

REDACTED DECISION – DK# 19-301 CORP. INCOME

**BY: A.M. “FENWAY” POLLACK, CHIEF ADMINISTRATIVE LAW JUDGE
SUBMITTED FOR DECISION ON JUNE 6, 2022
DECISION ENTERED ON AUGUST 18, 2022**

FINAL DECISION

On May 22, 2019, the Auditing Division of the West Virginia State Tax Commissioner’s Office (hereinafter “the Tax Department” or “the Respondent”) issued an Audit Notice of Assessment, against the Petitioner, Company A (“the Petitioner” or “Company A”). This assessment was issued pursuant to the authority of the State Tax Commissioner, granted to him by the provisions of Chapter 11, Article 10 *et seq.*, of the West Virginia Code. The assessment was for corporate income and franchise tax for the period of January 1, 2015, through December 31, 2017, for tax in the amount of \$_____, additions to tax in the amount of \$_____, and interest in the amount of \$_____, for a total assessed tax liability of \$_____. Written notice of the assessment was served on the Petitioner, as required by law. Thereafter, on July 26, 2019, the Petitioner timely filed with this Tribunal, the West Virginia Office of Tax Appeals, a petition for appeal. *See* W. Va. Code Ann. §§ 11-10A-8(1); 11-10A-9 (West 2010). Subsequently, notice of a hearing on the petition was sent to all parties, and an evidentiary hearing was held on December 14, 2021, at the conclusion of which the parties filed legal briefs. The matter became ripe for a decision at the conclusion of the briefing schedule.

FINDINGS OF FACT

1. The Petitioner is a Delaware corporation, with its principal place of business being [REDACTED], [REDACTED]. The Petitioner is in the business of the research and development of pharmaceutical products and the sale of the same. The Petitioner operates worldwide, and has hundreds of subsidiaries.

2. When the Petitioner filed its 2015 West Virginia income tax return¹ one of the attachments was a Schedule UB-3.² See State's Ex. 3. This Schedule UB-3 combines the adjustments, both upward and downward that West Virginia allows for certain entities to make to their West Virginia taxable income. Specifically, lines 2a through 2l are where Taxpayers list amounts that would increase their West Virginia taxable income. Lines 4a through 4j are where Taxpayers list amounts that would decrease their West Virginia taxable income. In this case, for tax year 2015, on line 4f, the Petitioner listed \$_____ as its taxable income from sources outside the United States. On line 4d, it listed its foreign dividend gross up, pursuant to Internal Revenue Code Section 78, as \$_____. Finally, on line 4e, it listed its Subpart F income, pursuant to Internal Revenue Code Section 951, as \$_____. The Petitioner added up these three (3) amounts and came up with a decreasing adjustment amount of \$_____.³

3. On the increasing adjustments portion of the UB-3 the Petitioner made various adjustments (not relevant to the arguments between the parties) totaling \$_____.

4. Finally, the Petitioner, following the instructions on the UB-3, took its federal taxable income of \$_____, added its increasing adjustment of \$_____ (from finding of fact #3), for a total of \$_____. Then, again following the instructions, the Petitioner deducted its decreasing

¹ While this matter involves tax years 2015-2017, for simplicities sake, most of the exhibits and testimony only involved tax year 2015. However, it is clear that the same factual and legal arguments would apply to tax years 2016 and 2017.

² While this matter has numerous exhibits, three documents make up the bulk of the discussion. The first, the UB-3 is a West Virginia state tax form, and is a schedule for calculating West Virginia taxable income for combined groups pursuant to West Virginia Code Section 11-24-6. The second document is the Petitioner's Federal income tax return, referred to as its 1120. It apparently comprises hundreds or perhaps thousands of pages, but for the purpose of this matter only two pages were utilized, the first page of the return and one other page labelled, Schedule C. Finally, there is the Petitioner's Federal form 1118, which is a form corporate taxpayers utilize to support and explain foreign tax credits.

³ For those following along mathematically, this amount is actually \$_____ more than the three (3) sums listed above. Line 4a of the Petitioner's UB-3 contain this amount, which was also added in. However, this \$_____ is not part of the dispute between the parties.

adjustment (from finding of fact #2) of \$_____. Once these adjustments were made the Petitioner had an adjusted West Virginia taxable income of (\$_____). ($\$_____ - \$_____ = (\$_____)$).

5. Between December of 2018 and May of 2019 an auditor employed by the Tax Commissioner undertook an audit of the Petitioner. Tr. P91 at 2-6.

6. During the audit the auditor was of the opinion that some of the figures on the Petitioner's UB-3 discussed in findings of fact numbers 2-4 above were incorrect, and violative of West Virginia tax law. As such, she made changes, which resulted in a new West Virginia taxable income amount for the Petitioner.

