

DEPARTMENT OF TAXATION

2004 Fiscal Impact Statement

1. **Patron** Vivian E. Watts

2. **Bill Number** HB 791

3. **Committee** House Finance

House of Origin:

 X **Introduced**

 Substitute

 Engrossed

4. **Title** Corporate Income Tax; Closing Loophole
For Intangible Holding Companies

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would close a corporate income tax loophole that allows corporations to avoid paying taxes on money paid to intangible holding companies in the form of royalties, interest and other intangible income. The loophole is closed by requiring the corporation to add back any deductible interest expenses and costs and intangible expenses and costs paid, accrued or incurred to one or more related members.

The bill would be effective for taxable years beginning on and after January 1, 2004.

6. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

6a. **Expenditure Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Fund</i>
2003-04	\$ 0	GF
2004-05	\$ 115,160	GF

6b. **Revenue Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Fund</i>
2003-04	\$ 0	GF
2004-05	\$ 34.0 million	GF
2005-06	\$ 22.4 million	GF
2006-07	\$ 23.2 million	GF
2007-08	\$ 24.1 million	GF
2008-09	\$ 25.0 million	GF
2009-10	\$ 25.9 million	GF

7. **Budget amendment necessary:** No.

8. Fiscal implications:

Administrative Impact

The Department would incur administrative expenses of \$115,600 in FY 2005 for systems modifications. These costs are identical to the costs assumed in the Executive Budget to implement the corporate loophole closing provisions in the Governor's tax reform plan.

Revenue Impact

It is estimated that this bill would increase corporate income tax revenue by \$34.0 million in FY 2005, \$22.4 million in FY 2006 and \$23.2 million in FY 2007. The Executive Budget assumes identical revenue increases for similar provisions in the Governor's tax reform plan.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

In order to conform this bill to the provisions of House Bill 1081, the following amendments are suggested:

Page 1, Line 57, after exchange,
Insert: lease, transfer

Page 2, Line 70, after acquisition,
Insert: use,

Page 2, Line 70, after exchange
Insert: , lease, transfer

Page 3, Line 145, after costs were
Insert: deductible or

Page 3, Line 146, after income
Insert: for Virginia purposes

Page 3, Line 151, after (2) The
Insert: corporation can establish to the satisfaction of the Tax Commissioner that the

Page 3, Line 151, after intangible expenses and costs
Strike: that the corporation can establish by the preponderance of the evidence

11. Other comments:

Of the 50 largest employers in Virginia subject to the corporate income tax, 21 of these corporations did not pay a single dollar to Virginia in corporation income tax for taxable year 1999. These corporations reported profits of \$22.1 billion to their shareholders that would have translated into over \$44 million in Virginia corporate income taxes. One of the major reasons that business income is escaping taxation in Virginia is the usage of intangible holding companies.

An intangible holding company is generally a corporation formed to hold intangible assets such as trademarks, trade names, or patents – typically in states that do not impose a corporate income tax. Corporations transfer their intangible assets to their intangible holding company and enter into an agreement to pay for the use of its own intangible assets. When the corporation computes its state corporate income tax, it deducts the expenses that it charged itself to use these intangible assets.

Virginia law is currently very limited in its ability to offset the effects of tax planning techniques such as the usage of intangible holding companies. Due to differences in corporate income tax structures, the use of intangible holding companies affects only corporate income taxes imposed by states east of the Mississippi River. The corporate income tax structure adopted by states west of the Mississippi River do not recognize an intangible holding company as a separate corporation. Recently, legislation has been very popular among the states that are affected by the use of intangible holding companies.

- Nine states (Alabama, Arkansas, Connecticut, Massachusetts, Michigan, Mississippi, New Jersey, North Carolina, and Ohio) have recently adopted legislation to eliminate the adverse tax effects on state taxable income from the use of intangible holding companies.
- Legislation is currently pending in Maryland, Pennsylvania, and the District of Columbia. Rhode Island is conducting a study on this issue.
- Maryland and Missouri considered but did not enact legislation to eliminate the effectiveness of intangible holding companies. On January 23, 2004, legislation was introduced at the request of Maryland's Governor seeking authority to deal with intangible holding companies.

