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HOUSE BILL NO. 1361

Offered January 22, 2004

A BILL to amend and reenact §§ 58.1-302 and 58.1-402 of the Code of Virginia, relating to Virginia corporate income tax.

Patron—Nixon

Referred to Committee on Finance

Be it enacted by the General Assembly of Virginia:**1. That §§ 58.1-302 and 58.1-402 of the Code of Virginia are amended and reenacted as follows:****§ 58.1-302. Definitions.**

For the purpose of this chapter and unless otherwise required by the context:

"Affiliated" means two or more corporations subject to Virginia income taxes whose relationship to each other is such that (i) one corporation owns at least ~~eighty~~ 80 percent of the voting stock of the other or others or (ii) at least ~~eighty~~ 80 percent of the voting stock of two or more corporations is owned by the same interests.

"Arms length rates and terms" means that (i) two or more related members enter into a written agreement for a transaction, (ii) such agreement is of a duration and contains rates and payment terms substantially similar to those that the related member would be able to obtain from an unrelated entity, and (iii) the borrower or payor substantially adheres to the payment terms of the agreement governing the transaction or any amendments thereto. There is a presumption that an interest rate is an arm's length rate if it conforms to §§ 482 and 1274 of the Internal Revenue Code of 1986, as amended.

"Compensation" means wages, salaries, commissions and any other form of remuneration paid or accrued to employees for personal services.

"Corporation" includes associations, joint stock companies and insurance companies.

"Domicile" means the permanent place of residence of a taxpayer and the place to which he intends to return even though he may actually reside elsewhere. In determining domicile, consideration may be given to the applicant's expressed intent, conduct, and all attendant circumstances including, but not limited to, financial independence, business pursuits, employment, income sources, residence for federal income tax purposes, marital status, residence of parents, spouse and children, if any, leasehold, sites of personal and real property owned by the applicant, motor vehicle and other personal property registration, residence for purposes of voting as proven by registration to vote, if any, and such other factors as may reasonably be deemed necessary to determine the person's domicile.

"Foreign source income" means:

1. Interest, other than interest derived from sources within the United States;
2. Dividends, other than dividends derived from sources within the United States;
3. Rents, royalties, license, and technical fees from property located or services performed without the United States or from any interest in such property, including rents, royalties, or fees for the use of or the privilege of using without the United States any patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties;
4. Gains, profits, or other income from the sale of intangible or real property located without the United States; and

5. The amount of an individual's share of net income attributable to a foreign source qualified business unit of an electing small business corporation (S corporation). For purposes of this subsection, qualified business unit shall be defined by § 989 of the Internal Revenue Code, and the source of such income shall be determined in accordance with §§ 861, 862 and 987 of the Internal Revenue Code.

In determining the source of "foreign source income," the provisions of §§ 861, 862, and 863 of the Internal Revenue Code shall be applied except as specifically provided in subsection 5 above.

"Income and deductions from Virginia sources" includes:

1. Items of income, gain, loss and deduction attributable to:
 - a. The ownership of any interest in real or tangible personal property in Virginia;
 - b. A business, trade, profession or occupation carried on in Virginia; or
 - c. Prizes paid by the Virginia Lottery Department, and gambling winnings from wagers placed or paid at a location in Virginia.

2. Income from intangible personal property, including annuities, dividends, interest, royalties and gains from the disposition of intangible personal property to the extent that such income is from property employed by the taxpayer in a business, trade, profession, or occupation carried on in Virginia.

"Individual" means all natural persons whether married or unmarried and fiduciaries acting for

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59 natural persons, but not fiduciaries acting for trusts or estates.

60 *"Intangible expenses and costs" means:*

61 1. Expenses, losses and costs for, related to, or in connection directly or indirectly with the direct or
62 indirect transfer, use, maintenance, or management of intangible property owned by a related member to
63 the extent such amounts are allowed as deductions or costs in determining taxable income;

64 2. Royalty, patent, technical and copyright fees;

65 3. Licensing fees; and

66 4. Other similar expenses and costs.

