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**HOUSE BILL NO. 2886**

Offered January 21, 2005

A *BILL to amend and reenact §§ 3.1-336.2 and 58.1-402 of the Code of Virginia, relating to the Master Settlement Agreement; required amounts for escrow and deductibility of escrow funds.*

Patron—Albo

Referred to Committee on Finance

**Be it enacted by the General Assembly of Virginia:****1. That §§ 3.1-336.2 and 58.1-402 of the Code of Virginia are amended and reenacted as follows:**

§ 3.1-336.2. Requirements on tobacco product manufacturers; escrow of funds; civil penalties for violations.

A. Any tobacco product manufacturer selling cigarettes to consumers within the Commonwealth, whether directly or through a distributor, retailer or similar intermediary or intermediaries, after July 1, 1999, shall do one of the following:

1. Become a participating manufacturer (as that term is defined in section II (jj) of the Master Settlement Agreement) and generally perform its financial obligations under the Master Settlement Agreement; or

2. Place into a qualified escrow fund by April 15 of the year following the year in question the following amounts (as such amounts are adjusted for inflation):

Year	Amount per unit sold in such year (except for 1999 the amount per unit sold after July 1, 1999)
1999	\$.0094241
2000	\$.0104712
each of 2001 and 2002	\$.0136125
each of 2003 through 2006	\$.0167539
each of 2007 and each year thereafter	\$.0188482

B. A tobacco product manufacturer that places funds into escrow pursuant to subdivision A 2 shall receive the interest or other appreciation on such funds as earned. ~~Such~~ *Except as provided in subsection D, such funds themselves shall be released from escrow only under the following circumstances:*

1. To pay a judgment or settlement on any released claim brought against such tobacco product manufacturer by the Commonwealth or any releasing party located or residing in the Commonwealth. Funds shall be released from escrow under this subdivision (i) in the order in which they were placed into escrow and (ii) only to the extent and at the time necessary to make payments required under such judgment or settlement;

2. To the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow *on account of units sold in this Commonwealth* in a particular year was greater than the Commonwealth's allocable share of the total payments that such manufacturer would have been required to make in that year under the Master Settlement Agreement (as determined pursuant to section IX (i) (2) of the Master Settlement Agreement, and before any of the adjustments or offsets described in section IX (i) (3) of that Agreement other than the Inflation Adjustment) *Master Settlement Agreement payments, as determined pursuant to section IX(i) of that Agreement, including after final determination of all adjustments, that such manufacturer would have been required to make on account of such units sold had it been a participating manufacturer, the excess shall be released from escrow and revert back to such tobacco product manufacturer; or*

3. To the extent not released from escrow under subdivisions 1 or 2, funds shall be released from escrow and revert back to such tobacco product manufacturer 25 years after the date on which they were placed into escrow.

C. Each tobacco product manufacturer that elects to place funds into escrow pursuant to subdivision A 2 shall annually certify to the Attorney General that it is in compliance with that subdivision. The Attorney General may bring a civil action on behalf of the Commonwealth against any tobacco product manufacturer that fails to place into escrow the funds required under this section. Any tobacco product manufacturer that fails in any year to place into escrow the funds required under this section shall:

1. Be required within 15 days to place such funds into escrow as shall bring it into compliance with this section. The court, upon a finding of a violation of this subsection, may impose a civil penalty, *to be paid into the general fund of the Commonwealth*, in an amount not to exceed five percent of the

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58 amount improperly withheld from escrow per day of the violation and in a total amount not to exceed  
59 100 percent of the original amount improperly withheld from escrow;

60 2. In the case of a knowing violation, be required within 15 days to place such funds into escrow as  
61 shall bring it into compliance with this section. The court, upon a finding of a knowing violation of this  
62 subsection, may impose a civil penalty, *to be paid into the general fund of the Commonwealth*, in an  
63 amount not to exceed 15 percent of the amount improperly withheld from escrow per day of the  
64 violation and in a total amount not to exceed 300 percent of the original amount improperly withheld  
65 from escrow; and

66 3. In the case of a second knowing violation, be prohibited from selling cigarettes to consumers  
67 within the Commonwealth (whether directly or through a distributor, retailer or similar intermediary) for  
68 a period not to exceed two years.

