Federal and State Audit Issues

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I. Federal Audit Issues


The Service is paying more attention to family limited partnerships in its audits of estate and gift tax returns. One auditor noted that “[t]he family limited partnership has apparently become the estate planning device of choice. They are sprouting like mushrooms.” The Service is likely to challenge the valuation of the various limited partnership interests, and particularly the discounts taken for lack of control (minority interests) and lack of marketability. The Service’s position appears to be that the taxpayer must be able to demonstrate that the partnership was established for nontax business purposes, and be able to produce documentation of those purposes. The taxpayer should expect that the auditor will require a copy of the limited partnership agreement. The auditor is likely to request the additional information detailed below. Note the confidentiality issues raised for tax counsel.

1. Estate Tax Context.

In the context of an estate tax audit, the auditor requested that the involved parties provide statements addressing the following topics:

- How the partnership’s assets were owned prior to contribution to the partnership (e.g., what each partner owned).
• How the assets were managed prior to and after their contribution to the partnership (e.g., identification of the person(s) responsible for management of assets before and after the creation of the partnership; amount of time devoted to management of partnership assets; whether general partner has any specific qualifications or duties with respect to management of assets; whether children participate in management of assets).

• An explanation of the reason for creating the partnership, and an explanation of why this purpose could not have been achieved through an outright gift or use of a trust.

• Identification of the person who recommended the creation of the partnership, when the recommendation was made and the reasons that the recommending person gave for recommending the partnership.

• Whether the fees associated with the creation of the partnership were deducted.

• A description of the decedent’s health at the time the partnership was created, whether someone signed the documents on the decedent’s behalf (e.g., under a durable power of attorney), and whether the partnership’s assets had been held in trust before the partnership was created.

• Whether the partnership was created to reduce estate tax.

• The business reason for the creation of the partnership.

2. **Gift Tax Context.**

The Service has prepared a questionnaire containing the following questions for use in auditing gift tax returns. Note that they address substantially the same topics as are listed above.

• Was the creation of the partnership a negotiated transaction?

• At whose suggestion was the partnership created? Did the idea of the partnership originate with the donor? With the donor’s children?

• Why was the partnership created at that particular time?

• What kind of advice did the donor seek, and what were the qualifications of the advisor?

• What benefits did the donor expect?

• What was the donor’s state of health when the partnership was formed?
• Why could the ___ shares of common stock of ______________ (a publicly-traded company listed on the ______ Exchange) no longer be managed as before?

• What were the business purposes for the creation of the partnership?

• Who managed the assets before and after the formation of the partnership?

• How did/does the partnership operate? Were partnership accounts obtained [for] cash and any securities? When?

• Was there a joining in the common conduct of a business by the family members? Please provide any evidence regarding the general and limited partners in the conduct of the partnership enterprise.

• What was/is the business?

• Did the donor's relationship to the assets and their income change as a result of the partnership apart from the gifts?

• What business transactions did/does the partnership engage in? When?

• Were/are the other partners involved or consulted in the operation of the partnership?

• Did/do the partners hold themselves out as partners to third parties?

• Have any partnership interests been sold, exchanged, or otherwise liquidated since the transfer?

• Did/do the partners view themselves as partners?

• Were/are books and records kept? Meetings held?

B. Crummey Powers

As part of estate tax audits, examining agents are reportedly asking to see the records of “Crummey Trusts” to confirm that all notices have been given in a timely and proper manner.

See, Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968) (power of beneficiary to withdraw contributions during 30 day window is a “present interest” for purposes of the $10,000 annual
gift tax exclusion under IRC § 2503). This level of scrutiny raises a host of issues. For example, what is the duty of the trustee or the trustee's advisor to prove that all notices have been given?

C. Income Tax: Environmental Clean-Up Costs

Throughout the 1990's, IRS exam agents have challenged the deductibility of costs incurred by businesses to investigate, evaluate, and remediate soil and groundwater contamination. The remediation process typically includes the excavation and removal of large amounts of contaminated soil and replacement with uncontaminated soil, sand, and gravel and the planting of grass over the previously contaminated area. In some cases, the contaminated soil is removed completely; in other cases, not all the contaminants are removed, but the land is "capped", often with polyethylene and grass, to prevent the remaining contaminants from spreading. The taxpayer may be required to install monitoring wells and, in some cases, water treatment facilities. Taxpayers traditionally have claimed that such environmental clean-up costs are deductible as ordinary and necessary business expenses. IRS exam agents often challenged such deductions, on the theory that the environmental clean-up was a permanent improvement the cost of which must be capitalized.

After having issued several, inconsistent technical advice memoranda, the IRS ruled in Revenue Ruling 94-38, 1994-1 C.B. 35, that costs incurred to remediate soil and groundwater contamination generally are deductible as ordinary and necessary business expenses, but that the costs of monitoring wells and water treatment facilities must be capitalized and depreciated. The theory for the deductibility of remediation costs is that remediation "repairs" the land by returning it to the uncontaminated condition it was in when acquired by the taxpayer. (That rationale implies that remediation costs incurred to clean up land that was contaminated when acquired by the taxpayer would not be deductible.) Revenue Ruling 94-38 did not expressly
address the tax treatment of costs incurred to “cap” a site. Consequently, many IRS exam agents have continued to argue that a cap, even an earthen one, is a separate asset the cost of which must be capitalized.

Early this year, the IRS issued Revenue Ruling 98-25, 1998-19 I.R.B. 4, which deals with the replacement of underground storage tanks. It holds that the costs of removing an old storage tank, removing the waste from the old tank, disposing of the old tank, and acquiring, installing, and filling a new storage tank are deductible when all the costs are incurred in the same year and the new tank, once installed and sealed, will not be emptied and reused and will have no resale value. The theory of the ruling is that the new tank then has no remaining useful life for income tax purposes. The ruling also holds that the same types of cost would be deductible in the case of an above-ground storage tank.

Some IRS exam agents are inferring from Revenue Ruling 98-25 that the costs of underground storage facilities are not deductible until the facility is filled and sealed. Moreover, they are treating capped remediation sites as storage facilities for underground waste and arguing that the deduction of remediation costs for a capped site must be deferred until the remediation and cap are completed. Although this would make deductibility largely a timing issue, it is nevertheless significant where remediation costs are large and the process takes several years to complete.

D. Reasonable Compensation.

1. IRS Audit Position. IRS Exams, at least in Virginia, continues to target closely held “C” corporations from which shareholder/employees are drawing what the IRS agents feel are unreasonably large salaries and bonuses. Audit adjustments are particularly
virulent where only a sole shareholder/employee is involved or employees/officers are all family members. Targeted industries include professionals as well as capital intensive businesses.