67 *"Intangible property" means patents, patent applications, trade names, trademarks, service marks,
68 copyrights and similar types of intangible assets.*

69 *"Interests expenses and costs" means amounts directly or indirectly allowed as interest deductions
70 under Section 163 of the Internal Revenue Code of 1986, as amended, for purposes of determining
71 taxable income under the Internal Revenue Code, of 1986, as amended.*

72 *"Nonresident estate or trust" means an estate or trust which is not a resident estate or trust.*

73 *"Related entity" means:*

74 1. A stockholder who is an individual, or a member of the stockholder's family enumerated in Section
75 318 of the Internal Revenue Code, of 1986, as amended, if the stockholder and the members of the
76 stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50
77 percent of the value of the taxpayer's outstanding stock;

78 2. A stockholder, or a stockholder's partnership, limited liability company, estate, trust or
79 corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates,
80 trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least
81 50 percent of the value of the taxpayer's outstanding stock; or

82 3. A corporation, or a party related to the corporation in a manner that would require an attribution
83 of stock from the corporation to the party or from the party to the corporation under the attribution
84 rules of Section 318 of the Internal Revenue Code, of 1986, as amended, if the taxpayer owns, directly,
85 indirectly, beneficially or constructively, at least fifty per cent of the value of the corporation's
86 outstanding stock. The attribution rules of Section 318 of the Internal Revenue Code, of 1986, as
87 amended, shall apply for purposes of determining whether the ownership requirements of this
88 subdivision have been met.

89 *"Related member" for purposes of clause (a) of subdivision B 8 of § 58.1-402 means a person who,
90 with respect to the taxpayer during all or any portion of the taxable year, is a related entity, a
91 component member as defined in Section 1563(b) of the Internal Revenue Code, of 1986, as amended,
92 or is a person to or from whom there is attribution of stock ownership in accordance with Section
93 1563(e) of the Internal Revenue Code, of 1986, as amended.*

94 *"Resident" applies only to natural persons and includes, for the purpose of determining liability for
95 the taxes imposed by this chapter upon the income of any taxable year every person domiciled in
96 Virginia at any time during the taxable year and every other person who, for an aggregate of more than
97 183 days of the taxable year, maintained his place of abode within Virginia, whether domiciled in
98 Virginia or not. The word "resident" shall not include any member of the United States Congress who is
99 domiciled in another state.*

100 *"Resident estate or trust" means:*

101 1. The estate of a decedent who at his death was domiciled in the Commonwealth;

102 2. A trust created by will of a decedent who at his death was domiciled in the Commonwealth;

103 3. A trust created by or consisting of property of a person domiciled in the Commonwealth; or

104 4. A trust or estate which is being administered in the Commonwealth.

105 *"Sales" means all gross receipts of the corporation not allocated under § 58.1-407, except the sale or
106 other disposition of intangible property shall include only the net gain realized from the transaction.*

107 *"State" means for purposes of Article 10 of this chapter any state of the United States, the District of
108 Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any
109 foreign country.*

110 *"Subject to a tax based on or measured by net income" means, for purposes of clause (a) of
111 subdivision B 8 of § 58.1-402, that the related member is required to file in another jurisdiction on a
112 separate basis or be included in a combined or consolidated tax return based on or measured by net
113 income in the jurisdiction in which the principal office of the related member is located. As used in this
114 definition, "tax based on or measured by net income" includes other taxes that are imposed as the
115 primary methodology by which a state taxes business entities, such as the Michigan single business tax
116 or the Washington business and occupation tax.*

117 *"Trust" or "estate" means a trust or estate, or a fiduciary thereof, which is required to file a fiduciary
118 income tax return under the laws of the United States.*

119 *"Valid business purpose" means one or more business purposes, which alone or in combination,
120 constitute the motivation for some business activity or transaction, which activity or transaction changes*

in a meaningful way, apart from tax effects, the economic position of the taxpayer.

"Virginia fiduciary adjustment" means the net amount of the applicable modifications described in § 58.1-322 (including subsection E thereof if the estate or trust is a beneficiary of another estate or trust) which relate to items of income, gain, loss or deduction of an estate or trust. The fiduciary adjustment shall not include the modification in subsection D of § 58.1-322, except that the amount of state income taxes excluded from federal taxable income shall be included. The fiduciary adjustment shall also include the modification in subsection D of § 58.1-322, regarding the deduction for the purchase of a prepaid tuition contract or contribution to a savings trust account.

§ 58.1-402. Virginia taxable income.

A. For purposes of this article, Virginia taxable income for a taxable year means the federal taxable income and any other income taxable to the corporation under federal law for such year of a corporation adjusted as provided in subsections B, C and D.