7. Specifically, the auditor reviewed an attachment to the Petitioner's federal tax filings called a Form 1118. From this form she determined that instead of having \$X in foreign source income, (finding of fact #2) the figure was actually \$Y. Tr. P70-71 and State's Ex. 4.⁴

8. The auditor took this \$Y foreign source income amount and subtracted the two amounts from lines 4d and 4e of the Petitioner's UB-3 discussed in finding of fact #2 above. Specifically, she took the foreign dividend gross up of \$_____, and the Subpart F income of \$_____ and subtracted them from her re-calculated foreign source income amount of \$Y. Mathematically this created a foreign source income loss on the part of the Petitioner in the amount of ($\$_____$). ($\$Y - \$_____ - \$_____ = (\$_____)$).⁵

⁴ State's Ex. 4, the Form 1118 is approximately 52 pages. The auditor used two figures to arrive at the \$Y foreign source income amount. She added \$_____ from bates stamped page 277 and \$_____ from bates stamped page 299. The figure from page 277 represents the Petitioner's passive category foreign income, less deductions. The figure from page 299 represents the Petitioner's general category foreign income, less deductions.

⁵ At this point, those following along closely might well be going "huh?", because, as discussed in findings of fact #2 and #8, the Petitioner **added** its UB-3 lines 4d and 4e to its foreign source income, while the auditor **subtracted** those amounts from the Petitioner's foreign source income. Unfortunately, the testimony and evidence does not clear up this confusion. It appears that the Petitioner properly followed the UB-3 instructions when it added them and the auditor testified that she subtracted them precisely because the Petitioner added them. Tr. P132-133 at 17-11. No evidence or testimony was advanced as to why the UB-3 directs Taxpayers to add them, which is puzzling, because, as will be discussed in greater detail below, the law of this case, West Virginia Code Section 11-24-6 directs that the line 4d and 4e amounts be subtracted from foreign source income.

9. Once she arrived at this negative \$_____ figure, the auditor applied West Virginia Code Section 11-24-6(b)(6), which dictates that for West Virginia corporate income tax purposes, a net operating loss from sources without the United States shall be added to a corporate taxpayer's federal taxable income. This addition to the Petitioner's income led in part to the assessment at issue, and the dispute between the parties.

10. Since the filing of its appeal the Petitioner and the Tax Commissioner have undertaken settlement negotiations, the result of which has led to modified amounts in controversy. These new amounts were proffered from the Tax Commissioner's counsel. For tax year 2015, the amount of tax in controversy went from \$_____ to \$_____. For 2016, the amount of tax in controversy went from \$_____ to \$_____, and for 2017, the amount of tax in controversy went from \$_____ to \$_____. Moreover, the Tax Commissioner agreed to waive the additions that had been assessed. Tr. P3 at 10-19.

DISCUSSION

The law of this matter is contained in West Virginia Code Section 11-24-6, which states:

§ 11-24-6. Adjustments in determining West Virginia taxable income

(a) *General.* -- In determining West Virginia taxable income of a corporation, its taxable income as defined for federal income tax purposes shall be adjusted and determined before the apportionment provided by section seven of this article, by the items specified in this section.

(b) *Adjustments increasing federal taxable income.* -- There shall be added to federal taxable income, unless already included in the computation of federal taxable income, the following items: . . . (6) Any amount included in federal taxable income which is a net operating loss from sources without the United States **after making the decreasing adjustments provided in subdivisions (5) and (7), subsection (c) of this section** for Section 951 income and Section 78 income. Federal taxable income from sources without the United States shall be determined in accordance with the provisions of Sections 861, 862 and 863 of the Internal Revenue Code of 1986, as amended; . . .

(c) *Adjustments decreasing federal taxable income.* -- There shall be subtracted from federal taxable income to the extent included therein: . . . (9) Any amount included in federal taxable income which is foreign source income. Foreign source income is any amount included in federal taxable income which is taxable income from sources without the United States, **less the adjustments provided in subdivisions (5) and (7) of this subsection.**

W. Va. Code Ann. § 11-24-6 (West)(emphasis added). Neither party argues that Section 6 is ambiguous. Therefore, as is our mandate we will apply it as written and give the words their plain and ordinary meaning. *See e.g. Foster Found. v. Gainer*, 228 W. Va. 99, 717 S.E.2d 883 (2011) (Statutes whose language is plain must be applied as written, while those whose language is ambiguous must be construed before they can be applied).

The Subdivisions (5) and (7) adjustments highlighted above, state:

(c) *Adjustments decreasing federal taxable income.*-- There shall be subtracted from federal taxable income to the extent included therein: . . . (5) The amount required to be added to federal taxable income as a dividend received from a foreign (non-United States) corporation under Section 78 of the Internal Revenue Code of 1986, as amended, by a corporation electing to take the foreign tax credit for federal income tax purposes; . . . (7) The amount included in federal adjusted gross income by the operation of Section 951 of the Internal Revenue Code of 1986, as amended[.]

Id.

Before the arguments of the parties are specifically addressed, it should be noted that the approach taken in this matter was ill advised. The Petitioner attempted, in a four (4) hour hearing, to explain to an ALJ who is not an accountant, the corporate tax filings of a multinational corporation, having tens of billions of dollars in sales, with hundreds of subsidiaries and international affiliates. The Petitioner was unsuccessful in this effort. As will be discussed in greater detail below, the Petitioner may have prevailed in this matter, had it called an accountant who is well versed in complex corporate tax filings. If such a witness had testified that the Tax Commissioner's audit violated generally accepted accounting principals, with exhibits, such as textbooks or other educational materials, perhaps our decision would be different. Instead, this

Tribunal was presented with a classic “he said, she said” argument, with each party arguing “this is how you do it” or “my number is the right number”. Again, as will be discussed below, this Tribunal was presented with no competent evidence to prove, from an accounting standpoint, whose argument was correct. Nonetheless, we will address the Petitioner’s arguments in turn.

