

**SANITIZED DECS. – 03-248 RFN & 03-249 RN – BY – GEORGE V. PIPER –  
SUBMITTED FOR DECISION ON POST-HEARING EVIDENCE AND ON BRIEFS  
– 02/26/04 - ISSUED – 03/12/04**

**SYNOPSIS**

**BUSINESS FRANCHISE TAX AND CORPORATE NET INCOME TAX -- WHOLLY OWNED SUBSIDIARY FINANCIAL ORGANIZATION** – Loan-servicing out-of-state subsidiary created by the Petitioner for the sole, but valid business, purpose of receiving installment note payments from another of its out-of-state subsidiaries qualifies as a financial organization under W. Va. Code § 11-23-3(b)(13)(C)(1)(II) [1991] and 11-24-3a(10)(C)(1)(II) [1991] because it engaged in “making, acquiring, selling or servicing loans,” etc.

**BUSINESS FRANCHISE TAX AND CORPORATE NET INCOME TAX -- WHOLLY OWNED SUBSIDIARY FINANCIAL ORGANIZATION’S CAPITAL AND INCOME PROPERLY REPORTED ON SEPARATE *PRO FORMA* RETURN** -- Special reporting provision requirements set forth in W. Va. Code §§ 11-23-9a(c)(3)(B) and 11-24-13a(c)(3)(B) for consolidated groups with a “financial” organization as a member of that group were met by Petitioner in that the subsidiary reported its income and capital on a separate “pro forma return” showing how it would have filed had it filed separately for federal income tax purposes.

**FINAL DECISION**

A Tax Examiner with the Field Auditing Division of the West Virginia State Tax Commissioner’s Office conducted an audit of the books and records of the Petitioner.

Thereafter, on February 4, 2003, the Director of this Division of the Commissioner’s Office issued a business franchise tax assessment against the Petitioner. This assessment was for the period of January 1, 1999 through December 31, 2001, for tax and interest, through January 31, 2003, and no additions to tax, for a total assessed liability.

Written notice of this assessment was served on the Petitioner.

Also, on February 4, 2003, the Commissioner issued a West Virginia corporate net income tax assessment against the Petitioner under the provisions of Chapter 11, Articles 10 and 24 of the West Virginia Code, for the period of January 1, 1999 through December 31, 2001, for tax and interest, through January 31, 2003, and no additions to tax, for a total assessed liability.

Written notice of this assessment was served on the Petitioner.

Thereafter, by hand delivery on April 7, 2003, the Petitioner timely filed with this tribunal, petitions for reassessment. *See* W. Va. Code § 11-10A-8(1) [2002].

On February 20, 2003, Petitioner remitted amounts, which represented the full amounts of both tax assessments, plus interest. Petitioner included same with two (2) separately and timely filed petitions for refund claiming that a portion of each should be refunded should it prevail in this matter.

Subsequently, written notice of a hearing on the petitions was sent to the Petitioner and a hearing was held in accordance with the provisions of W. Va. Code § 11-10A-10.

During the administrative hearing, the administrative law judge requested that the Petitioner provide post-hearing (1) information concerning the operations of Subsidiary 1, and (2) a pro forma income tax return and balance sheet for Subsidiary 1.

On October 30, 2003, Petitioner's counsel enclosed corporate minutes for the last three (3) years as well as its pro forma returns, for Subsidiary 1 as well as for the other members of the consolidated group, which are included in the consolidation schedule for the entire group.

### **FINDINGS OF FACT**

1. Petitioner engages in a variety of business activities through its several subsidiaries, including barge rental and wood product manufacturing. It filed consolidated West Virginia corporate net income tax and West Virginia business franchise tax returns for the periods under audit, including all of its subsidiaries.

2. The first audit adjustment relates to the sales factor in the apportionment percentage. The Petitioner agrees to this adjustment and has no objection to the tax related to it. The adjustment related to the sales factor was equal to an approximate amount in tax in the corporate net income tax assessment and an approximate amount in tax in the business franchise tax assessment.

3. The second adjustment relates to the disallowance of financial organization status for one of Petitioner's subsidiaries. The Petitioner objects to this adjustment, which represents an approximate amount in tax in the corporate net income tax assessment and in the business franchise tax assessment.