For a regulated investment company and a real estate investment trust, such term means the "investment company taxable income" and "real estate investment trust taxable income," respectively, to which shall be added in each case any amount of capital gains and any other income taxable to the corporation under federal law which shall be further adjusted as provided in subsections B, C and D.

B. There shall be added to the extent excluded from federal taxable income:

1. Interest, less related expenses to the extent not deducted in determining federal taxable income, on obligations of any state other than Virginia, or of a political subdivision of any such other state unless created by compact or agreement to which the Commonwealth is a party;

2. Interest or dividends, less related expenses to the extent not deducted in determining federal taxable income, on obligations or securities of any authority, commission or instrumentality of the United States, which the laws of the United States exempt from federal income tax but not from state income taxes;

3. [Repealed.]

4. The amount of any net income taxes and other taxes, including franchise and excise taxes, which are based on, measured by, or computed with reference to net income, imposed by the Commonwealth or any other taxing jurisdiction, to the extent deducted in determining federal taxable income;

5. Unrelated business taxable income as defined by § 512 of the Internal Revenue Code;

6. The amount of employee stock ownership credit carry-over deducted by the corporation in computing federal taxable income under § 404 (i) of the Internal Revenue Code;

7. The amount required to be included in income for the purpose of computing the partial tax on an accumulation distribution pursuant to § 667 of the Internal Revenue Code.

8. *a. For taxable years beginning on and after January 1, 2005, the amount of any interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia taxation purposes. This addition shall not be required for any portion of the interest expenses and costs and intangible expenses and costs if one of the following applies:*

(1) The related member during the same taxable year directly or indirectly paid, received, accrued or incurred such amount to or from a person or entity that is not a related member, and such transaction was done for a valid business purpose and the payments are made at arm's length rates and terms;

(2) The corresponding item of income received by the related member is subject to a tax based on or measured by net income imposed by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States government;

(3) The transaction giving rise to the expenses and costs between the corporation and the related member has a valid business purpose other than the avoidance or reduction of taxation and payments between the parties are made at arm's length rates and terms;

(4) Payments arise pursuant to a preexisting contract entered into when the parties were not related members provided the payments continue to be made at arm's length rates and terms;

(5) The related member has substantial business operations relating to intangible property or interest-generating activities, in which the related member bears the expenses for at least four full-time equivalent employees who maintain, manage, defend or are otherwise responsible for operations or administration relating to the intangible property or interest-generating activities;

(6) The related member engages in transactions with parties other than related members that generate revenue in excess of \$2 million annually; or

(7) The transaction giving rise to the interest payments between the corporation and a related member reflects arm's length rates and terms and meets any of the following:

(a) The related member uses funds that are borrowed from a party other than a related member or that are paid, incurred or passed through to a person who is not a related member;

182 (b) *The debt is part of a regular and systematic funds management or portfolio investment activity*
183 *conducted by the related member, whereby the funds of two or more related members are aggregated*
184 *for the purpose of achieving economies of scale, the internal financing of the active business operations*
185 *of members, or the benefit of centralized management of funds;*

186 (c) *Financing the expansion of the business operations; or*

187 (d) *Restructuring the debt of related members, or the pass-through of acquisition-related*
188 *indebtedness to related members.*

189 b. *Nothing in this subsection shall be construed to limit or negate the provisions of § 58.1-446.*

190 C. There shall be subtracted to the extent included in and not otherwise subtracted from federal
191 taxable income:

192 1. Income derived from obligations, or on the sale or exchange of obligations, of the United States
193 and on obligations or securities of any authority, commission or instrumentality of the United States to
194 the extent exempt from state income taxes under the laws of the United States including, but not limited
195 to, stocks, bonds, treasury bills, and treasury notes, but not including interest on refunds of federal taxes,
196 interest on equipment purchase contracts, or interest on other normal business transactions.

197 2. Income derived from obligations, or on the sale or exchange of obligations of this Commonwealth
198 or of any political subdivision or instrumentality of this Commonwealth.

199 3. Dividends upon stock in any domestic international sales corporation, as defined by § 992 of the
200 Internal Revenue Code, 50 percent or more of the income of which was assessable for the preceding
201 year, or the last year in which such corporation has income, under the provisions of the income tax laws
202 of the Commonwealth.