By its clear language, Section 6 deals with adjustments, both upward and downward to a corporate Taxpayer’s federal taxable income. Subsection (b) contains the adjustments that increase that income, and Subsection (c) contains those that decrease that income. Both subsections contain adjustments based upon the Taxpayer’s business outside of the U.S., (b) concerns losses from business outside of the U.S. and (c) concerns gains from those sources. This brings us to the main complaint of the Petitioner, namely that they made money overseas, and that the auditor turned those gains into a loss. Starting with the prehearing in this matter, and continuing all the way through the last post-hearing brief, the Petitioner was quite insistent on this point.

ATTORNEY [REDACTED] . . . So, the key to this, Your Honor, is that [Company A] did not have a net operating loss from foreign sources. Therefore, there is no need to increase the West Virginia taxable income for any reason, and if the returns that were filed are correct, now, you know--- that’s going to be the position of [Company A].

Tr. P11 at 17-20.

ATTORNEY [REDACTED]: Okay. And so, it is your testimony today that, on the 1120, we’re showing that there is no deduction included in our Federal taxable income from an operating loss from sources outside the United States?

MR. [REDACTED]: That’s correct.

Tr. P16 at 7-10.

ATTORNEY [REDACTED]: Mr. [REDACTED], for the 2015 tax year for [Company A] and its subsidiaries, did it have a net operating loss from sources outside of the United States?

MR. [REDACTED]: In the \$_____ of taxable income, Line 30, there was no foreign loss included in that number. So, no.

ATTORNEY [REDACTED]: All right. Nothing else, Your Honor.

Tr. P21-22.

JUDGE POLLACK: Go ahead. Say that again, Ms. [REDACTED].

MS. [REDACTED]: Yes, sir. It goes Form 2H under the increase and adjustments as net operating loss from sources outside the United States. What you're looking at is the form as we filed it, which has a zero, because we said we did not have a net operating loss from foreign source.

Tr. P55 at 3-7.

This Tribunal finds the Petitioner's insistence on this point quite baffling, because no one, including most importantly the auditor in this matter, stated that the Petitioner had losses from sources outside the U.S. In fact, for just tax year 2015, the auditor attributed \$Y of the Petitioner's income to sources outside of the United States. *See* State's Ex. 4. What the Petitioner is really complaining about is how the auditor applied West Virginia Code Section 11-24-6. Due to the fact that everyone acknowledges the Petitioner had gains and not losses from sources outside the U.S., the Petitioner is really arguing that the auditor had no cause to perform the calculations contained in Subdivision (6) of Subsection (b). In plain English, because Subdivision (6) concerns losses from sources outside the U.S., the Petitioner argues that the auditor had no ability to utilize it. Instead, the Petitioner argues, albeit halfheartedly, that the auditor should have utilized Subdivision (9) of Subsection (c), which deals with gains from sources outside the U.S. We find this argument from the Petitioner halfhearted because it ignores the proverbial elephant in the room. The evidence in this matter shows that the auditor did precisely what the Petitioner is arguing she should have. Specifically, she took the Petitioner's \$Y in foreign income and subtracted the amounts discussed in Subdivisions (5) and (7) of Subsection (6). These amounts are colloquially called the Petitioner's "foreign dividend gross up" and its "Subpart F income". Surprisingly, both parties seem to agree on these two (2) amounts. A review of both State's Ex. 3 & 4 shows that the Petitioner listed these two amounts on its UB-3 as \$_____ and \$_____, respectively and the auditor used these exact amounts in her calculations.

So, this brings us the first, and largest problem with the Petitioner's argument in this matter. The Petitioner offers no explanation, nor analysis as to what the auditor was supposed to do, under West Virginia law, when she took the Petitioner's \$Y in foreign income, subtracted the Petitioner's "foreign dividend gross up" and its "Subpart F income", and **came up with a negative number**. To review, both Subdivisions (b) and (c) clearly and unambiguously tell the Tax Commissioner to take Taxpayer's foreign source income (or loss) and subtract the foreign dividend gross up and the Subpart F income. While these two (2) subdivisions may not be as crystal clear as a mountain stream, neither party argues that they are ambiguous. In this matter, the auditor took the resulting negative \$_____ amount and treated it as a net operating loss from sources outside the U.S. She then, following the language of Subdivision (b), used that amount as an adjustment increasing the Petitioner's federal taxable income. The Petitioner offers no alternative theory as to what the auditor was supposed to do with this negative \$_____ amount that was the result of her calculations. The Petitioner clearly wants the auditor to be operating in Subsection (c), because that is the subsection of Section 6 that **decreases** a Taxpayer's federal taxable income. However, by its plain language, a Taxpayer only gets this decrease if it has "any amount included in federal taxable income which is taxable income from sources without the United States, **less the adjustments provided in subdivisions (5) and (7) of this subsection**". It is the Petitioner's silence regarding what should be consequences of the adjustments in Subdivisions (5) and (7) creating a negative number that causes this argument to fail.

