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SENATE BILL NO. 1147

AMENDMENT IN THE NATURE OF A SUBSTITUTE

(Proposed by the Joint Conference Committee
on February 20, 2009)

(Patron Prior to Substitute—Senator Whipple)

*A BILL to amend and reenact § 58.1-402 of the Code of Virginia, relating to corporate income tax; real estate investment trusts.***Be it enacted by the General Assembly of Virginia:****1. That § 58.1-402 of the Code of Virginia is amended and reenacted as follows:**

§ 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, D, and E.

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, D, and E.

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 [Repealed.]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, 2004, the amount of any 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 purposes. This addition shall not be required for any portion of the intangible expenses and costs if one of the following applies:

(1) 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;

(2) The related member derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members, and the transaction giving rise to the 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

60 transaction or transactions between the corporation and a related member or members that resulted in the
61 corporation's taxable income being increased, as required under subdivision a, for such intangible
62 expenses and costs.

63 If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and
64 convincing evidence, that the transaction or transactions between the corporation and a related member
65 or members resulting in such increase in taxable income pursuant to subdivision a had a valid business
66 purpose other than the avoidance or reduction of the tax due under this chapter, the Tax Commissioner
67 shall permit the corporation to file an amended return. For purposes of such amended return, the
68 requirements of subdivision a shall not apply to any transaction for which the Tax Commissioner is
69 satisfied (and has identified) that the transaction had a valid business purpose other than the avoidance
70 or reduction of the tax due under this chapter. Such amended return shall be filed by the corporation
71 within one year of the written permission granted by the Tax Commissioner and any refund of the tax
72 imposed under this article shall include interest at a rate equal to the rate of interest established under
73 § 58.1-15 and such interest shall accrue as provided under § 58.1-1833. However, upon the filing of
74 such amended return, any related member of the corporation that subtracted from taxable income
75 amounts received pursuant to subdivision C 21 shall be subject to the tax imposed under this article on
76 that portion of such amounts for which the corporation has filed an amended return pursuant to this
77 subdivision. In addition, for such transactions identified by the Tax Commissioner herein by which he
78 has been satisfied by clear and convincing evidence, the Tax Commissioner may permit the corporation
79 in filing income tax returns for subsequent taxable years to deduct the related intangible expenses and
80 costs without making the adjustment under subdivision a.

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

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

87 c. Nothing in subdivision B 8 shall be construed to limit or negate the Department's authority under
88 § 58.1-446;

89 9. a. For taxable years beginning on and after January 1, 2004, the amount of any interest expenses
90 and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with
91 one or more direct or indirect transactions with one or more related members to the extent such
92 expenses and costs were deductible or deducted in computing federal taxable income for Virginia
93 purposes. This addition shall not be required for any portion of the interest expenses and costs, if:

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

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

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

104 (4) One of the following applies:

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

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

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

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

121 b. A corporation required to add to its federal taxable income interest 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 interest 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 interest 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 and that the related payments between the parties were made at arm's length rates and terms, 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 and that the related payments between the parties were made at arm's length rates and terms. 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 interest 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 9 shall be construed to limit or negate the Department's authority under § 58.1-446.

d. For purposes of subdivision B 9:

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

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

10. a. For taxable years beginning on and after January 1, 2009, the amount of dividends deductible under §§ 561 and 857 of the Internal Revenue Code by a Captive Real Estate Investment Trust ("REIT"). For purposes of this subdivision, a REIT is a Captive REIT if:

(1) It is not regularly traded on an established securities market;

(2) More than 50 percent of the voting power or value of beneficial interests or shares of which, at any time during the last half of the taxable year, is owned or controlled, directly or indirectly, by a single entity that is (i) a corporation or an association taxable as a corporation under the Internal Revenue Code; and (ii) not exempt from federal income tax pursuant to § 501 (a) of the Internal Revenue Code; and

(3) More than 25% of its income consists of rents from real property as defined in § 856 (d) of the Internal Revenue Code.

b. For purposes of applying the ownership test of subdivision 10 a (2), the following entities shall not be considered a corporation or an association taxable as a corporation:

(1) Any REIT that is not treated as a Captive REIT;

(2) Any REIT subsidiary under § 856 of the Internal Revenue Code other than a qualified REIT

183 subsidiary of a Captive REIT;

184 (3) Any Listed Australian Property Trust, or an entity organized as a trust, provided that a Listed
185 Australian Property Trust owns or controls, directly or indirectly, 75 percent or more of the voting or
186 value of the beneficial interests or shares of such trust; and

187 (4) Any Qualified Foreign Entity.

