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This Week in State Tax (TWIST)

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Virginia: Appeals Court Find Two Businesses Lack Unity

The Virginia Court of Appeals recently upheld a trial court ruling that a corporation did not operate as a unitary business with a partnership in which it owned a minority interest because there was no functional integration, centralized management, or economies of scale between the businesses. As a result, the Commonwealth inappropriately apportioned the corporation's income. FJ Management, Inc. (FJM) is a stock corporation headquartered in Utah that was in the business of operating interstate travel centers and certain other businesses in multiple states including Virginia. In 2008, FJM, as part of a bankruptcy, transferred its travel centers to Pilot Travel Centers, LLC (PTC) in exchange for a minority ownership interest in PTC. FJM also entered an agreement to sell fuel to PTC through its separate oil refinery business. Pilot Corporation and Propeller Corp. owned the majority interest in PTC.

On its original returns for tax years 2015-2017, FJM reported its distributive share of income from PTC, a pass-through entity, as income subject to Virginia apportionment and combined PTC's apportionment factors with its own factors to determine its Virginia apportionable income. In 2017, FJM amended its original filings for these years and treated the income from PTC as allocable non-unitary business income and removed PTC's apportionment factors from its own factors. The Department of Taxation (Department) denied the amended returns, arguing that FJM's ownership interest in PTC was not sufficiently limited so as to call for removing PTC's apportionment factors. The issue at trial was whether the Department's denial of the amended returns resulted in an apportionment method that violates the U.S. Constitution.

The Virginia Court of Appeals upheld the earlier trial court decision and determined that the income from PTC could not be apportioned as part of FJM's apportionable income because a unitary business relationship did not exist between FJM and PTC. Requiring apportionment of FJM's income from PTC would violate the Due Process and Commerce Clauses of the U.S. Constitution because "the apportioned tax has no "rational relationship between the tax and the 'values connected with the taxing State'" and subjects FJM to an "unfairly apportioned tax"." The court found that FJM and PTC met none of the three tests of unity used in the Commonwealth.

- **Functional integration**. FJM and PTC were engaged in separate and distinct lines of business. PTC was in the business of operating the interstate travel centers, whereas FJM was in the business of operating an oil refinery and a bank. FJM and PTC did not share any business operations, and the fuel FJM sold fuel to PTC was based on pricing terms used for other purchasers.

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- **Centralized management**. FJM cannot exercise any significant management control over PTC. FJM owned a 17 percent interest in PTC and could appoint only two members of the board of managers. The majority shareholders (Pilot Corporation and Propeller Corp.) owned roughly 80 percent interest in PTC with the ability to appoint the remaining members of the board and exercise major control over PTC's operations.
- **Economies of Scale**. FJM and PTC did not share any business activities or resources, and they did not derive any cost advantages or efficiencies from their relationship.

Historically, Virginia has been reluctant to acknowledge income as non-unitary, but in this matter, clearly comparing the facts with the judicially developed tests for unity proved persuasive with the court. Please contact Diana Smith with questions on Commonwealth of Virginia v. FJ Management, Inc.

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