As one might expect, the Petitioner next argues that the auditor's determination that the Petitioner had \$Y in foreign source income was incorrect, and that its foreign income was really \$_____. Obviously, if the auditor had used this amount, and subtracted the Petitioner's foreign dividend gross up and Subpart F income, which totaled less than \$_____, then there would not be the negative \$_____ amount to be treated as a foreign loss (and accompanying increase under Subdivision (b)). There are numerous problems with the Petitioner's argument in this regard.

First, and foremost, while at first glance it appears that the parties are arguing about two different foreign source income amounts, (the Petitioner's \$X amount and the auditor's \$Y amount) there is a third, unexplained number. A review of the Petitioner's UB-3 for 2015 (State's Ex. 3) shows that on line 4f the Petitioner lists its taxable income from sources outside of the U.S. as \$____.⁶ The UB-3 is a document prepared by the Petitioner, as part of its West Virginia tax filings. During the evidentiary hearing and in post hearing briefs, no satisfactory explanation was given as to the origin of this number. To further complicate matters, in its post-hearing brief, the Petitioner alludes to both numbers in its proposed findings of fact. In proposed finding of fact number 36 the Petitioner states: "[T]he income from foreign sources was [\$____], which was included in federal taxable income that is related to all of the controlled foreign corporations, the disregarded entities, or the Partnerships. (Tr. Page 39)." See Petitioner's Brief p. 5. However, in proposed finding of fact number 45 the Petitioner states: "[P]ursuant to West Virginia Code § 11-24-6(c), the Petitioner then decreased the adjusted West Virginia taxable income by subtracting Taxable income from sources outside US of [\$____], as shown on Line 4f, Part 2 on West Virginia Schedule UB-3. (Tr. Page 53 and State's Exhibit 3)" See Petitioner's Brief p. 7.

Two of the Petitioner's witnesses testified regarding the origins of these differing amounts, however the testimony was less than illuminating.

ATTORNEY [REDACTED]: So, Mr. [REDACTED], as far as the foreign subsidiaries of [Company A] are concerned, all of their income --- all of --- well, scratch that. All of their activity is reflected on the Form 5471.

MR. [REDACTED]: Yes.

ATTORNEY [REDACTED]: And that, and that's that --- those 5471s then are --- sorry, Your Honor. Those 5471s are then

⁶ To compound the confusion in this matter, there is a **fourth** number in the record that purports to represent the Petitioner's foreign source income. That amount is \$____, and is show as "International Income from Continuing Operations" on Petitioner's Exhibit 3. There was brief testimony about this number during the evidentiary hearing. This testimony seems to suggest that this number may not represent **taxable income**. See Tr. P20.

combined that create the income from controlled foreign corporations under Subpart F, which is on Line 14 of Schedule C.

MR. [REDACTED]: Well, the Subpart F is determined on an individual CFC basis. And I just want to clarify, the---so, you have controlled foreign corporations, you have disregarded entities that are effectively underneath the controlled foreign corporations, and there's a handful of partnerships that do not file Form 5471s, but they have income that flows through to the 5471s. So, the 5471 ultimately does capture all the information and activity for the foreign subsidiaries.

ATTORNEY [REDACTED]: So, in reference to the taxable income that is related to all of the controlled foreign corporations, the disregarded entities, or the partnerships, that number is reflected on Schedule C.

MR. [REDACTED]: Correct. Schedule C, yeah, reflects the income that was determined to be taxable under Subpart F.

ATTORNEY [REDACTED]: Okay. And therefore, if we review the Schedule C for 2015 which is page 2 of Exhibit 2, that shows that at the end of the day there was a foreign source income of the combination of \$_____ plus?

MR. [REDACTED]: Correct.

Tr. P39 at 1-15.

JUDGE POLLACK: Okay. So, go ahead.

MS. [REDACTED]: All right. So, we're going to take subtractions for the foreign dividend gross-up, which we saw on that Schedule C, the \$_____. Subtract the subpart F, which again came from our Schedule C on the Federal return of \$_____. The calculation we made for foreign source was a \$X, but as reported, we came down and said once you take our foreign income out, we're left with a loss of \$Y. And that's the amount that is subject to tax in West Virginia.

JUDGE POLLACK: So, in other words, the \$____---is it both Lines 14 and 15 from your Schedule C, \$_____ and the \$_____?

MS. [REDACTED]: Yes, sir.

JUDGE POLLACK: You decreased your Federal adjusted gross income by those amounts?

MS. [REDACTED]: Yes, sir.

JUDGE POLLACK: On this form? And then your taxable income when you were done with that was, at least on Line 4F, was \$_____?

MS. [REDACTED]: The \$_____ is a different deduct---decreasing adjustment. That was our computation of whether we had a foreign

income or foreign loss left. We said we still have foreign income and so we put---backed out \$X. And when you go to page 2 of the return, for Line 6, you see that we ended up at a negative \$Y, and that was our West Virginia apportionable number. So, the number subject to tax.

