



Virginia  
Regulatory  
Town Hall

townhall.virginia.gov

## Notice of Intended Regulatory Action (NOIRA) Agency Background Document

<b>Agency name</b>	Department of Taxation ("TAX")
<b>Virginia Administrative Code (VAC) citation</b>	23 VAC10-120-103
<b>Regulation title</b>	Chapter 120 – Corporate Income Tax
<b>Action title</b>	Amendment of the Corporate Income Tax Regulation to Add a Section Regarding Intangible Expenses Paid to Related Entities
<b>Date this document prepared</b>	March 19, 2007

This information is required for executive branch review and the Virginia Registrar of Regulations, pursuant to the Virginia Administrative Process Act (APA), Executive Orders 21 (2002) and 58 (1999), and the *Virginia Register Form, Style, and Procedure Manual*.

### Purpose

*Please describe the subject matter and intent of the planned regulatory action. Also include a brief explanation of the need for and the goals of the new or amended regulation.*

Virginia Administrative Code Cite	Virginia Code Cite	Chapter	Proposed change and rationale
23VAC10-120-103	<i>Code of Va.</i> § 58.1-402 B (8) and (9)	Chapter 3 (2004 Special Session I)	This is a new regulation. The purpose of the regulation is to interpret the safe harbor provisions of <i>Code of Va.</i> § 58.1-402 B (8) and (9).

Legislation in the 2004 Session of the General Assembly (2004 *Acts of Assembly*, Special Session I, Chapter 3) amended the corporate income tax law by adding *Code of Va.* § 58.1-402 B(8) and (9), which require the corporation to add back any royalties and interest paid to a related entity in such a situation. The amendments contain a number of safe harbors to prevent the addition from applying to legitimate transactions that are not for the purpose of tax avoidance. In addition, if a corporation does not qualify for one of the safe harbors, but believes that an addition is unreasonable as applied to its legitimate transactions, it may apply to the Tax Commissioner for a waiver of the addition requirement and a refund of tax paid on the amounts added back to Virginia taxable income.

This regulatory action will interpret *Code of Va.* § 58.1-402 B (8) & (9). In particular the regulation will clarify the safe harbors granted by the General Assembly in passing *Code of Va.* § 58.1-402 B (8) & (9) in order to prevent abuse of the provision. More specifically, the regulation will ensure that the safe harbor

provisions are used only to protect transactions between related entities that serve a legitimate non-tax business purpose and are not for the purpose of avoiding Virginia income tax.

### Legal basis

*Please identify the state and/or federal legal authority to promulgate this proposed regulation, including (1) the most relevant law and/or regulation, including Code of Virginia citation and General Assembly chapter number(s), if applicable, and (2) promulgating entity, i.e., agency, board, or person. Describe the legal authority and the extent to which the authority is mandatory or discretionary.*

---

*Code of Va. § 58.1-203 provides that the “Tax Commissioner shall have the power to issue regulations relating to the interpretation and enforcement of the laws of this Commonwealth governing taxes administered by the Department.” The authority for the current regulatory action is discretionary.*

### Need

*Please detail the specific reasons why the agency has determined that the proposed regulatory action is essential to protect the health, safety, or welfare of citizens. In addition, delineate any potential issues that may need to be addressed as the regulation is developed.*

---

Government must have predictable and adequate revenue to provide for the health, safety and welfare of its citizens. Tax regulations enhance customer service and voluntary compliance. The interpretations, examples, and other guidance in tax regulations ensure uniform application of the tax laws to taxpayers. Business taxpayers in particular find regulations essential in predicting the tax consequences of transactions and avoiding unanticipated tax assessments as the result of audits. Tax regulations also ensure that audits and other compliance activity cause the assessment and collection of the correct amount of tax.

This regulatory action will interpret *Code of Va. § 58.1-402 B (8) & (9)*. In particular the regulation will clarify the safe harbors granted by the General Assembly in enacting *Code of Va. § 58.1-402 B (8) & (9)* in order to prevent abuse of the provision. More specifically, the regulation will ensure that the safe harbor provisions are used only to protect transactions between related entities that serve a legitimate non-tax business purpose and are not for the purpose of avoiding Virginia income tax.

### Substance

*Please detail any changes that will be proposed. For new regulations, include a summary of the proposed regulatory action. Where provisions of an existing regulation are being amended, explain how the existing regulation will be changed.*

---

This regulatory action will provide processes and procedures for compliance with *Code of Va. § 58.1-402 B (8) & (9)*. Specifically, the regulation will provide definitions of certain terms, examples of transactions covered by *Code of Va. § 58.1-402 B (8) & (9)*, and exceptions to the general rule that an add back is required. The regulation will also provide a process for applying for an exception to the add back rule, the factors considered in determining the validity of such an application and the fees associated with such application.