4. In 1999, one of the Petitioner's wholly owned subsidiaries, Subsidiary 1, an out-of-state LLC, declared a dividend to Petitioner to transfer a large amount of excess equity back to its parent. As Subsidiary 1 did not have sufficient cash on hand to fund this declaration, it issued a note to Petitioner for the amount of the dividend. Whereupon, Petitioner assigned the note payable to Subsidiary 2, a newly created subsidiary, to hold and receive payments of principal and interest from Subsidiary 1 and, in broad terms, conduct all of the activities necessary to service that obligation.

5. Although Petitioner could have demanded said monies at once, it decided to create Subsidiary 2 for the purpose of receiving same.

6. Subsidiary 2's sole business activity is to service said debt payments and its only corporate asset is the aforementioned note given by Subsidiary 1.

7. Subsidiary 2 has its own Board of Directors and is authorized to issue one class of common stock in its own name.

8. During the audit period, Petitioner reduced both its business franchise tax income and corporate net tax income, which represents the interest on the tax paid to Subsidiary 2 by Subsidiary 1.

## **DISCUSSION**

The first issue is whether the Petitioner's wholly owned subsidiary, Subsidiary 2, qualifies for business franchise tax purposes as a "financial organization" pursuant to W. Va. Code § 11-23-3(b)(13)(C)(1)(I)-(VI) [1991], and for corporate net income tax purposes as a financial organization under W. Va. Code § 11-24-3a(10)(C)(1)(I)-(VI) [1991].

Both statutes are essentially identical and include the following as one of the statutory definition of a "financial organization":

A corporation which derives more than fifty percent of its gross business income from either the making, acquiring, selling or servicing loans or extensions of credit. Loans and extensions of credit include various things such as secured or unsecured consumer loans, installment obligations, mortgages or other loans secured by real estate or other tangible personal property, credit card loans, secured and unsecured commercial loans of any type, and loans arising in factoring.

Because the statutes also provide that an entity may also be a “financial organization” if it engages “in any other activity with an economic effect comparable to those activities described,” Petitioner argues that such clearly broad language would encompass Subsidiary 2 and its receipt of installment payments, even between “related” parties, which are not excepted. W. Va. Code § 11-23-3(b)(13)(C)(6) [1991] and W. Va. Code § 11-24-3a(10)(C)(6) [1991]. Petitioner further argues that, because Subsidiary 2 is a “financial organization” which is a part of the affiliated group, it is irrelevant that none of these monies, payables and receivables, are reflected on Petitioner’s own books.

The Tax Commissioner argues, however, that to rule for the Petitioner under the statute, in the absence of defined terms such as “loans,” “installment obligations,” etc., means that words or terms used in a legislative enactment would not be given their “common, ordinary and accepted meaning” in the connection in which they are used, citing syllabus point 6, *CNG Transmission Corp. v. Craig*, 211 W. Va. 170, 564 S.E.2d 167 (2002). Specifically, the Tax Commissioner argues that the ordinary meanings of terms such as “loan” and “obligation” imply the existence of two (2) parties, a debtor and a creditor, who are not owned by the Petitioner. The Tax Commissioner further cites syllabus point 6 of *CB&T Operations Co. v. Tax Commissioner*, 211 W. Va. 198, 564 S.E.2d 408 (2002), for the proposition that ruling for Petitioner would exalt form over substance.

At first blush, it would seem that the Commissioner’s argument is logical, in that as a policy decision, a taxpayer should not be able to form a corporate subsidiary to merely receive monies from another of its subsidiaries and in so doing reduce or escape taxation.

The test, however, must always be to apply, not to construe, the clear statutory language, in light of the fact that the burden of proof rests with the Petitioner to show such applicability.

First, as per Petitioner's evidence, more than fifty percent (50%) of its gross income is received from payments on a note payable, which is consistent with the activities defining a financial organization that are listed in W. Va. Code § 11-23-3(b)(13)(C) and § 11-24-3a(10)(C). Specifically, Subsidiary 2 is involved in either the making, acquiring, selling or servicing of loans or extensions of credit including installment obligations, which is listed as an activity of a "financial organization" in W. Va. Code § 11-23-3(b)(13)(C)(1)(II) for business franchise tax purposes and W. Va. Code § 11-24-3a(10)(C)(1)(II) for corporation net income tax purposes. Subsidiary 2 receives regular installment payments of principal and interest on the note payable from Subsidiary 1. The note was written in 1999 and was based on the amount of capital that was available in Subsidiary 1 and the amount that was desired to be transferred to the parent by the board of directors for other business purposes. A market rate of interest of 8% was also provided for in the note, and it is undisputed that all payments of principal and interest have been made according to the terms of that note.

