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**Sec. 12-226a-1. Adjustments by commissioner**

(a) **In general.** All that is necessary in order for the Commissioner to make adjustments under section 12-226a of the general statutes is an agreement, arrangement or understanding between the company and another person that, whether by inadvertence or design, results in an improper or inaccurate reflection of income. The Commissioner is not required to establish improper accounting; fraudulent, colorable, or sham transactions; or arrangements designed to reduce or avoid tax by shifting or distorting income, deductions or capital. Nor is the Commissioner required to establish that the agreement, arrangement or understanding is unlawful or not legally binding upon the parties thereto. The Commissioner shall, however, examine whether the terms of such agreements, arrangements or understandings are consistent with the economic substance of the underlying transactions and the actual conduct of the parties. Said section 12-226a requires the Commissioner to adopt a regulation that sets forth standards for taking the actions that are authorized under section 12-226a. This regulation sets forth those standards.

(b) **Transactions at more or less than a fair price with related persons.**

(1) Section 12-226a of the general statutes authorizes the Commissioner to make adjustments where a company has entered into a transaction with a related person at more or less than a fair price which, but for such agreement, arrangement, or understanding, might have been paid or received therefor, and there is a significant deviation between the amount actually paid or received and the amount which, but for such agreement, arrangement, or understanding, might have been paid or received. The standard that the Commissioner adopts under this subsection of this regulation is arm's-length consideration, as defined in subdivision (4) of subsection (g) of this regulation. Adjustments made by the Commissioner under section 12-226a to reflect arm's-length consideration have no effect on other Connecticut taxes (e.g., sales and use taxes, real estate conveyance tax, etc.) where the amount paid or received—not the amount which, but for such agreement, arrangement, or understanding, might have been paid or received—is the measure of the tax.

(2) The following subparagraphs are by way of example and not of limitation.

(A) Transfers of tangible property. Where one person sells or otherwise disposes of tangible property to a related person at other than an arm's-length price, the Commissioner may make proper adjustments to reflect arm's-length consideration for that property.

(B) Loans and advances. Where one person makes a bona fide loan or advance directly or indirectly to, or otherwise becomes a creditor of, a related person, and either charges no interest, or charges interest at a rate which is not equal to an arm's-length rate of interest with respect to the loan or advance, the Commissioner may make proper adjustments to reflect an arm's-length rate of interest for that loan or advance.

(C) Services. Where one person performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of, a related person either without charge, or at a charge which is not equal to an arm's-length charge, the Commissioner may make proper adjustments to reflect an arm's-length charge for such services. However, a parent corporation providing supervisory services (also known as stewardship or overseeing functions) to a subsidiary need not charge the subsidiary for those services, which are regarded as providing the parent corporation with a benefit relating to the conservation and protection of its investment. (This

is due to the fact that a parent corporation often coordinates and oversees major policy decisions and sets strategic direction for its subsidiaries.) A parent corporation is required to make an arm's-length charge only for managerial services that would have provided the subsidiary with a benefit had they been provided by a third party.

(D) Use of tangible property. Where possession, use or occupancy of tangible property owned or leased by one person is transferred by lease or other arrangement to a related person either without charge or at a charge which is not equal to an arm's-length rental charge, the Commissioner may make appropriate adjustments to reflect an arm's-length rental charge.

(E) Transfer or use of intangible property. Where intangible property or an interest therein is transferred, sold, assigned, loaned or otherwise made available in any manner by one person to a related person for other than arm's-length consideration for such property or its use, the Commissioner may make appropriate adjustments to reflect an arm's-length consideration for such property or its use.

(c) **Arrangements with little or no business purpose.** (1) Section 12-226a of the general statutes authorizes the Commissioner to disregard an arrangement under which related companies may operate where one company so dominates and controls the other that income of the companies is improperly or inaccurately reflected, and it is neither realistic nor feasible to reconstruct the transactions between them using the arm's-length consideration standard.

(2) In determining whether an arrangement under which related companies may operate results in the improper or inaccurate reflection of the activity, business, income or capital of the companies, the Commissioner shall consider whether (A) the companies are motivated by business purposes other than tax avoidance or are principally motivated by tax avoidance purposes; (B) the separate businesses of the companies have economic substance because a reasonable possibility of obtaining a profit exists, apart from achieving tax benefits; and (C) one company has a significant amount of capital gains, interest, dividend, or similar income, with only minimal capital, activity, or expenses, because essential corporate functions are performed for the company by the other company without arm's-length charges.

(3) In determining whether related companies are motivated by business purposes other than tax avoidance or are principally motivated by tax avoidance purposes and whether the separate businesses of the companies have economic substance, the Commissioner shall consider whether (A) the related person has an identifiable place of business with supporting business records; (B) the related person maintains books and related accounting records; (C) the related person has a staff of employees or engaged contractors adequate in number and with sufficient expertise to conduct its business affairs; (D) the company so controls and dominates the finances, policy and business activities of the related person that the related person has virtually no separate existence; (E) the form employed for doing business is a sham; and (F) the separate businesses have economic substance because a reasonable possibility of obtaining a profit exists, apart from achieving tax benefits. No one factor is controlling in determining whether the company and the related person are motivated by business purposes and whether the arrangements have economic substance. An arrangement between a foreign sales corporation, as defined in 26 U.S.C. §922 and meeting the requirements of 26 U.S.C. §§921 to 927, and its shareholders shall not be considered an arrangement that is principally motivated by tax avoidance purposes.

(4) The following examples illustrate the application of this subsection.