69 Each failure to make an annual deposit required under this section shall constitute a separate  
70 violation.

71 *D. Any tobacco product manufacturer subject to the provisions of subdivision A 2 may elect to take*  
72 *the tax deduction pursuant to subsection E of § 58.1-402 if it:*

73 1. *Elects to forego the full escrow release provisions contained in subdivisions B 2 and B 3 and*  
74 *agrees to permanently release escrowed funds to the state; or*

75 2. *Elects to forego the full escrow release provisions contained in subdivisions B 2 and B 3 and*  
76 *agrees to receive in refund only those escrowed funds that would have otherwise reverted back to the*  
77 *manufacturer after 25 years pursuant to subdivision B 3, reduced by the value of the state income tax*  
78 *deduction that was claimed 25 years earlier, which relates to the escrowed funds. For purposes of this*  
79 *computation, the "value of the state income tax deduction" means the amount deducted pursuant to*  
80 *subsection E of § 58.1-402 multiplied by the state corporate income tax rate in effect in the taxable year*  
81 *the deduction was claimed.*

82 *Any agreement pursuant to this subsection shall be in such form as the Attorney General may direct.*

83 § 58.1-402. Virginia taxable income.

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

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

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

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

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

99 3. [Repealed.]

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

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

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

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

108 8. a. For taxable years beginning on and after January 1, 2004, the amount of any intangible  
109 expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or  
110 indirectly with one or more direct or indirect transactions with one or more related members to the  
111 extent such expenses and costs were deductible or deducted in computing federal taxable income for  
112 Virginia purposes. This addition shall not be required for any portion of the intangible expenses and  
113 costs if one of the following applies:

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

117 (2) The related member derives at least one-third of its gross revenues from the licensing of  
118 intangible property to parties who are not related members, and the transaction giving rise to the  
119 expenses and costs between the corporation and the related member was made at rates and terms

comparable to the rates and terms of agreements that the related member has entered into with parties who are not related members for the licensing of intangible property; or

(3) The corporation can establish to the satisfaction of the Tax Commissioner that the intangible expenses and costs meet both of the following: (i) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person who is not a related member, and (ii) the transaction giving rise to the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any portion of the tax due under this chapter.

b. A corporation required to add to its federal taxable income intangible expenses and costs pursuant to subdivision a may petition the Tax Commissioner, after filing the related income tax return for the taxable year and remitting to the Tax Commissioner all taxes, penalties, and interest due under this article for such taxable year including tax upon any amount of intangible expenses and costs required to be added to federal taxable income pursuant to subdivision a, to consider evidence relating to the transaction or transactions between the corporation and a related member or members that resulted in the corporation's taxable income being increased, as required under subdivision a, for such intangible expenses and costs.

If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and convincing evidence, that the transaction or transactions between the corporation and a related member or members resulting in such increase in taxable income pursuant to subdivision a had a valid business purpose other than the avoidance or reduction of the tax due under this chapter, the Tax Commissioner shall permit the corporation to file an amended return. For purposes of such amended return, the requirements of subdivision a shall not apply to any transaction for which the Tax Commissioner is satisfied (and has identified) that the transaction had a valid business purpose other than the avoidance or reduction of the tax due under this chapter. Such amended return shall be filed by the corporation within one year of the written permission granted by the Tax Commissioner and any refund of the tax imposed under this article shall include interest at a rate equal to the rate of interest established under § 58.1-15 and such interest shall accrue as provided under § 58.1-1833. However, upon the filing of such amended return, any related member of the corporation that subtracted from taxable income amounts received pursuant to subdivision C 21 shall be subject to the tax imposed under this article on that portion of such amounts for which the corporation has filed an amended return pursuant to this subdivision. In addition, for such transactions identified by the Tax Commissioner herein by which he has been satisfied by clear and convincing evidence, the Tax Commissioner may permit the corporation in filing income tax returns for subsequent taxable years to deduct the related intangible expenses and costs without making the adjustment under subdivision a.

