including such December 31 if such corporation —

(A) is a member of such group for less than one-half the number of days in such taxable year which precede such December 31,

(B) is exempt from taxation under IRC § 501(a) (except a corporation which is subject to tax on its unrelated business taxable income under IRC § 511) for such taxable year,

(C) is a foreign corporation subject to tax under IRC § 881 for such taxable year,

(D) is an insurance company subject to taxation under IRC § 801 (other than an insurance company which is a member of a controlled group described in subsection (a)(4)), or

(E) is a franchised corporation, as defined in IRC § 1563(f)(4).

(3) *Additional members*. – A corporation which —

(A) was a member of a controlled group of corporations at any time during a calendar year,

(B) is not a member of such group on December 31 of such calendar year, and

(C) is not described, with respect to such group, in subparagraph (B), (C), (D), or (E) of paragraph (2), above,

(3) A person to or from whom there is attribution of stock ownership in accordance with IRC § 1563(e); or

(4) A person that, notwithstanding its form or organization, bears the same relationship to the taxpayer as a person described in subdivisions (A) through (C), above. *See* W. Va. Code § 11-24-3a(32).

"Valid business purpose" means one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets. *See* W. Va. Code § 11-24-3a(45).

When Add-Back Taxpayer Allowed Credit against WVCNIT. Under certain circumstances, a corporation required to add-back an intangible expense or an interest expense is entitled to a credit against the WVCNIT. *See* W. Va. Code § 11-24-4b(c)(2). Credit is allowed when the related member was subject to tax in West Virginia, or another state or possession of the United States or a foreign nation, or some combination thereof, on a tax base that included the intangible expense or interest expense paid, accrued or incurred by the corporation. The credit is an amount equal to the higher of the tax paid by the related member with respect to the portion of its income representing the intangible expense or interest expense paid, accrued or incurred by the corporation, or the tax that would have been paid by the related member with respect to that portion of its income if: (A) that portion of its income had not been offset by expenses or losses; or (B) the tax liability had not been offset by a credit or credits.

The amount of credit so determined is then multiplied by the corporation's West Virginia apportionment factor. However, in no event may the credit allowed exceed the corporation's liability in West Virginia attributable to the net income taxed as a result of the add-back of intangible expenses and interest expenses required by W. Va. Code § 11-24-4b(c)(1) or (d)(1).

Exceptions to Intangible Expense Add-Back Requirement. The add-back of intangible expenses required in subdivision 11-24-4b(c)(1) and the credit allowed in subdivision 11-24-4b(c)(2) do not apply:

(1) To the portion of the intangible expense that the payor corporation establishes **by clear and convincing evidence** meets both of the following requirements: (i) the related member during the same taxable year directly or indirectly paid, accrued or incurred a portion of the intangible expense payment to a person that is not a related member; **and** (ii) The transaction giving rise to the intangible expense between the

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shall be treated as an additional member of such group on December 31 for its taxable year including such December 31 if it was a member of such group for one-half (or more) of the number of days in such taxable year which precede such December 31.

(4) *Overlapping groups.* – If a corporation is a component member of more than one controlled group of corporations with respect to any taxable year, such corporation shall be treated as a component member of only one controlled group. The determination as to the group of which such corporation is a component member shall be made under regulations prescribed by the Secretary which are consistent with the purposes of this part.

corporation and the related member was undertaken for a **valid business purpose**. *See* W. Va. Code § 11-24-4b(c)(3)(A).

(2) To the portion of the intangible expenses that the payor corporation establishes by **clear and convincing evidence** of the type and in the form specified by the Tax Commissioner that: (i) the related member was subject to tax on its net income in West Virginia or another state or possession of the United States or some combination thereof; (ii) the tax base for said tax included the intangible expense paid, accrued or incurred by the corporation; **and** (iii) the aggregate effective rate of tax applied to the related member is not less than the WVCNIT rate (presently 8.5%). *See* W. Va. Code § 11-24-4b(c)(3)(B).

(3) To the portion of the intangible expenses that the payor corporation establishes by **clear and convincing evidence** of the type and in the form specified by the commissioner that: (i) the intangible expense was paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (ii) the related member's income from the transaction was subject to a comprehensive income tax treaty between that country and the United States; (iii) the related member's income from the transaction was taxed in that country at a tax rate at least equal to that imposed by West Virginia (presently 8.5%); **and** (iv) the intangible expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a **valid business purpose** in an **arm's length** relationship. W. Va. Code § 11-24-4b(c)(3)(C).

(4) If the corporation and the Tax Commissioner agree in writing to the application or use of alternative adjustments or computations. W. Va. Code § 11-24-4b(c)(3)(D). The Commissioner may, in his or her discretion, agree to the application or use of alternative adjustments or computations when he or she concludes that in the absence of agreement the income of the taxpayer would not be reflected accurately. *Id*.