Example 1: Company A carries on business in Connecticut and is subject to corporation business tax. Company B, a wholly-owned subsidiary of Company A, is a company that is exempt from the Delaware Corporation Income Tax, under

Del. Code Ann. tit. 30, §1902(b) (8), because its activities within Delaware are confined to the maintenance and management of its intangible investments. Company B leases an office for its exclusive use in Delaware where it has a staff of employees adequate in number to conduct all of its business affairs. All of Company B's assets are located in Delaware, and all its business activities, including all day-to-day decision-making and management functions, are conducted by its own officers and employees in Delaware, who have appropriate authority and expertise commensurate with their responsibilities. Company B received its intangible assets from Company A in a transfer by Company A under 26 U.S.C. §351 solely in exchange for stock in Company B.

Based on these facts, the Commissioner shall determine that the arrangement under which Company A and Company B operate does not result in the improper or inaccurate reflection of the activity, business, income or capital of the companies.

Example 2: Company G carries on business in Connecticut and is subject to corporation business tax. Company H, a wholly-owned subsidiary of Company G, is a company that is exempt from the Delaware Corporation Income Tax, under Del. Code Ann. tit. 30, §1902(b) (8), because its activities within Delaware are confined to the maintenance and management of its intangible investments. Company H does not lease an office for its exclusive use in Delaware and it does not have adequate staff to conduct its business affairs. Not all of Company H's assets are located in Delaware, and some or all its business activities, including all day-to-day decision-making and management functions, are conducted by Company G in Connecticut. Company H received its intangible assets from Company G in a transfer by Company G under 26 U.S.C. §351 solely in exchange for stock in Company H.

Based on these facts, the Commissioner shall determine that the arrangement under which Company G and Company H operate results in the improper or inaccurate reflection of the activity, business, income or capital of the companies, because Company G controls and dominates the business activities of Company H. Therefore, the Commissioner may shift income from Company H to Company G, or expenses from Company G to Company H, to reflect income properly or accurately.

**(d) Transfers for tax avoidance purposes.** (1) Section 12-226a of the general statutes authorizes the Commissioner to make adjustments to items of income, deduction or capital in order to prevent the avoidance, in whole or in part, of corporation business tax, where property is transferred between a company and a related person in anticipation of a sale to an unrelated person. The Commissioner shall weigh, as a factor in determining whether a transfer was made to avoid, in whole or in part, corporation business tax, the interval of time between the transfer by the company to the related person and the sale to the unrelated person. This subsection may apply even if arm's-length consideration is paid or received between the company and the related person. However, this subsection shall not apply to any transfer to which the provisions of subsection (c) of this regulation also apply.

(2) The following examples illustrate the application of this subsection.

Example 1: Company J carries on business in Connecticut and is subject to corporation business tax. Company K, a wholly-owned subsidiary of Company J, does not carry on business in Connecticut. In anticipation of a sale of certain of its property that is situated in Connecticut to an unrelated person, Company J transfers the property to Company K, which then promptly sells the property to the unrelated person for the sales price for which Company J itself could have sold the property directly to the unrelated person.

Based on these facts, the Commissioner shall determine that the arrangement between Company J and Company K with respect to the property results in the

improper or inaccurate reflection of the net income of Company J, and shall include in the net income of Company J the fair profits which, but for such arrangement, Company J might have derived from the sale of the property.

Example 2: The facts are the same as in Example 1, except that Company K holds the property for a considerable length of time, making use of it in the interim in its own business, before eventually reselling it to the unrelated person.

Based on these facts, the Commissioner shall determine that the arrangement between Company J and Company K with respect to the property does not result in the improper or inaccurate reflection of the net income of Company J (assuming that arm's-length consideration was paid by Company K on the transfer of the property to it by Company J).

(e) **Nonrecognition provisions may not bar adjustments.** Section 12-226a of the general statutes authorizes the Commissioner to disregard statutory nonrecognition provisions when necessary to prevent the avoidance of taxes or to reflect income properly or accurately.

(f) **Use of section 12-226a by a company.** A company has no right to apply section 12-226a of the general statutes at will or to compel its application by the Commissioner. However, section 12-226a of the general statutes does not limit a company's ability properly or accurately to reflect its activity, business, income or capital on its corporation business tax return. Thus, if a company has conducted its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any other persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement, or understanding, might have been paid or received therefor, the company may report the results of any such transaction based upon a price different from that actually paid or received if necessary to reflect an arm's-length result. (If reported results differ from transactional results recorded in the regular books and records of the company, such difference must be accounted for in the same manner as such difference would be accounted for federal income tax purposes.)

(g) **Definitions.** For purposes of this regulation, unless the context otherwise requires:

(1) "Person" means person, as defined in section 12-1 of the general statutes;

(2) "Commissioner" means the Commissioner of Revenue Services;

(3) "Arm's-length consideration" is the amount of consideration that would be paid or received (or the profits that would have been earned) in a transaction between unrelated persons, where neither person is under any compulsion to enter into the transaction and each person has reasonable knowledge of all relevant facts.

(4) "Arms-length price" or "arms-length charge" is the price or charge, respectively, that would be paid or received (or the profits that would have been earned) in a transaction between unrelated persons, where neither person is under any compulsion to enter into the transaction and each person has reasonable knowledge of all relevant facts.

(5) "Arms-length rental charge" is the rental charge that would be paid or received (or the profits that would have been earned) in a rental transaction between unrelated persons, where neither person is under any compulsion to enter into the transaction and each person has reasonable knowledge of all relevant facts.

(h) **Effective date.** This regulation shall apply to actions taken by the Commissioner on or after the date of filing of this regulation with the Secretary of the State. (Effective November 22, 1995)