Subsidiary 2 also, or alternatively, meets the description of a "financial organization" set forth in statutory item (6), because, at the very least, it is engaged in an activity with an economic effect comparable to the activities set forth in West Virginia Code § 11-23-3(b)(13)(C)(1)(II) and § 11-24-3a(10)(C)(1)(II) (installment obligations).

In TSD 397, "Taxation of Financial Organizations Under West Virginia's Business Franchise Tax and Corporation Net Income Tax," the Tax Commissioner stated as follows:

The law defines a 'financial institution' broadly to include more than just traditional financial institutions such as banks and savings and loan institutions. Just because you are not a traditional financial organization, does not mean that you are not a financial organization for purposes of West Virginia's business franchise tax and corporation net income tax.

Furthermore, these statutes set forth only a quantitative measurement, so that if the entity is engaged in certain activities and meets the requirements (50% gross income test), it is included. There is, indeed, no provision in the statute providing discretion to require, or even allow, exclusion of an entity that is engaged in the activities listed which meet the quantitative measurements set forth by the West Virginia Legislature.

Lastly, despite the objections raised by the Tax Commissioner, there is no statutory requirement that the entity treated as a “financial organization” have numerous obligations or that the obligations be from an unrelated party.

That the parties disagree as to the meaning or the applicability of [a statutory] provision does not of itself render [the] provision ambiguous or of doubtful, uncertain or obscure meaning. *Estate of Resseger v. Battle*, 152 W. Va. 216, 220, 161 S.E.2d 257, 260 (1968).’ Rules of interpretation are resorted to for the purpose of resolving an ambiguity, not for the purpose of creating it.’ *Crockett v. Andrews*, 153 W. Va. 714, 719, 172 S.E.2d 384, 387 (1970).

*Deller v. Naymick*, 176 W. Va. 108, 112, 342 S.E.2d 73, 77 (1985).

If this tribunal were to resort to the rules of statutory construction, the following rule would apply: “Laws imposing a license or tax are strictly construed and when there is doubt as to the meaning of such laws they are construed in favor of the taxpayer and against the State.’ Syllabus point 1, *State ex rel. Lambert v. Carman*, 145 W. Va. 635, 116 S.E.2d 265 (1960).” Syllabus point 3, *Coordinating Council for Independent Living v. Palmer*, 209 W. Va. 275, 546 S.E.2d 454 (2001).

It is, therefore, Determined that Subsidiary 2 meets the definition of “financial organization” set forth in the statutes.

The only remaining issue to be decided is whether the gross receipts of Subsidiary 2 were properly reported. Again, the statutes are clear. For example, the West Virginia corporate net income tax statute provides:

§ 11-24-13a [1996]. Method of filing business taxes.

(c) Consolidated return -- financial organizations. -- An affiliated group that includes one or more financial organizations may

elect under this section to file a consolidated return when that affiliated group complies with all of the following rules:

(1) The affiliated group of which the financial organization is a member must file a federal consolidated income tax return for the taxable year.

(2) All members of the affiliated group included in the federal consolidated return must consent to being included in the consolidated return filed under this article.

(3) The filing of a consolidated return under this article is conclusive proof of such consent. The West Virginia taxable income of the affiliated group shall be the sum of:

(A) The pro forma West Virginia taxable income of all financial organizations having their commercial domicile in this state that are included in the federal consolidated return, as shown on a combined pro forma West Virginia return prepared for such financial organizations; plus

(B) The pro forma West Virginia taxable income of all financial organizations not having their commercial domicile in this state that are included in the federal consolidated return, as shown on a combined pro forma West Virginia return prepared for such financial organizations; plus

(C) The pro forma West Virginia taxable income of all other members included in the federal consolidated income tax return, as shown on a combined pro forma West Virginia return prepared for all such nonfinancial organizations members, except that the income, income adjustments and exclusions, apportionment factors and other items considered when determining tax liability shall not be included in the pro forma return prepared under this paragraph for a member that is totally exempt from tax under section five of this article, or for a member that is subject to a different special industry apportionment rule provided for in this article. When a different special industry apportionment rule applies, the West Virginia taxable income of a member(s) subject to that special industry apportionment rule shall be determined on a separate pro forma West Virginia return for the member(s) subject to that special industry rule and the West Virginia taxable income so determined shall be included in the consolidated return.

(4) The West Virginia consolidated return is prepared in accordance with regulations of the tax commissioner promulgated as provided in article three, chapter twenty-nine-a of this code.