Section 162(a) of the Internal Revenue Code allows an employer to deduct as a business expense a “reasonable allowance for salaries or other compensation for personal services actually rendered.” To come within the ambit of § 162(a)(1), compensation must be both reasonable in amount and in fact paid purely for services. Treas. Reg. § 1.162-7. There are many factors relevant in determining the reasonableness of compensation, but no single factor is decisive.

Mayson Manufacturing Co. v. Comm'r., 178 F.2d 115 (6th Cir. 1949); Elliotts, Inc. v. Comm'r., 716 F.2d 1241 (9th Cir. 1983) 2. Recent Case Law is Pro Taxpayer. Fortunately, the case law recently has been generally favorable to taxpayers. Indeed, not only has the Tax Court found recently more in favor of taxpayers than the IRS, but Appeals Courts have been sharply critical when the Tax Court finds against the taxpayer. Most notably, the U.S. Second Circuit Court of Appeals recently overturned the U.S. Tax Court’s decision in Dexsil Corporation v. Comm’r., 69 T.C.M. (CCH) 2267 (1995), holding that the Tax Court erred as a matter of law in failing to adopt the perspective of an independent investor in determining the reasonableness of compensation paid to the corporation’s chief executive officer. See Dexsil Corporation v. Comm’r., Docket No. 95-4209, 1998 U.S. App. LEXIS 11499, (Second Cir., June 3, 1998). Also of interest is the U.S. Ninth Circuit Court of Appeals decision in Leonard Pipeline Contractors, Ltd. v. Commissioner, 1998 WL 196243 (Ninth Cir., Apr. 24, 1998), in which the Ninth Circuit overturned the U.S. Tax Court’s decision on the reasonableness of compensation paid to a company’s president, holding that the Tax Court had not furnished an adequate explanation of what it found “reasonable.” In Leonard Pipeline, the U.S. Tax Court had agreed with the Service that the taxpayer had paid
excessive compensation to its president. However, the Tax Court determined that the taxpayer was entitled to a greater compensation deduction than that allowed by the Service. Using its "best judgment," the Tax Court arrived at a figure that it deemed to constitute reasonable compensation, without explaining how it reached this conclusion. See, Leonard Pipeline Contractors, Ltd. v. Comm'r., 72 T.C.M. (CCH) 83 (1996). Characterizing the Tax Court's opinion as "opaque," the Ninth Circuit reversed, holding that,

It is the obligation of the Tax Court to spell out its reasoning and to do more than enumerate the factors and leap to a figure intermediate between Petitioner's and the Commissioner's. We can see the pieces of the puzzle. We can only guess how the trial judge put them together... A reasoned decision as to what is reasonable in this context must bring together the disparate elements and give some account of how the judge has reached his conclusion.”


Nonetheless, the Ninth Circuit's opinion in Leonard Pipeline makes clear that the determination of reasonable compensation is a heavily fact-based inquiry, and failure to fully analyze and explain the factors that go into such determination constitutes error as a matter of law. To the extent that the Revenue Agent's adjustments are premised on conclusory assumptions regarding a company's business and the services provided by its owner employees, the Ninth Circuit's decision in Leonard Pipeline suggests that such analysis would not, as a matter of law, support a finding as to the unreasonableness of the compensation paid.

3. "Intrinsic Value." In judging what is reasonable, the Tax Court has cautioned against IRS's persistent failure to consider the "intrinsic value" of a highly
compensated employee/shareholder. Tax Court Judge Laro summed up this concern when he stated:

Inherently, there is a natural tension between (1) shareholders/employees who feel that they are entitled to be paid from a corporation's profits, even to the exhaustion thereof, of an amount that reflects their skills and efforts, and (2) a provision in the tax law that conditions the deductibility of compensation on the concept of reasonableness. What is reasonable to the entrepreneur/employee often may not be to the tax collector. Accordingly, this and other courts are repeatedly asked to examine the relevant facts and circumstances of the business and the underlying employment relationship in order to render an opinion as to whether the compensation paid was reasonable. In so doing, we must be careful not to define the term "reasonable" too narrowly. The dynamic nature of business, the entrepreneurial spirit, and the dedication of purpose all play a role in the composition of reasonable compensation. We must not rigidly apply form over substance when we measure one's contribution to the success of his or her business. Of course, it may be argued that when an individual chooses to conduct business in the corporate form, he or she is obligated to observe all of the corporate formalities inherent in that form, including the standard that to be deductible, the compensation paid must be reasonable. The term "reasonable," however, must reflect the intrinsic value of employees in the broadest and most comprehensive sense.


4. Nine Factor Test. The following nine factors are typically considered in determining the reasonableness of an officer/stockholder's salary:

a. Employee's qualifications.

In Mad Auto Wrecking, Judge Laro succinctly summarized the role of an employee's qualifications in determining the reasonableness of compensation paid to the employee:

The Shareholders are exceptionally qualified for petitioner's business, by virtue of their training, experience, and dedication, and understand and control every aspect of petitioner's operations.
The Shareholders are also highly motivated and extremely productive employees, and are the primary reason for petitioner’s success. We conclude that this factor favors petitioner. The Shareholder’s outstanding qualifications justify high compensation. Petitioner’s profitability rests upon its sales, and the Shareholders’ ambition, inventiveness, and energy (as opposed to petitioner’s investment in capital) are the primary reasons for petitioner’s sales, growth, and success.

Mad Auto Wrecking Co., 69 T.C.M. (CCH) at 2335. Likewise, in Pulsar Components International, Inc. v. Comm'r., 71 T.C.M. (CCH) 2436 (1996) the Court found that a company had paid reasonable compensation to an officer who had founded the business, served as chief executive officer, and performed various duties essential to the success of the operation.

b. Nature, extent and scope of the Employee’s work

Again, Judge Laro's articulation of this factor in Mad Auto Wrecking bears reading. He stated:

The nature, extent, and scope of petitioner's work performed by the Shareholders is fundamental, substantial, and all-encompassing. The Shareholders performed all of petitioner's executive and managerial functions, except accounting, and performed or oversaw all of its manual labor. The Shareholders also supervised petitioner's daily operations, including supervising and directing the other employees, and made petitioner's business decisions. Given the vital role played by the Shareholders in petitioner's operations and success, and the long hours that they each dedicated thereto, we view the Shareholders as indispensable to petitioner's business. Petitioner's growth and prosperity is due directly to their skills, dedication, and creativity. If petitioner were to lose either of the Shareholders, it would be in a rough situation until a suitable replacement (if any) could be found. We conclude that this factor favors petitioner.