The precise number of corporations that would be affected by a provision to eliminate the effectiveness of an intangible holding company is not available. Analysis of recent media reports and the appeals filed with the Department involving this issue involving as many as 47 corporations show that the type of corporations that utilize intangible holding companies are very large multi-state corporations.

A recent *Wall Street Journal* article identified 49 corporations that have been involved in litigation with other states regarding the use of intangible holding companies. Those corporations identified by the *Wall Street Journal* are:

Aaron Rents
ADP, Inc.
American Greetings Corp.
Beatrice
Budget Rent-a-Car Corp.
Burger King
CompUSA
ConAgra Foods Inc.
Crown Cork & Seal
Dover Elevator
Dress Barn
Eaton Admin Corp.
Gap, Inc.
Gore Industries
Hologic, Inc.
Home Depot USA
Honeywell International

J.P. Stevens and Co.
Kimberly Clark Corp.
Kmart Corp.
Kohl's
Lamb Weston, Inc.
Long John Silver's
Mallinckrodt Medical
Marsh Supermarkets, Inc.
Marsh Village Pantries, Inc.
May Dept. Stores
McCormick & Co.
Novacare
Payless Shoesource, Inc.
PF Brands, Inc.
Premark FEG Corporation
R. Scientific Products
Radio Shack Corp.

Sherwin Williams
Snap on Tool
Sonoco Products Co.
Stanley Works
Staples
Sunglass Hut International, Inc.
Syms
The Limited Brands
TJX Cos.
Toys R Us
Tyson Foods, Inc.
United Refrigeration of Del.
Urban Outfitters
Yellow Freight System
York International

Current Law

Corporations start with federal taxable income, which reflects deductions taken for royalties, interest and other expenses paid to an affiliated intangible holding company. If the corporation has done its planning thoroughly (i.e., established a non-tax reason for the intangible holding company's existence and arm's length rates for their transactions), then Virginia cannot invoke its authority under existing law to correct transactions between related companies that improperly reflect income. In extreme cases, a corporation may contribute a valuable patent or trademark to an affiliated intangible holding company in a tax-free transaction, pay royalties for its use, then borrow the funds back from the intangible holding company and pay interest for the use of its own money.

Proposed Change

Corporations would be required to add back to federal taxable income any interest and intangible expenses directly or indirectly paid to one or more related members. A related member is defined through conformity with the Internal Revenue Code. Two safe-harbors would be allowed:

- The addback would not be required if in the same taxable year of the payment the item of income received by the related member is subject to a tax on or measured by the related member's net income in any state of the United States or a foreign country that has an income tax treaty in force with the United States.
- The addback would not be required if the corporation can establish to the satisfaction of the Tax Commissioner both of the following:
 - The related member directly or indirectly incurred the same costs to a person who is not a related member (e.g., interest paid to a bank), and
 - the transaction did not have as a principal or primary purpose the avoidance of any state tax

Other Legislation

House Bill 1081 and **Senate Bill 467** are the Governor's tax reform plan which includes provisions eliminating the effects of transactions with intangible holding companies from the computation of the corporate income tax.

House Bill 859 contains intangible holding company provisions similar to those in the Governor's tax reform plan and would make numerous other changes to individual income tax and sales tax.

House Bill 1079 contains intangible holding company and nowhere income provisions similar to those in this bill and the Governor's tax reform plan.

Senate Bill 530 contains intangible holding company provisions similar to those in the Governor's tax reform plan and would make numerous other changes to individual income tax and sales tax.

Senate Bill 589 contains intangible holding company provisions similar to those in the Governor's tax reform plan and would make numerous other changes to individual income tax, corporate income tax, and sales tax.

Senate Bill 635 contains intangible holding company provisions similar to those in the Governor's tax reform plan and would make numerous other changes to individual income tax and sales tax.

House Bill 1361 and **Senate Bill 683** contain intangible holding company provisions with numerous safe harbors.

cc : Secretary of Finance

Date: 2/6/2004 JPJ