188 c. For purposes of subdivision B 10, the constructive ownership rules prescribed under § 318 (a) of
189 the Internal Revenue Code, as modified by § 856 (d) (5) of the Internal Revenue Code, shall apply in
190 determining the ownership of stock, assets, or net profits of any person.

191 d. For purposes of subdivision B 10:

192 "Listed Australian Property Trust" means an Australian unit trust registered as a Management
193 Investment Scheme, pursuant to the Australian Corporations Act, in which the principal class of units is
194 listed on a recognized stock exchange in Australia and is regularly traded on an established securities
195 market.

196 "Qualified Foreign Entity" means a corporation, trust, association or partnership organized outside
197 the laws of the United States and that satisfies all of the following criteria:

198 (1) At least 75 percent of the entity's total asset value at the close of its taxable year is represented
199 by real estate assets, as defined in § 856 (c) (5) (B) of the Internal Revenue Code, thereby including
200 shares or certificates of beneficial interest in any REIT, cash and cash equivalents, and U.S.
201 Government securities;

202 (2) The entity is not subject to a tax on amounts distributed to its beneficial owners, or is exempt
203 from entity level tax;

204 (3) The entity distributes, on an annual basis, at least 85 percent of its taxable income, as computed
205 in the jurisdiction in which it is organized, to the holders of its shares or certificates of beneficial
206 interest;

207 (4) The shares or certificates of beneficial interest of such entity are regularly traded on an
208 established securities market or, if not so traded, not more than 10 percent of the voting power or value
209 in such entity is held directly, indirectly, or constructively by a single entity or individual; and

210 (5) The entity is organized in a country that has a tax treaty with the United States.

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

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

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

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

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

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

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

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

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

233 9. [Repealed.]

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

236 11. [Repealed.]

237 12, 13. [Expired.]

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

241 15. For taxable years beginning on or after January 1, 2000, the total amount actually contributed in
242 funds to the Virginia Public School Construction Grants Program and Fund established in Chapter 11.1
243 (§ 22.1-175.1 et seq.) of Title 22.1.

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

22. For taxable years beginning on and after January 1, 2009, any gain recognized from the sale of launch services to space flight participants, as defined in 49 U.S.C. § 70102, or launch services intended to provide individuals the training or experience of a launch, without performing an actual launch. To qualify for a deduction under this subdivision, launch services must be performed in Virginia or originate from an airport or spaceport in Virginia.

23. For taxable years beginning on and after January 1, 2009, any gain recognized as a result of resupply services contracts for delivering payload, as defined in 49 U.S.C. § 70102, entered into with the Commercial Orbital Transportation Services division of the National Aeronautics and Space Administration or other space flight entity, as defined in § 8.01-227.8, and launched from an airport or spaceport in Virginia.

D. For taxable years beginning on and after January 1, 2006, there shall be subtracted from federal taxable income contract payments to a producer of quota tobacco or a tobacco quota holder as provided under the American Jobs Creation Act of 2004 (P.L. 108-357) as follows:

1. If the payment is received in installment payments, then the recognized gain, including any gain recognized in taxable year 2005, may be subtracted in the taxable year immediately following the year in which the installment payment is received.

2. If the payment is received in a single payment, then 10% of the recognized gain may be subtracted in the taxable year immediately following the year in which the single payment is received. The taxpayer may then deduct an equal amount in each of the nine succeeding taxable years.

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

2. Notwithstanding the provisions of subdivision B 10 a of § 58.1-402, the addition specified in such subdivision shall be reduced by one-half for taxable years beginning on and after January 1, 2009, but before January 1, 2011.