The multiple roles that an owner/employee performs in a small company may also justify a larger salary. The Second Circuit U.S. Court of Appeals in Dexsil vacated the Tax Court’s decision in part because it failed to consider the officer’s multiple roles and to compare the officer’s salary and bonuses to those paid by similar companies for comparable services. The Court noted that,
though it may not be extraordinary for the president of a small company to perform multiple roles
within the organization, a court must, nevertheless, take into account such multiple roles in
conducting a meaningful comparison to other companies. See Dexsil Corp., 1998 U.S. App.
LEXIS 11499 at 16-17.

c. Comparison of Employee's compensation with that paid by
comparable companies for comparable services.

In theory, the ideal benchmark for determining reasonableness of an officer's
compensation is a comparison with the salaries of other executives who have comparable
positions and responsibilities in comparable companies. The courts, IRS, and taxpayers agree
that this factor is one of the hardest factors to evaluate. It is often difficult to find truly
comparable companies, but, even if a comparable employer can be found, locating a comparable
employee in that comparable company is an even harder task. Such is the case here.

Revenue Agents often resort to salary surveys to prove unreasonableness. Indeed, the
primary benchmark used by Revenue Agents is the Robert Morris Associates ("RMA") study. In
Pulsar, the Tax Court deemed such studies to be of such "dubious value" that it gave no weight to
this factor in the government's argument. Indeed, the RMA study has been explicitly rejected as
unreliable by the Tax Court in determining reasonable compensation because it lacks sufficient
evidence of comparability and is used primarily by credit managers and bankers in gauging
expected cashflow levels for businesses seeking credit or financing. PMT, Inc. v. Comm'r., 72
T.C.M. (CCH) 5 (1996). The Tax Court stated in PMT:

The RMA study that [the IRS] relied on was a collection from
lending institutions that came from bank and credit loan records. It
was not designed to be used as a survey of compensation. An
important weakness of the RMA study is that it supplies the
amount of total officers' compensation, but does not supply
information regarding the number of officers or their duties.
Thus, you should reject an Agent's blind reliance on an unsupported RMA average as proof of reasonable compensation here. Surveys of industries and officers classified by titles are of no relevance when a business and an executive are unique.

d. The character and condition of the company

This factor focuses on the company's size as indicated by its sales, net income, or capital value.

e. Comparison with gross revenue and net income

The ratio of the employee's compensation to the company's gross revenue must be within reasonable levels. The Tax Court has previously held shareholder/employee compensation reasonable even though it was 60% of gross income and levels above 20% are common. See Pulsar v. Comm'r., supra. Courts also look to see if current compensation bears a reasonably consistent relationship to net income and retained earnings. In Mad Auto Wrecking, the Tax Court held compensation was reasonable where the ratio of compensation to net income ranged from 91% to 103% per annum over three years.

f. The salary policy of the company for all its employees, and the particular employee’s salary history with the company

This factor focuses on the overall corporate salary policy and consistency over time. The Second Circuit also found in Dexsil that the Tax Court committee reversible error by failing to consider whether the chief executive officer was paid consistent with a long-standing formula. Although the Tax Court’s opinion seemed to suggest that, in order for there to be a valid contingent compensation formula, it must have applied to Dexsil’s other employees, the Second Circuit found such position to be erroneous as a matter of law. The Court, therefore, remanded
the case to the Tax Court and directed it to consider whether Dexsil Corporation had paid the
CEO pursuant to an existing contingent compensation formula, whether the formula was
reasonable at its inception, and whether it was applied consistently. See Dexsil Corp. 1998 U.S.
App. LEXIS 11499 at 15.

g. The likelihood that a hypothetical, independent investor would be
willing to compensate the employee at the levels paid by the
company taking into account dividends paid and capital growth

This is often the number one factor in these cases. Judge Laro again succinctly summarized
the role of this factor in testing for the reasonableness of compensation. He stated:

Corporations are not required to pay dividends. Instead, an
individual shareholder may participate in the success of a
corporation through the appreciation in the value of his or her stock
brought on by retained earnings and the possibility of a future
return. Thus, a corporate employer with little or no dividend
history may be able to pay and deduct large amounts of
compensation if the Court is convinced that a reasonable person
would still have invested in the corporation. Courts sometimes
apply a hypothetical investor test to determine whether a
reasonable person would have invested in the corporation. Critical
to this test is whether the shareholders of the corporation received a
fair rate of return (without taking into account any compensation)
from the total of their initial and subsequent investments.

Mad Auto Wrecking, 69 T.C.M. (CCH) at 2339 (citations omitted).

In applying the hypothetical investor test, one measure of the investor return calculation
used is annual return to the investor in the form of dividends and capital appreciation, divided by
the actual stockholder's initial investment in the corporation plus any additional capital
contributions. In other words, under this method retained earnings are not in the denominator of
the ratio. Medina v. Comm'r., 46 T.C.M. (CCH) 76, 84 (1983); Elliotts, Inc., 716 F.2d at 1244;
Mad Auto Wrecking, 69 T.C.M. (CCH) at 2336 (1993). More typical is the return on equity
("ROE") method where retained earnings are in the denominator. See also Rev. Rul. 79-8, 1979-1 C.B. 92 (compensation not unreasonable merely because a corporation pays an insubstantial portion of its earnings as dividends). Failure to use this test constitutes reversible error.

According to the Second Circuit, the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed. . . . Thus, if the company's earnings on equity, when viewed in relation to such factors as the company's overall performance and levels of compensation, remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary.

h. Whether the employee and employer dealt at arm's length

Where an employer and an employee are not dealing at arm's length, the amount of compensation paid may be unreasonable. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1324 (5th Cir. 1987); Elliotts, Inc., 716 F.2d at 1246; Gilman Paper Co. v. Commissioner, 284 F.2d 697 (2d Cir. 1960), affg. T.C. Memo 1960-13.

In judging this factor, the Tax Court harks back to the hypothetical investor test and attaches no significance to the lack of formalities that the Service seeks to impose on owner-employees. Judge Laro states:

The Shareholders were purportedly paid high compensation as petitioner's principal employees. Given their relationship to petitioner as its only shareholders, we must inquire whether an independent investor would have paid the Shareholders the amount of compensation that they received during the years in issue. We conclude that an independent investor would have done so in view of the nature and quality of the services that the Shareholders performed for petitioner, and the effect of their services on a hypothetical investor's return on his or her investment. In so concluding, we downplay the act of adherence to corporate formalities shown by petitioner in paying the bonuses to the Shareholders.
Mad Auto Wrecking, Inc., 69 T.C.M. (CCH) at 2339 (emphasis supplied).

i. Absence of pension plan/profit-sharing plan

Courts have considered the absence of a pension plan or a profit-sharing plan in determining reasonable compensation. Rutter v. Comm'r., 853 F.2d 1267, 1274 (5th Cir. 1988), Kennedy v. Comm'r., 671 F.2d 167, 174-175 (6th Cir. 1982). Such an absence may allow the employer to pay the employee more compensation than the employer would have paid had the employer offered the employee a pension plan or a profit-sharing plan. Rutter v. Comm'r., supra at 1274.