Exceptions to Interest Expense Add-Back Requirement. The add-back of interest expense required by subdivision 11-24-4b(d)(1) and the credit allowed by subdivision 11-24-4b(d)(2) do not apply when the payor-corporation establishes by **clear and convincing evidence**, of the type and in the form determined by the Tax Commissioner, that one of the following four factual circumstances exist:

(1) The transaction giving rise to interest expense between the payor corporation and the related member was undertaken for a **valid business** purpose; **and** the interest expense was paid, accrued or incurred using terms that reflect an **arm's length** relationship. *See* W. Va. Code § 11-24-4b(d)(3)(A).

(2) The related member was subject to tax on its net income in West Virginia, or another state or possession of the United States or some combination thereof; (ii) the tax base for said tax included the interest expense paid, accrued or incurred by the payor-corporation; **and** (iii) the aggregate effective rate of tax applied to the related member is no less than the statutory rate of tax applied to the payor-corporation under chapter

11 of the West Virginia Code (presently 8.5%). *See* W. Va. Code § 11-24-4b(d)(3)(B).

(3) The interest expense is paid, accrued or incurred (i) to a related member organized under the laws of a country other than the United States; (ii) the related member's income from the transaction is subject to a comprehensive income tax treaty between that country and the United States; (iii) the related member's income from the transaction is taxed in that country at a tax rate at least equal to that imposed by West Virginia (presently 8.5%); **and** (iv) the interest expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a **valid business purpose** and using terms that reflect an **arm's length** relationship. See W. Va. Code § 11-24-4b(d)(3)(C).

(4) When the payor-corporation and the Tax Commissioner agree in writing to the application or use of alternative adjustments or computations. *See* W. Va. Code §11-24-4b(d)(3)(D). The Commissioner may, in his or her discretion, agree to the application or use of alternative adjustments or computations when he or she concludes that in the absence of agreement the income of the taxpayer would not be properly reflected. *Id*.

17. Real Estate Investment Trust

For taxable years beginning after December 31, 2008, the dividend paid deduction otherwise allowed by federal law in computing net income of a captive real estate investment trust must be added back to federal taxable income when computing the WVCNIT. *See* W. Va. Code § 11-24-4b(a).

The term "captive real estate investment trust" means a real estate investment trust, the shares or beneficial interests of which are not regularly traded on an established securities market and are more than 50% of the voting power or value of the beneficial interests or shares of which are owned or controlled, directly or indirectly or constructively, by a single entity that is:

(1) Treated as an association taxable as a corporation under the Internal Revenue Code; **and**

(2) Not exempt from federal income tax pursuant to the provisions of IRC § 501(a). See W. Va. Code § 11-24-3a(3).

For purposes of applying subparagraph (1) above, the following entities are not considered an association taxable as a corporation:

(1) Any real estate investment trust, as defined in IRC § 856, other than a "captive real estate investment trust;"

(2) Any qualified real estate investment trust subsidiary under IRC § 856(i) other than a qualified real estate investment trust subsidiary of a "captive real estate investment trust;"

(3) Any listed Australian property trust, which means an Australian unit trust registered as a "managed investment scheme" under the Australian Corporations Act in which the principal class of units is listed on a recognized stock exchange in Australia and is regularly traded on an established securities market, or an entity organized as a trust, provided that a listed Australian property trust owns or controls, directly or indirectly, 75% or more of the voting power or value of the beneficial interests or shares of the trust; or

(4) Any qualified foreign entity, meaning a corporation, trust, association or partnership organized outside the laws of the United States, which satisfies all of the following criteria:

(a) At least 75% of the entity's total asset value at the close of its taxable year is represented by real estate assets, as defined in IRC § 856(c)(5)(B), thereby including shares or certificates of beneficial interest in any real estate investment trust, cash and cash equivalents and United States Government securities;

(b) The entity is not subject to tax on amounts distributed to its beneficial owners or is exempt from entity-level taxation;

(c) The entity distributes at least 85% of its taxable income as computed in the jurisdiction in which it is organized to the holders of its shares or certificates of beneficial interest on an annual basis;

(d) Not more than 10% of the voting power or value in the entity is held directly or indirectly or constructively by a single entity or individual or the shares or beneficial interests of the entity are regularly traded on an established securities market; **and**

(e) The entity is organized in a country which has a tax treaty with the United States.

(5) A real estate investment trust that is intended to be regularly traded on an established securities market, and that satisfies the requirements of IRC § 856(a)(5) and (6) by reason of IRC § 856(h)(2), is not considered a captive real estate investment trust for WVCNIT purposes.

