



MULTISTATE INCOME/FRANCHISE TAX

## Virginia Supreme Court upholds refund for tobacco company by allowing exclusion of stored leaf tobacco from property factor Tax Alert

### Overview

On February 10, 2022, the Virginia Supreme Court issued its opinion in [Virginia Department of Taxation v. R.J. Reynolds Tobacco Co.](#) The court upheld a lower court's decision that Lorillard Tobacco Company ("Taxpayer") can exclude the value of leaf tobacco stored in Virginia warehouses and facilities from its property factor because the leaf tobacco is not being "used" while stored. As a result of the decision, the Virginia Department of Taxation ("Department") must refund R.J. Reynolds Tobacco Company ("R.J. Reynolds"), a successor by merger of Taxpayer, approximately \$11 million in corporate income tax, plus interest.

This Tax Alert summarizes the *R.J. Reynolds* decision. Unless otherwise noted, quotations included in this Alert are from the Virginia Supreme Court's decision.

### Virginia Supreme Court rules that Taxpayer may exclude the value of stored leaf tobacco from its property factor

#### Background facts

Taxpayer was a North Carolina-based tobacco company that was acquired by and merged into R.J. Reynolds. Prior to the merger and for the years at issue, Taxpayer manufactured cigarettes in North Carolina and sold those cigarettes throughout the U.S.

Taxpayer engaged in business in Virginia and maintained in-state warehouses and facilities, where it stored leaf tobacco so that it could age for 13 to 23 months. The aging is a natural process that occurs without specialized equipment or human intervention. After reaching the target drying age, the

leaf tobacco was shipped to North Carolina, where it was processed and manufactured into cigarettes.

According to Va. Code §58.1-408, multistate corporations generally must apportion their income to Virginia using a three-factor formula comprised of equally-weighted property and payroll factors, and a double-weighted sales factor.

Va. Code §58.1-409 provides that the property factor is a fraction with a numerator, which is the average value of the corporation's real and tangible personal property "owned and **used**...in [Virginia] during the taxable year," and a denominator, which is the average value of all the corporation's real and tangible personal property "owned and **used**...during the taxable year and located everywhere, to the extent that such property is used to produce Virginia taxable income..." (Emphasis added).

The above-described apportionment and property factor rules applied to tax years 2008 through 2012, which are the tax years at issue in this case. For those tax years, the following occurred:

- Taxpayer filed original Virginia corporation income tax returns and included the value of its stored leaf tobacco in its Virginia property factor.
- Taxpayer subsequently requested refunds by filing amended returns, where Taxpayer excluded the value of the stored leaf tobacco from both the numerator and denominator of the Virginia property factor.
- The Department denied Taxpayer's refund claims.
- Taxpayer filed suit in Virginia circuit court, challenging the denial of its refund claims and arguing that its tobacco should be excluded from the property factor because it was stored in Virginia but not "used" within the meaning of Va. Code §58.1-409.
- The circuit court agreed and ruled that Taxpayer had not "used" the leaf tobacco within the meaning of Va. Code § 58.1-409 and thus, Taxpayer could exclude the tobacco from the property factor.
- The circuit court ordered the Department to refund approximately \$11 million in tax, plus interest.
- The Department appealed to the Virginia Supreme Court.

### **Virginia Supreme Court analysis**

On appeal to the Virginia Supreme Court, the Department primarily argued the following:

- Taxpayer "used" the tobacco in Virginia because it was being processed for the next phase of production by being stored at the Virginia warehouse.
- Taxpayer's tobacco leaf is similar to "inventoriable goods in process" within the meaning of 23 Va. Admin. Code §10-120-160 and therefore, must be included in the property factor according to that regulation.

The Virginia Supreme Court disagreed with the Department. The court concluded that the term "used" in Va. Code §58.1-409 is unambiguous. As a result, the court decided that it did not need to look beyond the statute and was "bound by...the plain meaning of the word 'used', i.e., 'to put into action or service' or '[t]o employ for the accomplishment of a purpose.'"

Further, the court determined that the Department's reliance on 23 Va. Admin. Code §10-120-160 was unnecessary since the term "used" in Va. Code §58.1-409 was unambiguous and the regulation did not specifically address the issue of "aging agricultural raw materials" in categories of property that are deemed to be "used".

Deferring to the circuit court's factual findings, the Virginia Supreme Court cited the following facts as support for affirming the circuit court's decision that the leaf tobacco was not "used" within the meaning of Va. Code §58.1-409:

- Taxpayer did not have to store the leaf tobacco in Virginia for it to age because the tobacco will age regardless of its location.
- Taxpayer did "absolutely nothing" to the leaf tobacco and the tobacco "just [sat] there".
- Taxpayer did not introduce any treatment to the leaf tobacco and did not perform any affirmative act or activity to prompt or aid the aging process.
- The fact that the leaf tobacco ages as it sits in the ambient conditions of the Virginia storage facility is "a natural consequence of the passage of time, not of any effort on Taxpayer's part".

The court stated that "[a]llowing raw materials to sit does not constitute processing because processing requires that these materials undergo treatment that will result in a product that is more marketable or useful."

As a result, the Virginia Supreme Court affirmed the circuit court's ruling that the leaf tobacco should have been excluded from Taxpayer's Virginia property factor for tax years 2008 through 2012 and upheld the refund of approximately \$11 million in tax, plus interest.

## Considerations

For apportionment purposes, Virginia has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA"). The Virginia Supreme Court has narrowly defined the term "used" in Virginia's UDITPA-based statute, Va. Code §58.1-409. However, taxpayers should be aware that other states that adhere to UDITPA have not interpreted the term as narrowly. As a result, similar facts to those in *R.J. Reynolds* could produce different results for taxpayers in other states with UDITPA-based apportionment provisions.

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