Lastly, other additional factors are often considered, e.g., general economic conditions, the employer's past and present financial condition, the guarantee of the employer's debt and the employer's reimbursement policy regarding business expenses,

5. Summary of Reasonable Compensation Factors
   a. Employer's qualifications
   b. Nature, extent, and scope of employee's work
   c. Comparison with comparables
   d. Size and condition of the company
   e. Comparison with gross and net income
   f. Salary of other employees
   g. Hypothetical investor's return
   h. Arm's length nature
   i. Absence of pension plan
II. State Audit Issues.


The second paragraphs of Virginia Code § 58.1-446 allows the Virginia Department of Taxation (the "Department") to consolidate affiliated corporate taxpayers when, in the Department’s view, the arrangements and agreements between and among the affiliated taxpayers serve to distort a corporation’s income earned from business done within Virginia. The involuntary consolidation is supposed to effect an equitable adjustment to the taxpayer’s Virginia taxable income. The statute states in relevant part:

> Any corporation liable to taxation under this chapter and either owned or controlled by or owning or controlling, either directly or indirectly, another corporation may be required by the Department to make a report consolidated with such other corporation showing the combined gross and net income and such other information as the Department may require, but excluding intercorporate stockholdings and the intercorporate accounts. In case it appears to the Department that any arrangements exist in such a manner as improperly to reflect the business done or the Virginia taxable income earned from business done in this Commonwealth, the Department may, in such manner as it may determine, equitably adjust the tax. In all cases mentioned in this paragraph, such other corporations not otherwise liable to taxation under this chapter shall, for the purposes of this chapter, be deemed to be doing business in Virginia through the agency of the corporation liable to taxation under this chapter. (Emphasis added).

In recent years, state auditors have become increasingly aggressive in using § 58.1-446 to consolidate affiliated taxpayers on audit, and thereby to impose increased tax liability on the corporate group. As discussed below, this aggressive approach is not limited to so-called "Delaware Investment Holding Companies" (or "DHC’s"). but is reflected in audits involving other corporate income tax issues. However, if a taxpayer can establish that a transaction
between related entities meets the arm’s length standard of IRC § 482, it should have a good start on its argument that consolidation under § 58.1-446 is improper.

In Commonwealth v. General Electric Co., 236 Va. 34, 372 S.E.2d 599 (1988), the Supreme Court of Virginia considered the taxpayer’s argument that § 58.1-446 contains no ascertainable standard and, therefore, is unconstitutionally vague. In defending the constitutional validity of § 58.1-446, the Department took the position that the use of the term “improperly” in the statute constituted an adoption the arm’s length standard of IRC § 482. The Commonwealth’s brief is replete with references demonstrating the parallels between IRC § 482 and Virginia Code § 58.1-446. The Court’s opinion states:

The Department contends that the General Electric income in question is attributable to GE DISC pursuant to federal tax laws "through an arrangement which permits General Electric to engage in business dealings with its wholly-owned subsidiary GE DISC, a paper corporation, at less than an arm's length business standard."

General Electric, 236 Va. at 62-63 (emphasis added).

Positions taken in recent audits demonstrate that Virginia’s auditors have lost sight of their IRC § 482 roots and are using § 58.1-446 whenever doing so generates more tax liability. If the Commissioner does not remember those roots, Virginia could be well on the way to being a unitary state.

1. Delaware Holding Companies.

Parent is a Virginia corporation with its principal place of business in Virginia.

Subsidiary is a Delaware corporation with its sole place of business in Delaware, and is a wholly-owned subsidiary of Parent. Subsidiary meets the definition of a “financial corporation” under Virginia law (Va. Code Ann. § 58.1-418B; 23 VAC 10-120-364(E)) and has earned substantial
income on its investments. Subsidiary's only office is located in Delaware, and is used exclusively by Subsidiary. Subsidiary has one employee who works at the Delaware office. The employee is responsible for paying Subsidiary's routine and incidental expenses, filing regulatory forms, returns and reports with federal, state and local tax authorities, paying any applicable taxes and withholdings to the proper federal, state or local authority, and implementing the instructions from Subsidiary's board of directors. This staff of one is adequate to conduct all of Subsidiary's business affairs.

Subsidiary makes loans to both related and unrelated corporations. All loans are evidenced by demand notes and carry interest rates equal to the short-term applicable federal rate or the prime rate. The borrowers make cash payments of interest and principal on the loans. All borrowers have sufficient equity, assets and cash flow to repay the loans in accordance with commercially comparable credit terms. Affiliated and unrelated corporations are treated identically by Subsidiary.

The auditor made adjustments to include the income of Subsidiary with Parent's income under § 58.1-446. He provided no explanation of how loans made by Subsidiary on an arms-length basis, sometimes to unrelated corporations or to corporations not doing business in Virginia, could distort Parent's Virginia taxable income. Furthermore, the auditor did not address the regulatory "safe harbor" provisions applicable to Subsidiary's transactions (23 VAC 10-120-360, et seq.).

The auditor's position is contrary not only to the position that the Department vigorously advanced in General Electric, but also to the regulations that the Department promulgated effective March 10, 1993.
D corporation, a wholly owned subsidiary of P, is a "financial corporation" not subject to Delaware income taxation under Delaware Corporation Income Tax Code § 1902(b)(8). P is subject to Virginia income tax. D leases an office for its exclusive use in Delaware where it has a staff adequate to conduct all of its business affairs. D has substantial intangible assets which are loaned or otherwise made available to other group members for a consideration determined pursuant to the safe harbor provision of subdivision E 3 of 23 VAC 10-120-361. All of D's assets are located in Delaware, and all of its business activities, including all day-to-day decision making, are conducted by its own officers and employees in Delaware. D received its intangible assets from P in a transaction under Internal Revenue Code § 351.

In this instance, the group's income from business done in Virginia is not distorted due to the intragroup lending transactions. This conclusion is not changed by the mere fact that one or more officers or directors of D may reside in Virginia, or may be employed by an affiliate of D doing business in Virginia.

23 VAC 10-120-364(E).

Lending transactions. In an intragroup lending transaction, the lending party must be a discrete, separate business enterprise with its own employees, office space and books and records. Funds must be loaned at a fair market value interest rate, with collateral, payments, and credit standing substantially similar to those which the borrower could obtain from an unrelated lending institution.

23 VAC 10-120-361(E)(3).

The Commissioner has not issued any rulings regarding § 58.1-446 for taxable years since the promulgation of the foregoing regulations. Note that the Department may be trying to apply a stricter standard to tax years before 1993 than its own regulations apply after that time - even though there has been no change in the statute.