Tr. P53 at 3-23.

A review of the exhibits does not clarify matters. The testimony from witness [REDACTED] matches the Petitioner's Federal 1120, Schedule C. It shows that the Petitioner took its foreign dividend gross up and its Subpart F income, added those two amounts with some other categories of dividends and took the total amount of \$_____ and moved it to line 4, labelled "dividends" on the first page of its 1120. *See* Petitioner's Ex. 2.

A review of State's Ex. 3 matches Ms. [REDACTED]'s testimony. As discussed above, in its West Virginia UB-3 filing the Petitioner took its foreign dividend gross up and its Subpart F income and added it to the \$X amount it identified there as taxable income from sources outside the U.S., and called the total its decreasing adjustments.

These documents and the testimony cited above show why the Petitioner cannot prevail on this argument. In its federal filing, it has one group of numbers that it claims represents its income from sources outside of the United States, as that term is used in West Virginia Code Section 11-24-6. In another document, it has an entirely different set of numbers that it claims represents the same thing.

Moreover, the Petitioner failed to rebut the testimony of the auditor, who testified that the number she utilized for the Petitioner's income from sources outside of the U.S. was arrived at by reviewing an entirely different Federal tax filing of the Petitioner's. The auditor utilized the Petitioner's Federal 1118, and testified that this document was the only place where she could properly do as the West Virginia Legislature directed, namely applying Sections 861, 862 and 863 of the Internal Revenue Code to determine foreign source income. W. Va. Code Ann. § 11-24-6(b) *supra*.

ATTORNEY [REDACTED]: Okay. Can you please explain what is occurring there on Line 1 of the worksheet?

MS. [REDACTED]: Okay. In code section 11-24-6B6, it tells me that the Federal taxable income from sources without the United States shall be determined in accordance with the provisions of sections 861, 862, and 863 of the Internal Revenue Code as amended.

ATTORNEY [REDACTED]: Okay. And of those three code sections, which of those three IRS code sections are really the ones that were --- I mean, it lists three, but the one that you really are dealing with in this case is which one?

MS. [REDACTED]: The meat of the code section 862 tells me the numbers that I need in determining this adjustment.

ATTORNEY [REDACTED]: Okay. So, that first number, that \$____. Where did you get that number from?

MS. [REDACTED]: I can find that on the Form 1118, which is an attachment to the Form 1120 of the taxpayer's Federal Tax Return.

ATTORNEY [REDACTED]: Okay. And let's just start there. You heard some discussion today about why taxpayer seems to think they should use the number off the 1120 for foreign source income, but you think we should use the number that comes off of the 1118. They're saying well the 1118 is, I think they referred to it as an informational return, and I think it was also referred to as the foreign tax credit form. Why is---why would the tax department use the Form 1118 as opposed to the 1120 for that beginning number?

MS. [REDACTED]: Well, the numbers that I need to come up with the definition of foreign taxable income from the sources outside the United States, they can't be found on the 1120. They can be found on the 1118.

ATTORNEY [REDACTED]: So, there's more information available to you on the 1118 regarding the foreign source income than is found on the 1120.

MS. [REDACTED]: Right.

ATTORNEY [REDACTED]: Is that correct?

MS. [REDACTED]: That is correct.

Tr. P63-64.

This Tribunal is aware that it is unlikely that the Petitioner would inflate the amount of its income from sources outside the U.S.. Therefore, at first blush, one might be tempted to say,

“well, obviously they had \$_____ in foreign source income, no corporation is going to increase its income when the tax man comes calling”. This is why we find the testimony above from the auditor to be critical. As the auditor astutely explains, the West Virginia Legislature has given clear direction as to how to calculate foreign source income; **it must be determined in accordance with the provisions of Sections 861, 862, and 863 of the Internal Revenue Code of 1986.**

JUDGE POLLACK: So, how, how---where’s your authority to go to this 1118?

MS. [REDACTED]: I believe the Code Section.

JUDGE POLLACK: Which one?

MS. [REDACTED]: The 11-24-6---

JUDGE POLLACK: Uh-huh.

MS. [REDACTED]: ---B6.

JUDGE POLLACK: Uh-huh.

MS. [REDACTED]: Tells me that I can use the Sections 861, 862, and 863 to define my number.

JUDGE POLLACK: Right. Yes. I think we all agree that 861 is sources inside the U.S.

MS. [REDACTED]: Yes.

JUDGE POLLACK: And 863 is special rules, ---

MS. [REDACTED]: Yes.

JUDGE POLLACK: --- so that just leaves us with 862.

MS. [REDACTED]: Right.

JUDGE POLLACK: And it says, here’s what we consider gross income from sources without---outside the U.S. There’s nine categories. Then B says, and once you take these nine categories and add them all up, and we will let you take deductions, because we’re the generous IRS and we love corporations, and we will let you take these deductions, and then the rest is your income. Still not seeing anything about 1118.

MS. [REDACTED]: But the only source that I have to find those numbers, Your Honor, is the 1118. That’s the source document to find those---the income and those deductions that are allowed by the IRS---

JUDGE POLLACK: Okay.

