DEPARTMENT OF TAXATION
2004 Fiscal Impact Statement

1. Patron John C. Watkins

2. Bill Number SB 683

House of Origin:
X **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
_____ **In Committee**
_____ **Substitute**
_____ **Enrolled**

3. Committee Senate Finance

4. Title Corporate Income Tax; Closing Loopholes for Intangible Holding Companies

5. Summary/Purpose:

This bill describes permissible and impermissible transactions between related companies for purposes of calculating Virginia corporate income tax. A corporation would be required to add back any otherwise deductible interest expenses and costs and intangible expenses and costs paid, accrued or incurred to one or more related members, but several "safe harbors" protect transactions from the add-back.

The intangible expense add-back would be effective for taxable years beginning on and after January 1, 2005.

6. Fiscal Impact Estimates are: Not available. (See Line 8.)

6a. Expenditure Impact:

Fiscal Year	***Dollars***	***Fund***
2003-04	$0	GF
2004-05	$115,160	GF

7. Budget amendment necessary: No.

8. Fiscal implications:

Administrative Impact

The Department would incur administrative expenses of $115,160 in FY 2005 for systems modifications. These costs are identical to the costs assumed in the Executive Budget to implement the provision in the Governor's tax reform plan that closes the corporate loophole for intangible holding companies.

Revenue Impact

This bill does not significantly expand the Department's authority to reach transactions with related intangible holding companies because there would be few transactions outside one or more of the safe harbors. Therefore, this bill is estimated to increase General Fund revenue by a minimal amount.

The Governor's tax reform plan also contains provisions to remove the effects of transactions with intangible holding companies from the computation of the Virginia corporate income tax. The provisions in the Governor's tax reform plan were based on similar statutes already enacted in nine states. The primary difference between the provisions in the Governor's tax reform plan and this bill are the number of safe harbor provisions. It is estimated that the provisions in the Governor's tax reform plan would increase corporate income tax revenue by $34.0 million in FY 2005, $22.4 million in FY 2006, $23.2 million in FY 2007, $24.1 million in FY 2008, $25.0 million in FY 2009, and $25.9 million in FY 2010.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Background

Of the 50 largest employers in Virginia subject to the corporate income tax, 21 of these corporations did not pay any corporate income tax to Virginia 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 are 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. A corporation transfers its intangible assets tax-free to an affiliated intangible holding company, and enters 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 taxes imposed by states east of the Mississippi River. The corporate income tax structure adopted by western states 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. 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	J.P. Stevens and Co.	Sherwin Williams
ADP, Inc.	Kimberly Clark Corp.	Snap on Tool
American Greetings Corp.	Kmart Corp.	Sonoco Products Co.
Beatrice	Kohl's	Stanley Works
Budget Rent-a-Car Corp.	Lamb Weston, Inc.	Staples
Burger King	Long John Silver's	Sunglass Hut International, Inc.
CompUSA	Mallinckrodt Medical	Syms
ConAgra Foods Inc.	Marsh Supermarkets, Inc.	The Limited Brands
Crown Cork & Seal	Marsh Village Pantries, Inc.	TJX Cos.
Dover Elevator	May Dept. Stores	Toys R Us
Dress Barn	McCormick & Co.	Tyson Foods, Inc.
Eaton Admin Corp.	Novacare	United Refrigeration of Del.
Gap, Inc.	Payless Shoesource, Inc.	Urban Outfitters
Gore Industries	PF Brands, Inc.	Yellow Freight System
Hologic, Inc.	Premark FEG Corporation	York International
Home Depot USA	R. Scientific Products	
Honeywell International	Radio Shack Corp.	

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 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. Seven safe-harbors are provided that would not require the addback if:

- In the same taxable year of the payment the item of income received by the related member, it paid such amount to a party that is not a related member (e.g., interest paid to a bank)

- The payment of the item is subject to income tax in another state.
- The transaction has a valid business purpose and is at arm's length prices.
- The payments arise from a contract entered into when the parties were not related members of an affiliated group and are at arm's length prices.
- The related member has the equivalent of at least 4 full-time employees and substantial business operations relating to intangibles.
- The related member engages in at least $2 million in business with unrelated companies.
- Interest expense is at an arm's length rate and satisfies one of the following:
    - The related company obtains funds from an unrelated entity;
    - The related company centrally manages the funds of the corporation
    - Financing the expansion of business operations; or
    - Restructuring the debt of related members.

Other Legislation

House Bill 1361 is identical to this bill.

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 791 contains intangible holding company provisions similar to those in the Governor's tax reform plan.

House Bill 1079 contains intangible holding company provisions similar to those in the Governor's tax reform plan and including provisions to eliminate the effects of nowhere income.

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.

cc : Secretary of Finance
Date: 2/6/2004 JPJ