2. **Arm's Length Leasing Arrangements**

Company A and Company B are bother-sister corporations. Company A manufactures equipment. Initially, Company A leased or sold the equipment to its customers. For valid
business reasons, Company A transferred all of its leased equipment assets to Company B, and Company B now leases them to customers. Company A manufactures equipment and sells it to Company B at a price that appears to be in line with arm’s length terms generally. To finance its business, Company B re-sells the equipment to an unrelated financial institution, immediately leases the equipment back from that party, and then re-leases it to its customers. Company A provides administrative and marketing services for Company B in exchange for an additional arm’s length charge. Company B holds its own tangible (the equipment) and intangible (proceeds from leases) assets. Company A had no property, payroll or sales in Virginia during the period under audit, and, therefore, paid no tax. Company B was taxable in Virginia because it has leased equipment within Virginia.

The Auditor consolidated Company A and Company B under § 58.1-446. He explained that Company B’s acquisition of Company A’s leased assets (including some leased in Virginia) transferred nexus from Company A to Company B. However, in his view, Company B was essentially a holding company that generated minimal income and paid no salaries or wages, and, therefore, could not operate without Company A. The Auditor did not contend that the price at which Company A sold equipment to Company B was not an arm’s length price or that the fee Company B paid to Company A for administrative and marketing services was not an arm’s length fee. In short, the Auditor used § 58.1-446 to “create” nexus between Company A and Virginia.

Section 58.1-446 is intended to remedy the distortion of Virginia taxable income that can occur when affiliated corporations engage in transactions on terms other than arm’s length terms. Because there is no contention that the transactions between Company A and Company B were other than arm’s length, there should be no basis to consolidate under § 58.1-446. See General
Electric, 236 Va. 34; 23 VAC 10-120-361(C)(1) (rendering or receiving intragroup services without adequate compensation gives rise to rebuttable presumption of distortion of income).

Virginia follows a “bright line” nexus test. Numerous rulings of the Department have established that a corporation having no Virginia property, payroll or sales (unprotected by PL 86-272) has no Virginia taxable income. See, e.g., P.D. 95-113 (May 11, 1995). The Department’s rulings also establish that wages paid by a company must be attributed for corporate income tax apportionment factor purposes in the same way that they are reported for Virginia unemployment compensation purposes. See, e.g., P.D. 93-116 (April 29, 1993). A corporation that has no Virginia taxable income is not eligible to be included in a consolidated or combined Virginia return. 23 VAC 10-120-322(B)(2) (consolidated return) and 23 VAC 10-120-323 (combined return). Under the Department’s own rulings, Company A has no Virginia taxable income and could not voluntarily have filed a consolidated or combined return with Company B. The Auditor has not asserted that any transaction or arrangement between Company A and Company B was not at arm’s length. Therefore, under the Department’s own regulations and rulings, there should be no basis too involuntarily consolidate Company A and Company B under § 58.1-446.

3. **Factoring Arrangements Among Related Corporations**

Parent is a retail merchant which generates accounts receivable from retail sales operations. Parent has a Subsidiary which purchases the accounts receivable at face value and thereafter receives the payments of interest and service charges made by the debtor in connection with the account receivable. Parent has been engaging in this factoring practice for many years, and the practice is common in the retail industry.

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For reasons that are not entirely clear, the auditor took the position that the incomes of Subsidiary and Parent should be consolidated under § 58.1-446. His report notes only that prior to the sale of the accounts receivable, Parent received the service charge income, and after the sale, the purchasing Subsidiary received the service charge income. He also noted that the Subsidiary’s name was similar to the name of the Parent. The auditor did not contend that the sales of accounts receivable were not conducted at arm’s length.

23 VAC 10-120-361(E)(4) provides that

Intragroup transfer of receivables must occur at arm’s length, taking into account: the creditworthiness of the debtor or debtors, the collectibility of the transferred receivables, and the rate of return required by the transferor corporation with regard to similar assets.

The Auditor also did not contend that the criteria of 23 VAC 10-120-361(E)(4) were not satisfied. Accordingly, under General Electric and the Department’s own regulations, there should be no basis for using Va. Code Ann. § 58.1-446 consolidation.

4. Royalties for Trademarks and Rents for Real Property

Parent is a Delaware corporation with its principal place of business in a state other than Virginia. Subsidiary 1 and Subsidiary 2 are also Delaware corporations with their respective principal places of business outside of Virginia. Both are wholly-owned subsidiaries of Parent.

Subsidiary 1’s assets consist of trademarks, cash and investments. Some of the trademarks had been contributed to Subsidiary 1 by Parent before the period under audit, and others were acquired by Subsidiary 1 from an unrelated party prior to the period under audit. Subsidiary 1 has no property, payroll or sales in Virginia. Pursuant to a license agreement between Parent and Subsidiary 1, Subsidiary 1 granted to Parent a non-exclusive license to use certain trademarks and, in exchange, Parent agreed to pay to Subsidiary 1 royalties equal to 2.5%
of Parent’s net sales of the licensed trademark products. Cf. Geoffrey, Inc. v. South Carolina Tax Commission, 473 S.E.2d 13 (1993), cert. Denied 510 U.S. 992 (1993). The 2.5% rate falls within the range of royalties paid for licenses for similar trademarks pursuant to licensing agreements between unrelated parties. Additionally, Parent borrowed cash from Subsidiary 1 and paid interest to Subsidiary 1 at a rate equal to the prime interest rate as announced by a specified major national bank from time to time.

Subsidiary 2 is a real estate investment company and holds real property located outside of Virginia. It has no property, payroll or sales within Virginia. Parent contributed certain real estate to Subsidiary 2 prior to the period under audit. Parent leased the real estate from Subsidiary 2 for a specified initial annual rent which increased annually by the same percentage as the Consumer Price Index. The initial rent was based on an appraisal done by an unrelated third party. Parent also borrowed money from Subsidiary 2 and paid interest to Subsidiary 2 at the prime interest rate.

The auditor took the position that Subsidiary 1 and Subsidiary 2 should be consolidated with Parent under § 58.1-446. Accordingly, he added back to Parent’s income the interest paid to Subsidiaries 1 and 2, the royalties paid to Subsidiary 1 and the rent paid to Subsidiary 2. He did not contend that the interest rates, royalties or rents were not arm’s length.

There should be no basis for consolidating Subsidiaries 1 and 2 with parent under § 58.1-446 because there is no contention that any arrangement between Parent and Subsidiary 1 or Parent and Subsidiary 2 is not at arm’s length. See General Electric, 236 Va. 54. The Department has conceded consolidation under § 58.1-446 is improper where the arm’s length pricing method is used in transactions between a parent and its subsidiaries. PD 97-282 (October 9, 1996); PD 94-30 (October 11, 1994).
B. Retail Sales & Use Tax: Services Versus Sales of Tangible Personal Property.