A real estate investment trust that does not become regularly traded on an established securities market within one year of the date on which it first becomes a real estate investment trust is not considered not to have been regularly traded on an established securities market, retroactive to the date it first became a real estate investment trust, and must file an amended

WVCNIT return reflecting the retroactive designation for any tax year or part year occurring during its initial year of status as a real estate investment trust.). *See* W. Va. Code § 11-24-3a(3)(E).

For purposes of the definition of "captive real estate trust," a real estate investment trust becomes a real estate investment trust on the first day that it has both met the requirements of IRC § 856 and has elected to be treated as a real estate investment trust pursuant to IRC § 856(c)(1). *See* W. Va. Code § 11-24-3a(3)(E).

18. Regulated Investment Company

For taxable years beginning after December 31, 2008, the dividend paid deduction otherwise allowed by federal law in computing net income of a regulated investment company for federal income tax purposes must be added back in computing the WVCNIT, unless the regulated investment company is a qualified regulated investment company, as defined in section 11-24-3a. *See* W. Va. Code § 11-24-4b(b).

As used here, the term "regulated investment company" has the same meaning as ascribed to the term in IRC § 851. *See* W. Va. Code § 11-24-3a(30).

The term "qualified regulated investment company" means any regulated investment company other than a regulated investment company where more than 50% of the voting power or value of the beneficial interests or share of which are owned or controlled, directly or indirectly, constructively or otherwise, by a single entity that is:

(1) Subject to the provisions of IRC § 301 to §401;

(2) Not exempt from federal income tax pursuant to the provision of IRC § 501; **and**

(3) Not a regulated investment company as defined in Section 3 of the Investment Company Act of 1940, as amended, 15 U. S. C. 80a-3, except that a regulated investment company, the shares of which are held in a segregated asset account of a life insurance corporation (as described in IRC § 817), is treated as a qualified regulated investment company. *See* W. Va. Code § 11-24-3a(28).

19. Financial Organizations

Financial organizations are subject to the WVCNIT but are not subject to the general method for apportionment of business income set forth in W. Va. Code § 11-24-7(e). The term "financial organization" is broadly defined in W. Va. Code § 11-24-3a(14) and because its meaning has not been amended since the term was first added to the WVCNIT in 1991, the definition will not be replicated here.

For taxable years beginning before January 1, 2009, a domestic financial organization, meaning one that had its commercial domicile and was doing business in West Virginia and in one or more other states was not allowed to apportion it business income. Instead, it computed

tax on its entire West Virginia taxable income and then was allowed to claim credit against its WVCNIT liability for income taxes paid to another state, as provided in W. Va. Code § 11-24-24. In contrast, a financial organization doing business in West Virginia that had its commercial domicile in another state was required to apportion its business income using a single, special gross receipts factor computed as provided in W. Va. Code § 11-24-7b(g).

For taxable years beginning after December 31, 2008, all financial organizations doing business in West Virginia and in one or more other states, regardless of the state in which its commercial domicile is located, must apportion its business income using a single, special gross receipts factor, computed as provided in W. Va. Code § 11-24-7b(g). The credit previously allowed under W. Va. Code § 11-24-24 is no longer allowed to any financial organization.

A financial organization that is engaged in a unitary business with one or more other corporations must be included in the combined report required by W. Va. Code § 11-24-13a(j) and filed by the taxable members of the combined group. When all members of the combined group are financial organizations, they will use the same method of apportionment to determine the West Virginia portion of their respective incomes from the unitary business.

When the combined group engaged in a unitary business includes one or more financial organizations and one or more corporations that uses the general apportionment formula to apportion business income, the WVCNIT law is silent on how combined group unitary business income is to be apportioned. The Tax Commissioner's proposed legislative rule, W. Va. C.S.R. § 110-24-7a.1, provides that the business income for each segment that uses a different apportionment method must be separately computed using the appropriate apportionment method.

20. Combined Reporting Also Applies to Computation of Business Franchise Tax Liability.

The combined reporting rules used to apportion the unitary business income of the combined group also apply to computation of the taxable capital of members of the combined group for business franchise tax purposes. *See* W. Va. Code § 11-24-13a(e) and (j) and § 11-24-13f(c).

For business franchise tax purposes, the capital of a corporation, except an S corporation, is the average of the beginning and ending year balances of the sum of the following entries from Schedule L of Federal Form 1120, prepared following generally accepted accounting principles and as filed by the taxpayer with the Internal Revenue Service for the taxable year:

(1) The value of all common stock and preferred stock of the taxpayer;
(2) The amount of paid-in or capital surplus;
(3) The amount of retained earnings, appropriated and unappropriated; and
(4) Less the cost of treasury stock. W. Va. Code § 11-23-3(b)(2).