MS. [REDACTED]: ---from sources outside the United States.

Tr. P101-102.

After this testimony from the auditor, the undersigned made other attempts to clarify why the auditor's reliance on the 1118 was misplaced, and how the Petitioner's \$_____ amount comported with the directives of West Virginia Code Section 11-24-6(b)&(c).

JUDGE POLLACK: So, give me the fifth grader's version. If she has to go to the 1118, what should she have done differently?

MR. [REDACTED]: I think you have to go and use the gross numbers.

JUDGE POLLACK: And where are those gross number?

MR. [REDACTED]: So, the Schedule A.

JUDGE POLLACK: Are we still on Page 299?

MR. [REDACTED]: Column 8.

JUDGE POLLACK: Okay.

MR. [REDACTED]: Correct.

JUDGE POLLACK: I see \$_____.

MR. [REDACTED]: Right.

JUDGE POLLACK: Take that number and do what with it?

MR. [REDACTED]: You could back out the Section 78 gross-up and Subpart F from the 1120.

JUDGE POLLACK: Lines 14 and 15 from your Schedule C, 2015 Return?

MR. [REDACTED]: Right.

JUDGE POLLACK: Instead, Ms. [REDACTED] took those, Line 14 and 15, numbers from your Schedule C, and backed them out of the \$_____?

MR. [REDACTED]: Correct. In addition to that, the 1120 amounts include U.S. source income that aren't reflected on the 1118.

JUDGE POLLACK: Which 1120 amounts are you talking about?

MR. [REDACTED]: The Section 78 gross-up and the Subpart F.

JUDGE POLLACK: Those are not just foreign source amounts?

MR. [REDACTED]: Right. There's a portion that's U.S. source that doesn't go into the foreign tax credit calculation, so they're

excluded from the 1118. Your foreign tax credit is based on your foreign source income only. The Schedule C includes all types of income, U.S. and foreign.

JUDGE POLLACK: Well, but Lines 14 and 15 say income from controlled foreign corporations under Subpart F and foreign dividend gross-up. It doesn't say anything about domestic.

MR. [REDACTED]: So, it's just the sourcing of the income. So, an example would be if we have a controlled foreign corporation that makes a loan to the U.S. So, the U.S. pays interest to that controlled foreign corporation. So, that type of income is U.S. source. So, the IRS is not going to allow you to use that U.S. source income on your 1118 to potentially increase your foreign tax credit. So, it's not included on the 1118.

JUDGE POLLACK: But it is on the Schedule C?

MR. [REDACTED]: Yes.

JUDGE POLLACK: Under which line, 14 or 15? I guess 14?

MR. [REDACTED]: And it's going to be in both numbers. So, you could have a gross-up that's U.S. source also.

JUDGE POLLACK: But yet I thought earlier today we agreed that \$_____ was [Company A]'s foreign source income?

MR. [REDACTED]: That---it's income from foreign entities, but it's basketed---there's passive, general, and U.S. basketing of the income.

JUDGE POLLACK: Okay. All right.

MR. [REDACTED]: I know it's very complicated.

JUDGE POLLACK: Yeah, and I'm curious to know how, not just me, but any reviewing court is going to make heads or tails out of this. Mr. [REDACTED], Mr. [REDACTED], I don't know if you're going to be able to pull rabbits out of your hats in your briefs, 'cause this---without anybody reviewing, none of them are going to be accountants. Much of it is going to be gibberish to them. I mean, I'm looking at the documents while the people are testifying and I'm understanding most of it, but not all of it.

Tr. P121-123.⁷

⁷ This Tribunal does not normally insert large portions of hearing transcripts in its decisions. In this matter, we do so to demonstrate the confusion that arose as a result of the Petitioner's attempts to explain its federal tax filings in a four (4) hour hearing.

In its post-hearing brief, the Petitioner again argues that the auditor's reliance on the figures in its 1118 was misplaced, stating:

The Auditor further stated that she considered the Form 1118 as a source document instead of a tax form and that she was unaware that the income and expense numbers that are contained in Form 1118 are based upon I.R.C. §§ 861, 862, 863, 864, 865, 901 and 904 because this Form is used for purposes of determining Foreign Tax Credits and not Income.

Because the Auditor failed to review source documents and relied upon numbers that were specifically generated and created for the purpose of determining Foreign Tax Credits, she determined that there was a [substantial] net operating loss from sources outside the United States. She erroneously reached this conclusion despite the fact that it is clearly shown on both the U.S. Federal Tax Form 1120 and the SEC 10-K form that the Petitioner in fact had substantial net income from sources outside the United States. (Petitioner's Exhibits 2 and 4) As discussed below in Section IV-C, the auditor also failed to account for the fact that she had adjusted income to include \$_____ of Subpart F income.

See Petitioner's Brief p.14.