Retail sales of tangible personal property are subject to the retail sales tax unless an exemption applies. With certain exceptions, the sale of services is not subject to tax, but the service provider is the taxable user and consumer of the tangible personal property used in rendering the service. The Department’s regulations and rulings clearly state that the “true object” test is to be applied in determining the taxability of tangible personal property transferred pursuant to a contract for both tangible personal property and the provision of services. 23 VAC 10-210-4040 provides, in relevant part:

A. Generally. Charges for services generally are exempt from the retail sales and use tax. However, services provided in connection with sales of tangible personal property are taxable.

Transactions involving both the sale of tangible personal property and the provision of services generally, are either taxable or exempt on the full amount charged, regardless of whether the charges for the service and property components are separately stated. As explained in subsection D of this section, the “true object” test is used to determine the taxability of these transactions.

D. Determination of the appropriate tax treatment of service and sale transactions; information services. In order to determine whether a particular transaction which involves both the rendering of a service and the provision of tangible personal property constitutes an exempt service or a taxable retail sale, the “true object” of the transaction must be examined. If the object of the transaction is to secure a service and the tangible personal property which is transferred to the customer is not critical to the transaction, then the transaction may constitute an exempt service. However, if the object of the transaction is to secure the property which it produces, then the entire charge, including the charge for any services provided, is taxable.
Auditors frequently ignore this "clear" standard and characterize mixed transactions as sales of tangible personal property and assess sales tax with respect to them.

1. **Contract for Research Services**

   Taxpayer, a manufacturer, and a non-profit organization ("Researcher") entered a research agreement pursuant to which Taxpayer would pay Researcher for developing a new process that Taxpayer could ultimately use in its manufacturing business. The research was performed outside of Virginia. The payments were to be made on a periodic basis over the term of the contract. From time to time, Researcher would provide to Taxpayer samples that it had developed in the course of research. Taxpayer tested and evaluated the samples to gauge the progress of the research, and then destroyed them. Beyond this function, the samples were useless to Taxpayer.

   The Auditor assessed sales tax on the payments that Taxpayer made to Researcher under the agreement. Evidently, the Auditor characterized the agreement as a sale of tangible personal property rather than a contract for research services.

   The true object of the research agreement was the development of a process which Taxpayer could use in its manufacturing business. Researcher was not retained to engage in manufacturing for Taxpayer, and, indeed, produced only a few samples to demonstrate the progress of the research. Thus, under the true object test, the agreement should have been characterized as a nontaxable provision of services (a position which the Department acquiesced in on appeal). Additionally, even if the agreement were for services which are of a taxable nature under Virginia law, the tax should not have applied in this case because the services were rendered outside of Virginia. Virginia sales tax applies only to services of a taxable nature that are furnished in Virginia. Va. Code Ann. § 58.1-603.
2. Government Contracting

The U.S. Government awarded Taxpayer, a manufacturer, a contract to design, develop and construct a prototype of a new product. If after evaluation the prototype met the design objectives, the product would be produced for use by the Government, either by Taxpayer or by an unrelated third party, pursuant to a separate contract. Taxpayer produced the prototype and delivered it to the Government. Taxpayer and the Government considered the contract to be one for the sale of tangible personal property and Taxpayer did not pay any tax on the tangible personal property used in manufacturing it (direct use exemption).

The auditor characterized the contract as one for the provision of services, and assessed tax with respect to the tangible personal property that Taxpayer used in constructing the prototype.

Under the true object test, should the contract be characterized as one for the sale of tangible personal property? Taxpayer understood that it had been engaged to construct and deliver a full scale, working model, and the Government understood that it would pay for and receive a full scale, working model. As such, much of the tangible personal property that Taxpayer purchased and used in performing the contract was in fact sold to the Government. Thus Taxpayer’s purchases should have been exempt under the resale “exemption” (which is a misnomer), and the transfer to the Government would have been exempt as well under the governmental exemption. Va. Code Ann. § 58.1-609.1(4) (tangible personal property for use or consumption by the United States).

Are the results changed if Taxpayer combines into one contract the terms of the R&D project and the “follow on” manufacture? But see WTAR Radio TV v. Commonwealth, 217 Va. 877, 234 S.E.2d 245 (1977) (purchase price for videotaped commercial taxable even though
tangibles and services separately stated). Are Virginia businesses at a competitive disadvantage because of sales tax rules as applied to services?

Regardless of whether the contract was characterized as one for the sale of tangible personal property or one for the provision of services, Taxpayer’s purchases should have been exempt under the research and development exemption which applies to tangible personal property purchased for “use or consumption directly and exclusively in basic research or research and development in the experimental or laboratory sense.” Va. Code Ann. § 58.1-609.3(5); see also 23 VAC 10-210-3070 et seq.

3. Real Property Contractors.

Taxpayer is a general contractor who constructs gas stations. It paid the applicable sales tax on all tangible personal property that it used in the construction of gas stations at the time it made its purchases. It did not collect any sales tax from its customers in connection with the construction of the gas stations. Under some contracts, Taxpayer was allowed a mark-up of 20 percent over its cost price on the gas station equipment that it purchased (e.g., pumps, tanks) and was required to submit to its customers an itemized statement of all job costs. In doing so, it listed the sales tax it paid on its purchases of gas station equipment separately rather than including the tax in its total cost price of items of property.

The auditor took the position that Taxpayer, because of its cost plus billing method, had collected sales tax from its customers and failed to remit it to the State. With respect to several construction contracts, the auditor also asserted that sales tax was due with respect to the whole contract price, even though most, if not all, of the components sold under the contract were installed by Taxpayer and became realty upon installation (e.g., underground storage tanks, underground lines, pumps set in concrete). The auditor acknowledged that the taxpayer had paid
the applicable tax at the time it purchased the tangible personal property in question, but would not allow a credit for those payments. He asserted that the taxpayer had to go back to his vendors for a refund of those overpayments. See 23 VAC 10-210-3080 (returned goods). See also 23 VAC 10-210-3040 (dealer’s refunds net of dealer discount).

The gas station equipment, once installed, loses its character as tangible personal property and becomes realty. See Transcontinental Gas Pipeline Corp. v. Prince William County, 210 Va. 550, 172 S.E.2d 757 (1970); Danville Holding Corp. v. Clement, 178 Va. 223, 16 S.E.2d 345 (1941). Under Virginia law, a contractor is “any person who contracts … to perform construction, reconstruction, installation, repair or any other service with respect to real estate or the fixtures thereon…” Va. Code Ann. § 58.1-610. The Department has repeatedly acknowledged that contractors are deemed the taxable users and consumers of tangible personal property that they purchase or furnish in connection with the construction, installation, repair or maintenance of real property, including tangible personal property that becomes realty upon installation. See, e.g., 23 VAC 10-210-410A. Therefore, there should be no basis for assessing sales tax with respect to the transfer of the gas stations to Taxpayer’s customers. Note, however, that auditors are trying to split real estate contracts apart, for example, treating the gas pump as personalty and the underground tanks to which they are attached as realty. Because they are integral parts of a system that is adapted to the use of the land, even the gas pumps (integrated computer system too) should be real estate fixtures under Transco and Danville Holding Co.