When a corporation does business in West Virginia and is taxable in one or more other states, the corporation must apportion its capital using the same method the corporation uses to apportion its business income. This is true even though the WVBFT law does not provide a

special method for apportioning the capital of a motor carrier. Conformity of use of apportionment methods facilitates the combining of the annual WVBFT return and the annual WVCNIT return into one document.

In the combined report required by W. Va. Code § 11-24-13a(e) and (j), the capital of each corporation that is a member of the combined group will be determined in the manner described above, prior to apportionment, and then added together to determine the capital of the combined group. This number will then be apportioned among the members of the combined group in the same manner that the unitary business income of the combined group is apportioned for WVCNIT purposes. When all of the combined group's business income is from the unitary business, it follows that all of the capital of the corporation is attributable to the unitary business as well. This will not be true where the corporation has nonbusiness income from investment activity or has business income from business activity that is not part of the unitary business or has business income from two or more unitary businesses.

While there are methods to determine the portion of a corporation's adjusted federal taxable income that is attributable to nonbusiness activity and to each discrete business activity in which it is engaged, it does not follow that capital can be so segregated, except perhaps in the case of retained earnings. Moreover, the United States Supreme Court has made it clear that the income a state seeks to be taxed must be fairly related to the activities of the corporation in the taxing state. and that a state may not tax extraterritorial income.[18] It logically follows that the capital a state seeks to tax should be fairly related to the instate activities and that a state should not be allowed to tax extraterritorial capital. Yet, unless capital can be traced in some constitutional way, the WVBFT imposed in a given case may not be an exaction that can survive constitutional scrutiny. To date, the Tax Commissioner has not proposed a legislative rule implementing combined reporting for purposes of the business franchise tax.

The second problem with using combined reporting for business franchise tax purposes is how capital is apportioned when members of the combined group use different apportionment methodologies. The issues here are identical to those previously discussed for apportionment of combined business income when the members of the combined group use different apportionment methods. It appears that a combined group that includes corporations that use different apportionment methodologies will separately compute their capital by grouping the members by the apportionment methodology they use. *See* discussion, *supra*, regarding computation of a combined group business income when different apportionment methods are used.

The third problem is that because a corporate partnership interest in a partnership doing business in West Virginia subjects an out-of-state corporate partner to business franchise tax when the corporation would not otherwise have a business franchise tax liability, the corporation's capital apportioned to West Virginia may be greater under combined reporting than

[18] The Due Process and Commerce Clauses of the United States Constitution forbid the states from taxing extraterritorial values. *See Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983); *see also Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 U.S. 768, 777, 112 S.Ct. 2251, 119 L.Ed.2d 533 (1992); *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 441-442, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980).

it otherwise would be, when the corporation does not otherwise have taxable nexus with West Virginia, again raising the specter that extraterritorial values may be taxed in violation of the United States Constitution.

Conclusion

For taxable years beginning after December 31, 2008, computing the WVCNIT and the WVBFT will be more difficult for any corporation that is part of an affiliated group, however defined. No longer will the group be allowed to file a consolidated WVBFT/CNIT annual return. Each corporation must file a separate return unless the taxable members of a combined group of corporations elect to file a combined WVBFT/CNIT annual return.

When a corporation is part of a group of related corporations engaged in various business activities, the relationships of the group must be analyzed to determine which corporations are engaged in a unitary business in West Virginia and must be included in the combined report. The taxable members of the combined group must compute their unitary business income subject to the WVCNIT as a percentage of the combined group's total business income from unitary business activity. When all members of the group use the same apportionment method, apportionment of group's unitary business income is relatively straight forward. When the group includes one or more members that use a different method of apportionment, the process becomes more complicated.

The new method of treating a corporate ownership interest in a pass-through entity presents new challenges. The corporation will need to determine whether the partnership interest is part of its unitary business or a separate business or, depending upon the interest, an investment that generates nonbusiness distributive share. Finally, if the partnership interest is part of the unitary business of the corporation but the corporation has no other activity in West Virginia, the combined report filed by the corporation will include other members of the corporation's combined group engaged in unitary business activity with the pass-through entity and their business income will be included when determining the business income of the corporate partner from activity in West Virginia.

When a corporation pays an interest expense or intangible expense to a related person, the corporation is required to add back to federal taxable income the amount paid or accrued unless certain narrow exceptions apply. Entitlement to an exception must be shown by clear and convincing evidence, and appropriate documentation must be retained as part of the business records of the corporation that are subject to audit by the Tax Commissioner.

Lastly, while the Tax Commissioner's proposed legislative rule is helpful when complying with the combined reporting requirements of the WVCNIT, there are many other WVCNIT issues not addressed in the proposed legislative rule. Additionally, the proposed rule provides no guidance for complying with the combined reporting requirements of the WVBFT.

These changes separately and collectively present new compliance challenges for both taxpayers and tax practitioners.