We find this argument from the Petitioner to be unpersuasive, due in large part because it merely reiterates the underlying complaint that forms the basis of this matter. As discussed above, this Tribunal is aware that the Petitioner argues that it did not lose money overseas, and that it disagrees with the auditor's calculations that, pursuant to West Virginia Code Section 11-26-6(b), led to a \$_____ upward adjustment in its Federal taxable income. However, reiterating those arguments on page 14 of its post-hearing brief does not rebut the auditor's testimony that the only way for her to determine the Petitioner's foreign source income **pursuant to IRC Section 862**, was to utilize the Petitioner's 1118.

Finally, we would note that both the 1120 and the 1118 are federal tax documents prepared by the Petitioner. The portion of the 1120 entered into evidence at hearing consists of two pages, while the 1118 is over fifty pages. By definition, the 1118 clearly contains more detailed information regarding the Petitioner's income from foreign sources.

Despite the discussion above, this Tribunal recognizes the possibility that both parties are correct. Perhaps the Petitioner may well have had a total of \$_____ in overseas income. At the same time, when IRC Section 862 is utilized perhaps that foreign income amount becomes \$_____. We cannot be certain, because, again, the Petitioner did not offer testimony from an accountant, utilizing GAAP, to explain the difference in the numbers. This Tribunal rules that the auditor's testimony in regards to her utilization of the Petitioner's 1118 was not effectively rebutted.

The Petitioner's final argument again concerns the auditor's application of West Virginia Code Section 11-24-6(c)(7). As discussed above, and is evidenced by the auditor's worksheet, (State's Ex. 4), the auditor took her \$_____ foreign income amount and subtracted the Petitioner's foreign dividend gross up and its Subpart F income. Again, as discussed above, the parties seem to agree that the Petitioner's Subpart F income amount for 2015 was \$_____. In fact, it can be said definitively that this \$_____ is correct, because the Petitioner listed that amount on line 14 of Schedule C of its Federal 1120 and on line 4e of its West Virginia UB-3. Now, in post-hearing briefs, the Petitioner argues that pursuant to West Virginia Code Section 11-24-13(5), the amount the auditor should have subtracted was really \$_____. The Petitioner argues as such because it claims that the remainder of the \$_____ of Subpart F income, namely \$_____, was already included in its West Virginia base, pursuant to West Virginia Code Section 11-24-13(5). Actually, the Petitioner makes this argument twice in its post hearing brief. First, on page 11 it states:

The West Virginia auditor computed the includable foreign source income of these controlled foreign corporations to be [\$_____] and made an adjustment to include that amount in the Taxpayer's West Virginia return under the [REDACTED] provisions. That amount was computed by taking the total Subpart F income of [\$_____] and reducing it by U.S. earnings that are invested in U.S. properties and the income from U.S. territories included in Subpart F . . .

See Petitioner's Brief P.11.

The Petitioner repeats this argument on page 16 of its post-hearing brief.

[Company A]’s West Virginia taxable income based was not reduced by \$_____ for Subpart F income, because [Company A] was required to include \$_____ of Subpart F income in its base pursuant to West Virginia Code § 11-24-13(5). **As clearly demonstrated below**, [Company A]’s West Virginia taxable income base prior to the Auditor’s Foreign source loss adjustment under West Virginia Code § 11-24-6(b)(6), included a net Subpart F inclusion of \$_____.

Subpart F Income Excluded from WV Taxable Income Base

Subpart F income deducted under 11-24-6(c)(7)	aaa
Subpart F income added back under 11-24-13f(a)(5)	(bbb)
<hr/> Net Subpart F Subtracted on the WV Return	<hr/> ccc

See Petitioner’s Brief P.16. (emphasis added).

This Tribunal finds this argument to be particularly unfounded. The Petitioner’s use of the phrase “as clearly demonstrated below” is puzzling. While the \$_____ amount that purportedly was added back under 11-24-13f(a)(5) may be “clearly demonstrated” in the Petitioner’s post hearing brief, a review of the transcript shows that no testimony was presented regarding this argument. Nor was this argument addressed during the pre-hearing conference held in this matter. It should be noted that during the evidentiary hearing there was testimony from both parties regarding the auditor’s use of both “gross” and “net” numbers from the Petitioner’s 1118. Due to the Petitioner’s failure to utilize the expertise of an accountant well versed in complex multinational tax filings, it is impossible to say for certain if the “gross” versus “net” testimony presented at hearing is even the same argument as contained in pages 11 and 16-17 of the Petitioner’s post-hearing brief. The arguments appear to be related, but it cannot be said for certain. One thing is certain, this \$_____ amount that allegedly was already part of the Petitioner’s base, was never discussed at hearing.