If a taxpayer collects sales tax, even erroneously, he is required to remit the same to the State. Va. Code Ann. § 58.1-625. Be careful with billing statements.

As to requiring the taxpayer to go back to vendors for refunds of overcollected tax, how can that be fair? If nothing else, it is contrary to the concept of a sample audit in which only a
sampling of vendors is made. Although the Department has problems with the dealer discount and allocating localities' share of refunds, that should not be the taxpayer's problem. Note that all the statutory procedures (including amended returns and suits) are available notwithstanding auditors' position. Virginia Code § 58.1-1120 provides, in part:

1. "Person assessed with any tax," with standing to contest such assessment, shall include the person in whose name such assessment is made, a consumer of goods who ... has paid any sales or use tax assessed against a dealer ....

Be sure to file a simultaneous refund claim with the auditor and watch the statute of limitations if waivers are signed.

C. Business, Professional and Occupational License Tax

1. Assembly of Custom Computer Equipment

Taxpayer supplies local area networks, computers, software, peripherals, and consulting services to its clients. It makes the computer equipment that it sells by acquiring components from the original equipment manufacturers and putting them together to meet the client's specifications. It also incorporates the required programming software, and transfers the finished product to the client.

In P.D. 98-40 (March 5, 1998), the Commissioner ruled that Taxpayer's activity constituted assembly, not manufacturing or processing. This is significant because localities are precluded from levying BPOL taxes on manufacturers. In the Commissioner's view, manufacturing activity has three elements: (1) an original material, (2) is processed and (3) changed substantially into a product of a different character from the original material. He ruled

[T]he procedure of putting the OEM parts together into a personal computer or server is not "manufacturing" or even "processing." Specifically, there are no second and third elements to complete a three-element analysis – no process (the second
element) caused substantial transformation of the original material (third element).

Note that this conclusion is contrary to the holding of *Fairfax County v. DataComp*, 36 Va. Cir. 60 (1995), wherein the court held that the assembly of computer components and peripherals constituted manufacturing. It is also contrary to the *BPOL Guidelines*, Appendix B.

Why isn’t “assembly” a process? It is clearly a procedure applied to the original materials that makes them more useful.

Ruling is under reconsideration.

D. **The Hard Sell for the Sales Tax “Occasional Sale” Exemption in M&A Transactions.**

1. **Steuart Petroleum Explodes Virginia Tax Department’s Hardline Position in Sales Tax Cases.**

   a. **Holding.** On February 4, 1998, In *Steuart Petroleum v. Virginia Department of Taxation* (No. CL 1390-4) (Petition for Appeal denied July 29, 1998) the trial court held that the Virginia Department of Taxation erroneously levied the 4½% state sales tax on Steuart’s sell-off of its 24 Virginia convenience stores that it sold to five separate purchasers over nine months in 1994 and 1995. Unless appealed, the Department must now refund to Steuart more than $150,000 in sales tax and interest collected on the store sales.

   b. **Background.** Under Virginia law, not only sales of inventory, but virtually any sale of equipment by a business is subject to a 4½% sales tax unless the sale is otherwise exempted. The key sales tax exemption for businesses having to dispose of capital assets is the "occasional sale" exemption. The concept of exempting so-called "occasional sales" from sales tax is that such sales are infrequent and not in the ordinary course of business.
Consistent with this concept, Virginia law expressly defines occasional sales to include the liquidation or sale of all (or substantially all) the assets of a business. See Va. Code § 58.1-602.

c. **More Than Three Strikes, You’re Out.** The Department of Taxation’s long-held position has been that any such sale or liquidation of a business must be accomplished in not more than three transactions in order to qualify for the "occasional sale" exemption.

d. **Trap for the Unwary.** Armed with this hardline view and the usual deference courts accord the Department in tax exemption cases, the Department routinely imposes the 4½% sales tax on businesses selling off capital assets, regardless of whether the sale is pursuant to a liquidation or a sale of all the assets, if the liquidation or sale takes more than three transactions to finish. This hardline position has long been a trap for unwary business owners and advisors who fail to plan for the sales tax liability or do not structure the sell-off to meet the Department’s "three or fewer" rule.

e. **Three or Fewer Is Only One Test.** In Steuart Petroleum the trial court completely rejected the Department’s "three or fewer" test for occasional sales of business assets. Despite the fact that Steuart Petroleum as the taxpayer bore the burden of proof at trial and tax exemptions are strictly construed against the taxpayer, the Court was persuaded that the Department’s "three or fewer" rule was not part of the definition of "occasional sale" applicable to business liquidations and asset sales. Both the Virginia statute and the Department’s own regulation provide that a business liquidation or sale of all (or substantially all) of a business’ assets are occasional sales. The Court pointed out that the statute and regulation reference the actual number of sales as material but do not specify that the "three or fewer" test is the maximum allowable. The "three or fewer" definition is a stand-alone alternative definition of
occasional sale and is applicable to anyone in any circumstance, e.g., yard sales. Thus, the Court reasoned that the "three or fewer" limitation was not part of the test in cases of business liquidations and sales. Further, both the law and the Department’s regulation require the Department to also consider the "scope" and "character" of a liquidating transaction or sale of assets when determining a business transaction’s status as an occasional sale.

f. Now The “Scope and Character” Test. Given this broader focus on "number, scope and character," the Court reasoned that Steuart’s sell-off of its entire line of Virginia convenience stores over a nine month period to only five purchasers was still in “number, scope and character” both a complete liquidation of that business and a sale of substantially all of its assets. Particularly persuasive to the trial court in Steuart Petroleum was evidence at trial that the five sales were part of an “orderly liquidation” of the taxpayer’s convenience store business in Virginia. The Department conceded that Steuart’s ongoing operations of stores outside Virginia were not relevant to testing the occasional sale status of the store sales in Virginia. Thus, the overall transaction qualifies as an occasional sale given the limited number, scope and character of the store sales even though the “three or fewer” test was not met. Judge Markow stated:

The defendant’s over broad application of the “three or fewer” provision to all types of occasional sales ignores the clear construction of the regulations. The term “occasional sale” may also be read to include the sale of all the assets of any business and the liquidation of any business.