**Alternatives**

*Please describe all viable alternatives to the proposed regulatory action that have been or will be considered to meet the essential purpose of the action. Also, please describe the process by which the agency has considered or will consider other alternatives for achieving the need in the most cost-effective manner.*

Since 1980, administrative interpretations of the tax laws that are not in the form of published rulings or a regulation have not been admissible as evidence in court. *Code of Va. § 58.1-205*. Even published “rulings and policies themselves are not entitled to great weight, unless expressed in regulations.” *Chesapeake Hospital Authority v. Commonwealth*, 262 Va. 551, 554 S.E.2d 55 (2001). Therefore, to ensure enforcement, it is necessary to promulgate regulations containing the Tax Commissioner’s interpretations of the tax laws.

The Department has considered alternatives to the proposed regulatory action. Virginia and other states have used their authority to adjust income when transactions between affiliates improperly reduce income taxes. See *Code of Virginia § 58.1-446*. *Comptroller v. SYL, Inc.*, 375 Md. 78, 825 A.2d 399, *cert denied*, 124 S.Ct. 478 (2003). This approach has proven unsatisfactory because each case must be determined on the facts and circumstances, which is very time consuming for both the taxpayer and tax administrator and generates uncertainty. In one case, the courts of Massachusetts and New York reviewed the same transactions of the same taxpayer for the same taxable years and reached opposite conclusions. Compare *The Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E. 2d 504 (2002) and *The Sherwin-Williams Co., New York Division of Tax Appeals*, Tax Appeals Tribunal, DTA No. 816712, June 5, 2003.

Recently several states have required that royalties paid to related entities be added back to taxable income. These states include Alabama, Arkansas, Connecticut, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, and Ohio. This is the approach adopted by the Virginia General Assembly.

**Public participation**

*Please indicate the agency is seeking comments on the intended regulatory action, to include ideas to assist the agency in the development of the proposal and the costs and benefits of the alternatives stated in this notice or other alternatives. Also, indicate whether a public hearing is to be held to receive comments on this notice.*

TAX is seeking comments on the intended regulatory action, including but not limited to 1) ideas to assist in the development of a proposal, 2) the costs and benefits of the alternatives stated in this background document or other alternatives and 3) potential impacts of the regulation. The agency is also seeking information on impacts on small businesses as defined in *Code of Va. § 2.2-4007.1*. Information may include 1) projected reporting, recordkeeping and other administrative costs, 2) probable effect of the regulation on affected small businesses, and 3) description of less intrusive or costly alternative methods of achieving the purpose of the regulation.

Anyone wishing to submit written comments may do so on the Town Hall Public Comment Forum for this action or by email to the agency contact person listed on the Town Hall for this regulatory action. In order to be considered comments must be received by the last day of the public comment period.

A public hearing will not be held during the NOIRA stage of this regulatory action. A public hearing will be held during the Proposed Regulation stage of this regulatory action. Notice of the hearing may be found on the Virginia Regulatory Town Hall website ([www.townhall.virginia.gov](http://www.townhall.virginia.gov)) and can be found in the Calendar of Events section of the Virginia Register of Regulations. Both oral and written comments may be submitted at that time.

### Participatory approach

*Please indicate, to the extent known, if advisers (e.g., ad hoc advisory committees, technical advisory committees) will be involved in the development of the proposed regulation. Indicate that 1) the agency is not using the participatory approach in the development of the proposal because the agency has authorized proceeding without using the participatory approach; 2) the agency is using the participatory approach in the development of the proposal; or 3) the agency is inviting comment on whether to use the participatory approach to assist the agency in the development of a proposal.*

TAX is using the participatory approach to develop the proposal. TAX will form a technical advisory committee to consist of interested parties to assist in the development of the proposed regulation. Persons interested in participating on the advisory committee should contact the agency contact person listed for this regulatory action on the Town Hall prior to the end of the public comment period.

John Cox, Analyst  
600 East Main Street  
Richmond, VA 23219  
Ph: (804) 371-2338  
Fax: (804) 371-2355  
E-mail: [John.Cox@tax.virginia.gov](mailto:John.Cox@tax.virginia.gov)

### Family impact

*Assess the potential impact of the proposed regulatory action on the institution of the family and family stability including to what extent the regulatory action will: 1) strengthen or erode the authority and rights of parents in the education, nurturing, and supervision of their children; 2) encourage or discourage economic self-sufficiency, self-pride, and the assumption of responsibility for oneself, one's spouse, and one's children and/or elderly parents; 3) strengthen or erode the marital commitment; and 4) increase or decrease disposable family income.*

This regulatory action is not expected to have an impact on family formation, stability and autonomy.