The Tax Commissioner may charge a fee for all direct and indirect costs relating to the review of any petition pursuant to this subdivision, to include costs necessary to secure outside experts in evaluating the petition. The Tax Commissioner may condition the review of any petition pursuant to this subdivision upon payment of such fee.

No suit for the purpose of contesting any action of the Tax Commissioner under this subdivision shall be maintained in any court of this Commonwealth.

c. Nothing in subdivision B 8 shall be construed to limit or negate the Department's authority under § 58.1-446;

9. a. For taxable years beginning on and after January 1, 2004, the amount of any interest 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 purposes. This addition shall not be required for any portion of the interest expenses and costs, if:

(1) The related member has substantial business operations relating to interest-generating activities, in which the related member pays expenses for at least five full-time employees who maintain, manage, defend or are otherwise responsible for operations or administration relating to the interest-generating activities; and

(2) The interest expenses and costs are not directly or indirectly for, related to or in connection with the direct or indirect acquisition, maintenance, management, sale, exchange, or disposition of intangible property; and

(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; and

(4) One of the following applies:

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

181 (ii) Payments arise pursuant to a pre-existing contract entered into when the parties were not related  
182 members provided the payments continue to be made at arm's length rates and terms;

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

185 (iv) The transaction giving rise to the interest payments between the corporation and a related  
186 member was done at arm's length rates and terms and meets any of the following: (a) the related  
187 member uses funds that are borrowed from a party other than a related member or that are paid,  
188 incurred or passed-through to a person who is not a related member; (b) the debt is part of a regular and  
189 systematic funds management or portfolio investment activity conducted by the related member, whereby  
190 the funds of two or more related members are aggregated for the purpose of achieving economies of  
191 scale, the internal financing of the active business operations of members, or the benefit of centralized  
192 management of funds; (c) financing the expansion of the business operations; or (d) restructuring the  
193 debt of related members, or the pass-through of acquisition-related indebtedness to related members.

194 b. A corporation required to add to its federal taxable income interest expenses and costs pursuant to  
195 subdivision a may petition the Tax Commissioner, after filing the related income tax return for the  
196 taxable year and remitting to the Tax Commissioner all taxes, penalties, and interest due under this  
197 article for such taxable year including tax upon any amount of interest expenses and costs required to be  
198 added to federal taxable income pursuant to subdivision a, to consider evidence relating to the  
199 transaction or transactions between the corporation and a related member or members that resulted in the  
200 corporation's taxable income being increased, as required under subdivision a, for such interest expenses  
201 and costs.

202 If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and  
203 convincing evidence, that the transaction or transactions between the corporation and a related member  
204 or members resulting in such increase in taxable income pursuant to subdivision a had a valid business  
205 purpose other than the avoidance or reduction of the tax due under this chapter and that the related  
206 payments between the parties were made at arm's length rates and terms, the Tax Commissioner shall  
207 permit the corporation to file an amended return. For purposes of such amended return, the requirements  
208 of subdivision a shall not apply to any transaction for which the Tax Commissioner is satisfied (and has  
209 identified) that the transaction had a valid business purpose other than the avoidance or reduction of the  
210 tax due under this chapter and that the related payments between the parties were made at arm's length  
211 rates and terms. Such amended return shall be filed by the corporation within one year of the written  
212 permission granted by the Tax Commissioner and any refund of the tax imposed under this article shall  
213 include interest at a rate equal to the rate of interest established under § 58.1-15 and such interest shall  
214 accrue as provided under § 58.1-1833. However, upon the filing of such amended return, any related  
215 member of the corporation that subtracted from taxable income amounts received pursuant to subdivision  
216 C 21 shall be subject to the tax imposed under this article on that portion of such amounts for which the  
217 corporation has filed an amended return pursuant to this subdivision. In addition, for such transactions  
218 identified by the Tax Commissioner herein by which he has been satisfied by clear and convincing  
219 evidence, the Tax Commissioner may permit the corporation in filing income tax returns for subsequent  
220 taxable years to deduct the related interest expenses and costs without making the adjustment under  
221 subdivision a.