203 4. The amount of any refund or credit for overpayment of income taxes imposed by this
204 Commonwealth or any other taxing jurisdiction.

205 5. Any amount included therein by the operation of the provisions of § 78 of the Internal Revenue
206 Code (foreign dividend gross-up).

207 6. The amount of wages or salaries eligible for the federal Targeted Jobs Credit which was not
208 deducted for federal purposes on account of the provisions of § 280C (a) of the Internal Revenue Code.

209 7. Any amount included therein by the operation of § 951 of the Internal Revenue Code (subpart F
210 income).

211 8. Any amount included therein which is foreign source income as defined in § 58.1-302.

212 9. [Repealed.]

213 10. The amount of any dividends received from corporations in which the taxpaying corporation
214 owns 50 percent or more of the voting stock.

215 11. [Repealed.]

216 12. [Expired.]

217 13. (Expires for taxable years beginning on and after January 1, 2004) The amount of any qualified
218 agricultural contribution as determined in § 58.1-322.2.

219 14. For taxable years beginning on or after January 1, 1995, the amount for "qualified research
220 expenses" or "basic research expenses" eligible for deduction for federal purposes, but which were not
221 deducted, on account of the provisions of § 280C (c) of the Internal Revenue Code.

222 15. For taxable years beginning on or after January 1, 2000, the total amount actually contributed in
223 funds to the Virginia Public School Construction Grants Program and Fund established in Chapter 11.1
224 (§ 22.1-175.1 et seq.) of Title 22.1.

225 16. For taxable years beginning on or after January 1, 2000, the gain derived from the sale or
226 exchange of real property or the sale or exchange of an easement to real property which results in the
227 real property or the easement thereto being devoted to open-space use, as that term is defined in
228 § 58.1-3230, for a period of time not less than 30 years. To the extent a subtraction is taken in
229 accordance with this subdivision, no tax credit under this chapter for donating land for its preservation
230 shall be allowed for three years following the year in which the subtraction is taken.

231 17. For taxable years beginning on and after January 1, 2001, any amount included therein with
232 respect to § 58.1-440.1.

233 18. For taxable years beginning on and after January 1, 1999, income received as a result of (i) the
234 "Master Settlement Agreement," as defined in § 3.1-1106; (ii) the National Tobacco Grower Settlement
235 Trust dated July 19, 1999; and (iii) the Tobacco Loss Assistance Program, pursuant to 7 C.F.R. Part
236 1464 (Subpart C, §§ 1464.201 through 1464.205), by (a) tobacco farming businesses; (b) any business
237 holding a tobacco marketing quota, or tobacco farm acreage allotment, under the Agricultural
238 Adjustment Act of 1938; or (c) any business having the right to grow tobacco pursuant to such a quota
239 allotment.

240 19. Effective for all taxable years beginning on and after January 1, 2002, but before January 1,
241 2005, the indemnification payments received by contract poultry growers and table egg producers from
242 the U.S. Department of Agriculture as a result of the depopulation of poultry flocks because of low
243 pathogenic avian influenza in 2002. In no event shall indemnification payments made to owners of

244 poultry who contract with poultry growers qualify for this subtraction.

245 20. For taxable years beginning on and after January 1, 2002, any gain recognized as a result of the
246 Peanut Quota Buyout Program of the Farm Security and Rural Investment Act of 2002 pursuant to 7
247 C.F.R. Part 1412 (Subpart H, §§ 1412.801 through 1412.811) as follows:

248 a. If the payment is received in installment payments pursuant to 7 C.F.R. § 1412.807(a)(2), then the
249 entire gain recognized may be subtracted.

250 b. If the payment is received in a single payment pursuant to 7 C.F.R. § 1412.807(a)(3), then 20
251 percent of the recognized gain may be subtracted. The taxpayer may then deduct an equal amount in
252 each of the four succeeding taxable years.

253 21. *For taxable years beginning on and after January 1, 2005, any amount of intangible expenses*
254 *and costs or interest expenses and costs added to the federal taxable income of a corporation in*
255 *accordance with the provisions of clause (a) of subdivision B 8 of this section shall be subtracted from*
256 *the federal taxable income of the related member that received such amount if such related member is*
257 *subject to Virginia income tax on the same income.*

258 D. Adjustments to federal taxable income shall be made to reflect the transitional modifications
259 provided in § 58.1-315.