(5) The filing of a consolidated return does not distort taxable income. In any proceeding, the burden of proof that taxpayer's method of filing does not distort taxable income shall be upon the taxpayer.

Virtually identical rules exist for the filing of consolidated returns by affiliated groups with "financial organizations" as members for purposes of the business franchise tax. *See* W. Va. Code § 11-23-9a [1996].

These statutory provisions affect how an affiliated group that has a financial organization as a member files for West Virginia corporate net income tax and business franchise tax purposes. As required by statute, the Petitioner included the entire federal affiliated group in the return, with Subsidiary 2 set forth separately on a pro forma return, because it was a financial organization that was domiciled outside of West Virginia. Subsidiary 2 has no nexus with West Virginia under the rules set forth in West Virginia Code § 11-24-7b(d), because it does not have any customers in West Virginia, and received payments only from Subsidiary 1, whose commercial domicile is out-of-state.

Moreover, a “pro forma return” is defined in West Virginia Code § 11-24-3a(15) [1991] and § 11-23-3(b)(19) [1991] as “the return which the taxpayer would have filed with the Internal Revenue Service had it not elected to file federally as part of a consolidated group.” As such, Subsidiary 2’s West Virginia taxable income computation must begin with its separate company federal taxable income as it would have been shown on a “pro forma” return.

Subsidiary 2 had income consisting of the interest received from Subsidiary 1 on the note payable. As previously stated, the note was written in 1999 and was based on the amount of capital that was available in Subsidiary 1 and the amount that was desired to be transferred to the parent by the board of directors for other business purposes. Although the transaction was between related parties, in order to preserve its arms length nature, a market rate of interest was set in the note and payments of principal and interest were made according to the terms of the note.

Finally, because Subsidiary 2 was a non-domiciled financial organization, it presented its pro forma return separately and not combined with the other members of the consolidated group. Therefore, its income would not be offset by the interest expense of Subsidiary 1 as advanced by the Tax Commissioner.

The Office of Tax Appeals (and the predecessor Office of Hearings and Appeals) have previously addressed the issue of the proper filing method for financial organizations. Specifically, in Administrative Decision 03-304 RN (Oct. 31, 2003), and Administrative Decision 01-340 N

(February 11, 2002), this tribunal (or its predecessor) ruled that financial organizations must all file “pro forma returns.”

Accordingly, it is further Determined that Petitioner’s filing of a pro forma return for subsidiary 2, and the results thereon, are consistent with that shown on Petitioner’s group’s federal consolidated tax return and therefore properly reported in accordance with the provisions set forth in W. Va. Code § 11-23-9a(c)(3) [1996] and § 11-24-13a(c)(3) [1996].

### **CONCLUSION(S) OF LAW**

Based upon all of the above it is **DETERMINED** that:

1. In a hearing before the West Virginia Office of Tax Appeals on a petition for refund, the burden of proof is upon the petitioner-taxpayer, to show that the petitioner-taxpayer is entitled to the refund. *See* W. Va. Code § 11-10A-10(e) [2002] and 121 C.S.R. 1, § 63.1 (Apr. 20, 2003).

2. The Petitioner-taxpayer in this matter has carried the burden of proof with respect to the legal issues related to whether it properly reported its gross receipts received by its affiliate, Subsidiary 2, for both business franchise tax and corporate net income tax purposes.

### **DIRECTIVES RESPECTING COMPUTATION OF THE AMOUNT OF TAX DUE**

1. In accordance with 121 C.S.R. 1, § 73.1.1, the above shall constitute a statement of the opinion of the West Virginia Office of Tax Appeals determining the issues in the above-captioned matter;

2. The West Virginia Office of Tax Appeals is withholding entry of its decision for the purpose of requiring the parties to submit computations of the tax due and owing consistent with the opinion set forth above;

3. Within 30 days of service of this Final Decision on the legal Issues, the parties shall meet in an attempt to reach an agreement with respect to the computation of tax due and the amount of refund to be returned to Petitioner, in accordance with the above-stated opinion;

4. If, after the submission of computations of the amount of refund due by both parties, either party believes that an evidentiary hearing is necessary, within 10 days of receipt of the opposing party's computation, it shall submit a request for an evidentiary hearing, clearly and succinctly setting forth the grounds upon which its request is based, and describing the nature of any evidence that it intends to introduce.

Upon receipt of an agreed upon computation of tax due, pursuant to 121 C.S.R. 1, §§ 73.2.1 & 73.2.2, the West Virginia Office of Tax Appeals will enter its computation of the refunded amount due.