In summary, both parties agree that West Virginia Code Section 11-24-6 is clear and unambiguous. It provides both upward and downward adjustments to corporate Taxpayer’s federal

taxable income. The adjustments at issue in this case appear to be relatively simple. A Taxpayer takes their foreign income or loss, pursuant to IRC Section 862 and then subtracts its foreign dividend gross up and its Subpart F income. Once this simple math is done, if the Taxpayer has a loss that amount is added to its federal taxable income, (for West Virginia income tax purposes) and if the Taxpayer has a gain, then again (for West Virginia income tax purposes) that amount is deducted from its federal taxable income. Beginning with the prehearing conference in this matter, and continuing through to post-hearing briefs, the Petitioner embarked on a particularly ill-advised journey by its continued insistence that it did not have losses from sources outside the United States. The hearing in this matter would have been shorter and more focused had the Petitioner clearly and cogently stated that its dispute with the Tax Commissioner simply involved its contention that its overseas income was \$_____ versus the auditor's contention that the correct amount was \$Y. Based upon all of the evidence, we rule that the Petitioner failed to adequately prove that in determining its "[F]ederal taxable income from sources without the United States . . . in accordance with the provisions of Sections . . . 862 of the Internal Revenue Code of 1986" as that phrase is used in West Virginia Code Sections 11-24-6(b) & (c), the auditor mistakenly relied on the Petitioner's Federal Form 1118. Nor has the Petitioner met its burden of proving that the auditor failed to follow any statutory, regulatory or case law authority during her audit.

CONCLUSIONS OF LAW

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2010).

2. "The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any of the other articles of this chapter to which this article is applicable." W. Va. Code Ann. § 11-10-11(a) (West 2010).

3. For the purpose of ascertaining the correctness of any tax return or assessment and for the purpose of making an estimate of any taxpayer's liability for tax administered under this article . . . the tax commissioner shall have the power to examine or cause to be examined, by any agent or representative designated by the tax commissioner, any books, papers, records, memoranda, inventory or equipment bearing upon the matters required to be included in the tax return W. Va. Code Ann. § 11-10-5a (West)

4. Section 6 of Article 24, Chapter 11 of the West Virginia Code deals with upward and downward adjustments to corporate taxpayers' federal taxable income. (a) *General.* - In determining West Virginia taxable income of a corporation, its taxable income as defined for federal income tax purposes shall be adjusted and determined before the apportionment provided by section seven of this article, by the items specified in this section. W. Va. Code Ann. § 11-24-6(a)(West).

5. The adjustments increasing corporate taxpayers federal taxable income are contained in subsection (b). (b) *Adjustments increasing federal taxable income.* -- There shall be added to federal taxable income, unless already included in the computation of federal taxable income, the following items: . . . (6) Any amount included in federal taxable income which is a net operating loss from sources without the United States after making the decreasing adjustments provided in subdivisions (5) and (7), subsection (c) of this section for Section 951 income and Section 78 income. Federal taxable income from sources without the United States shall be determined in accordance with the provisions of Sections 861, 862 and 863 of the Internal Revenue Code of 1986, as amended; . . . W. Va. Code Ann. § 11-24-6(b)(6)(West).

6. The adjustments decreasing corporate taxpayers federal taxable income are contained in subsection (c). (c) *Adjustments decreasing federal taxable income.*-- There shall be subtracted from federal taxable income to the extent included therein: . . . (9) Any amount included

in federal taxable income which is foreign source income. Foreign source income is any amount included in federal taxable income which is taxable income from sources without the United States, less the adjustments provided in subdivisions (5) and (7) of this subsection. In determining “foreign source income”, the provisions of Sections 861, 862 and 863 of the Internal Revenue Code of 1986, as amended, shall be applied. W. Va. Code Ann. § 11-24-6(c)(9)(West).

7. The subdivisions (5) and (7) adjustments state: There shall be subtracted from federal taxable income to the extent included therein: . . . (5) The amount required to be added to federal taxable income as a dividend received from a foreign (non-United States) corporation under Section 78 of the Internal Revenue Code of 1986, as amended, by a corporation electing to take the foreign tax credit for federal income tax purposes; . . . (7) The amount included in federal adjusted gross income by the operation of Section 951 of the Internal Revenue Code of 1986, as amended; W. Va. Code Ann. § 11-24-6(c)(5)&(7)(West).

8. In a hearing before the West Virginia Office of Tax Appeals, the burden of proof is upon the Petitioner to show that any assessment is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e) (West 2019).

9. Here, the Petitioner has not met its burden of showing that the auditor erroneously or unlawfully applied West Virginia Code Section 11-24-6 during her audit of the Petitioner’s business. Nor has the Petitioner met its burden of showing that the auditor committed an error in her reliance on the Petitioner’s Federal form 1118 to ascertain the proper amounts of the Petitioner’s income from sources outside the U.S. Nor has the Petitioner met its burden of showing that the auditor committed an error in her utilization of Section 862 of the Internal Revenue Code of 1986 to determine the Petitioner’s “foreign source income”, as that phrase is used in West Virginia Code Section 11-24-6(C)(9).

DISPOSITION

WHEREFORE, it is the **FINAL DECISION** of the West Virginia Office of Tax Appeals that the May 22, 2019 corporate income and franchise tax assessment issued against the Petitioner for the period January 1, 2015, through December 31, 2017 should be and is hereby **AFFIRMED**.

It is further **ORDERED** that pursuant to the agreement of the parties, as of the date of this decision, the amount of tax in controversy is \$_____, plus accruing interest.

Pursuant to West Virginia Code Section 11-10-17(a), interest continues to accrue on the unpaid tax until this liability is fully paid.

WEST VIRGINIA OFFICE OF TAX APPEALS

By: _____
A. M. "Fenway" Pollack
Chief Administrative Law Judge

Date Entered