* * *

The scope and character of these sales surely falls within the intent of the General Assembly to shield such transactions from sales tax. The number (five) and time frame (nine months) of sales collides with a single alternative subsection of VDT’s regulations [i.e., the three or fewer test]. This sale/liquidation may not be denied an
exemption solely by virtue of the defendant’s misguided application of the “three or fewer” provision.

2. **No Occasional Sale for Sell-Off of 8 Hotels to 8 Buyers in 8 Closings Over 8+ Months.**

   a. **Facts.** Taxpayer is a Virginia hotel which began its operation by purchasing the assets of an existing hotel – land, buildings, and tangible property – from the Seller. The Seller is a limited partnership which was formed primarily by a major credit corporation and a major investment firm. The Seller was formed to liquidate properties which were acquired by its partners through foreclosure and bankruptcy proceedings.

   The properties owned by the Seller include eight Virginia hotels. The Seller held certificates of registration for these hotels. In the instant case, the hotel was run by a management company hired by the Seller. The hotels were operated for periods ranging from 5 months to 18 months prior to each being sold. The Seller eventually sold all its Virginia hotels. The sales were made to eight separate buyers in eight separate transactions beginning in August 1995 and culminating in February 1996.

   b. **Hardline Ruling.** The Department’s awkward 3-step conclusion deserves mention. First, the Department ruled that the Seller held certificates of registration to collect and remit the Virginia sales tax on the sale of hotel accommodations. Thus, the tangible personal property sold to the Taxpayer as part of the hotel sale was held or used by the Seller in a registerable activity and therefore taxable.

   Secondly, the Department ruled on “number, scope, and character.” Since the sale of one hotel to the Taxpayer was one of a series of sales of hotels, these multiple sales were sufficient in “number, scope, and character” to require the holding of a certificate of registration. But see Steuart Petroleum, above.
Thirdly, the Department attacks the "business" of the Taxpayer. Here, because the Seller was a special purpose partnership the Department was able to argue that its sole business was selling hotels even though the hotels were operated by the Seller for a year or so. Thus, the seller's inventory was the hotels. Query whether this special purpose partnership had sold off the hotels to one buyer, whether the Department would prevail. P.D. 98-11, January 20, 1998.

3. Sale of One Hotel Out of Two Hotel Group Not Exempt and Penalized Too.

The taxpayer operated two Virginia hotels during the audit period. One of the hotels was sold in June 1996, and the taxpayer remained in business with the remaining hotel. distinguished from prior rulings in which taxpayers had disposed of separate and distinct activities of multifaceted business operations as in P.D. 85-149 (7/11/85) in which the taxpayer operated a clothing division and a food division.

In this case, however, the taxpayer operated two hotels, but did not operate "separate activities of a multifaceted business operation." As such, the sale of a single location does not constitute the sale of all or substantially all of the taxpayer's assets.

a. Penalty on the Sale For Prior Low Compliance. Penalty is generally not assessed on first audits. Penalty is assessed on purchases if the compliance ratio is below 60 percent for second audits and below 85 percent for third and subsequent audits. I understand that the current audit is the third audit of the taxpayer. While the compliance ratio on sales made by the two hotels was sufficiently high to avoid penalty charges, the compliance ratio for purchases was less than one percent. Accordingly, the penalty charges were assessed.

4. Sale of Separate Division: Department Sticks to the Hardline. In P.D. 98-38 the Department lists five factors for division sale to be occasional sale. The Taxpayer's
operations primarily involve the refining of petroleum which results in the production of heating oil and gasoline as end products for sale or resale. The Taxpayer found that quality control was a critical factor in the production of its product and, as a result, formed its laboratory division in 1994 to perform the quality control functions. Subsequently, in 1996, the Taxpayer ceased its laboratory operations, selling its interest to a third party. The Department's audit assessed tax on the seller for the sale of tangible personal property to the third party.

In previous decisions by the Department, the occasional sale exemption has been granted to organizations whose sales of internal divisions were completely independent from the remainder of the business, but the Department lists these five factors as the acid test.

a. **Each division must have a completely separate set of books which are separately maintained; separate bank accounts must be maintained.** "While the laboratory division had separate checks with its own logo, the actual checking account is the same checking account owned by the corporation. Funds drawn or deposited to the checking account affect the cash balance available to the laboratory as well as the corporation. Financial reports were prepared by the laboratory; however, the laboratory’s financial information was incorporated into the total financial report for the corporation’s primary business.

The liquidation of the laboratory’s assets was not total, as some of the equipment was retained by the corporation. Additionally, the auditor indicates that after the asset transfer, the asset account reflects a reduction of the overall assets of the corporation, and not just those of the laboratory.”

b. **Employees must be active in only one division.** "The manager of the laboratory, while a separate manager from the remainder of the corporation, answered to the executive management of the corporation. The executive management of the corporation..."
maintained decision-making power regarding the laboratory’s direction and expenditures, and made the decision to sell the laboratory division."

c. Divisions must be separately housed. The laboratory was located in a separate area of the corporation’s facility.

d. Each division must have its own fixed assets which are not used interchangeably.

e. Sale of assets not held or used by the seller in an activity for which it is required to hold a certificate of registration. “As the laboratory operations are not separate and distinct from the corporation, I also find that the assets in question were inextricably linked to the production process of the Taxpayer. The laboratory’s assets, given the highly specialized nature of the corporation’s product, were used to perform an integral quality control function in the marketable product, for which the Taxpayer was required to hold a registration certificate.”


5. How to Do It Right: Incorporation of Subsidiary Followed by its Spin-Off, and Then its Liquidation Is a Reorganization and, Therefore, Not Sales Taxable. The transfer in kind of assets from a first tier sub to parent or asset purchaser may be taxable as not meeting the “occasional sale” test if the first tier sub still continued in business. The Taxpayer proposes a corporate reorganization to shift all aspects of operating the stores held by its wholly owned subsidiary to the Taxpayer. To this end, the Taxpayer and the Subsidiary will conduct a series of transactions. First, the Subsidiary will form a new corporate subsidiary (“New Company”) and contribute to New Company all of the assets used by the Subsidiary in the stores in exchange for all of the stock of New Company. This transaction is a tax free reorganization under Internal Revenue Code § 351. The Subsidiary will then distribute all of the stock of New Company to the
Taxpayer as a dividend. [The Subsidiary could also have sold the New Company stock to a third party.] Finally, the Taxpayer will liquidate New Company and receive all of the assets in New Company. The first transaction between the Subsidiary and New Company is a tax exempt reorganization of assets used for stock in the commencing organization. The second transaction, as it is a stock dividend, does not entail any transfer of tangible personal property. The final transaction is a liquidation of all the assets of New Company. This transaction is a qualifying liquidation under the occasional sale exemption as it represents the “sale or exchange of all or substantially all the assets” of New Company.