222 The Tax Commissioner may charge a fee for all direct and indirect costs relating to the review of  
223 any petition pursuant to this subdivision, to include costs necessary to secure outside experts in  
224 evaluating the petition. The Tax Commissioner may condition the review of any petition pursuant to this  
225 subdivision upon payment of such fee.

226 No suit for the purpose of contesting any action of the Tax Commissioner under this subdivision  
227 shall be maintained in any court of this Commonwealth.

228 c. Nothing in subdivision B 9 shall be construed to limit or negate the Department's authority under  
229 § 58.1-446.

230 d. For purposes of subdivision B 9:

231 "Arm's length rates and terms" means that (i) two or more related members enter into a written  
232 agreement for the transaction, (ii) such agreement is of a duration and contains payment terms  
233 substantially similar to those that the related member would be able to obtain from an unrelated entity,  
234 (iii) the interest is at or below the applicable federal rate compounded annually for debt instruments  
235 under § 1274(d) of the Internal Revenue Code that was in effect at the time of the agreement, and (iv)  
236 the borrower or payor adheres to the payment terms of the agreement governing the transaction or any  
237 amendments thereto.

238 "Valid business purpose" means one or more business purposes that alone or in combination  
239 constitute the motivation for some business activity or transaction, which activity or transaction  
240 improves, apart from tax effects, the economic position of the taxpayer, as further defined by regulation.

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

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

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

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

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

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

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

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

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

9. [Repealed.]

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

11. [Repealed.]

12, 13. [Expired.]

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

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

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

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

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

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

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

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

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

21. For taxable years beginning on and after January 1, 2004, any amount of intangible expenses and costs or interest expenses and costs added to the federal taxable income of a corporation pursuant to

304 subdivision B 8 or B 9 shall be subtracted from the federal taxable income of the related member that  
305 received such amount if such related member is subject to Virginia income tax on the same amount.

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

308 *E. For taxable years beginning on or after January 1, 2005, in computing Virginia taxable income,*  
309 *there shall be deducted from federal taxable income all amounts deposited by the nonparticipating*  
310 *tobacco product manufacturer during the taxable year into a qualified escrow fund pursuant to*  
311 *subdivision A 2 of § 3.1-336.2, but the deduction shall be allowed only to the extent that such amounts*  
312 *have not been deducted in determining federal taxable income. In addition, no deduction shall be*  
313 *allowed under this subdivision unless and until the nonparticipating tobacco product manufacturer has*  
314 *executed an agreement with the Attorney General pursuant to subsection D of § 3.1-336.2.*

315 **2. That, if any portion of the amendments to subdivision B 2 of § 3.1-336.2 pursuant to this act**  
316 **are held by a court of competent jurisdiction to be unconstitutional, then such amendments to**  
317 **subdivision B 2 shall be deemed repealed in their entirety, and subdivision B 2 of § 3.1-336.2 shall**  
318 **be in effect as such subdivision existed on June 30, 2005. Neither any holding of**  
319 **unconstitutionality nor any repeal of subdivision B 2 of § 3.1-336.2 pursuant to this enactment**  
320 **clause shall affect, impair, or invalidate any other portion of § 3.1-336.2, or the application of such**  
321 **section to any other person or circumstance, and such remaining portions of § 3.1-336.2 shall at all**  
322 **times continue in full force and effect.**