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HOUSE BILL NO. 1267

Offered January 20, 2012

A BILL to amend the Code of Virginia by adding in Chapter 3 of Title 58.1 an article numbered 10.1, consisting of sections numbered 58.1-423.1 through 58.1-423.6, relating to corporate income tax; combined reporting requirements.

Patron—Scott, J.M.

Referred to Committee on Finance

Be it enacted by the General Assembly of Virginia:

1. That the Code of Virginia is amended by adding in Chapter 3 of Title 58.1 an article numbered 10.1, consisting of sections numbered 58.1-423.1 through 58.1-423.6, as follows:

Article 10.1.

Combined Reporting Requirements.

§ 58.1-423.1. Combined reporting requirements.

For taxable years beginning on or after January 1, 2013, applicable persons shall be subject to combined reporting requirements as set forth in this article and implemented by the Department of Taxation.

§ 58.1-423.2. Definitions.

For the purpose of this article:

"Combined group" means the group of all persons whose income and apportionment factors are required to be taken into account pursuant to subsection A or B of § 58.1-423.3 in determining the taxpayer's share of the net business income or loss apportionable to the Commonwealth.

"Corporation" means any corporation as defined by the laws of the Commonwealth or organization of any kind treated as a corporation for tax purposes under the laws of the Commonwealth, wherever located, which, if it were doing business in the Commonwealth, would be a "taxpayer." The business conducted by a partnership that is directly or indirectly held by a corporation shall be considered the business of the corporation to the extent of the corporation's distributive share of the partnership income, inclusive of guaranteed payments to the extent prescribed by regulation.

"Internal Revenue Code" means Title 26 of the United States Code of 1986, as amended, without regard to application of federal treaties unless expressly made applicable to states of the United States.

"Partnership" means a general or limited partnership, or organization of any kind treated as a partnership for tax purposes under the laws of the Commonwealth.

"Person" means any individual, firm, partnership, general partner of a partnership, limited liability company, registered limited liability partnership, foreign limited liability partnership, association, corporation, company, syndicate, estate, trust, business trust, trustee, trustee in bankruptcy, receiver, executor, administrator, assignee, or organization of any kind.

"Tax haven" means a jurisdiction that, during the tax year in question:

1. Is identified by the Organisation for Economic Co-operation and Development (OECD) as a tax haven or as having a harmful preferential tax regime, or,

2. Exhibits the following characteristics established by the OECD in its 1998 report entitled "Harmful Tax Competition: An Emerging Global Issue" as indicative of a tax haven or as a jurisdiction having a harmful preferential tax regime, regardless of whether it is listed by the OECD as an uncooperative tax haven:

a. Has no or nominal effective tax on the relevant income; and

b. (1) Has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

(2) Has a tax regime that lacks transparency. A tax regime lacks transparency if the details of legislative, legal, or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;

(3) Facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;

(4) Explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or

(5) Has created a tax regime that is favorable for tax avoidance, based upon an overall assessment

of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial and related services sector relative to its overall economy.

"Taxpayer" means every person, corporation, partnership, organization, trust, or estate subject to taxation under the laws of the Commonwealth, or under the ordinances, resolutions, or orders of any county, city, town, or other political subdivision of the Commonwealth.

"Unitary business" means a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that is sufficiently interdependent, integrated, and interrelated through its activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among the separate parts and a significant flow of value to the separate parts. Any business conducted by a partnership shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or its distributive or any other share of partnership income. A business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a partnership if there is a synergy, exchange and flow of value between the two parts of the business, and the two corporations are members of the same commonly controlled group.

§ 58.1-423.3. Combined reporting required, when; discretionary under certain circumstances.

A. A taxpayer engaged in a unitary business with one or more other corporations shall file a combined report that includes the income, determined under subsection C of § 58.1-423.4, and apportionment factors, determined under Article 10 (§ 58.1-400 et seq.) and subdivision B of § 58.1-423.4, of all corporations that are members of the unitary business, and such other information as required by the Commissioner.

B. The Commissioner may, by regulation, require that the combined report include the income and associated apportionment factors of any persons that are not included pursuant to subsection A, but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses. Authority to require combination by regulation under this subsection includes authority to require combination of persons that are not, or would not be if doing business in the Commonwealth, subject to the laws of the Commonwealth.

In addition, if the Commissioner determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included pursuant to subsection A represents an avoidance or evasion of tax by such taxpayer, the Director may, on a case by case basis, require all or any part of the income and associated apportionment factors of such person be included in the taxpayer's combined report.

With respect to inclusion of associated apportionment factors pursuant to this subsection, the Commissioner may require the exclusion of any one or more of the factors, the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in the Commonwealth, or the employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

§ 58.1-423.4. Determination of taxable income or loss using combined report.

The use of a combined report does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to the Commonwealth, which shall include, in addition to other types of income, the taxpayer member's apportioned share of business income of the combined group, where business income of the combined group is calculated as a summation of the individual net business incomes of all members of the combined group. A member's net business income is determined by removing all but business income, expense, and loss from that member's total income, as provided in detail below.

A. Components of income subject to tax in the Commonwealth; application of tax credits, and post apportionment deductions.

1. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to the Commonwealth, which shall include:

a. Its share of any business income apportionable to the Commonwealth of each of the combined groups of which it is a member, determined under subsection B;

b. Its share of any business income apportionable to the Commonwealth of a distinct business activity conducted within and without the Commonwealth wholly by the taxpayer member, determined under Article 10 (§ 58.1-400 et seq.) ;

c. Its income from a business conducted wholly by the taxpayer member entirely within the Commonwealth;

d. Its income sourced to the Commonwealth from the sale or exchange of capital or assets, and from involuntary conversions, as determined under subdivision C 2 g;

e. Its nonbusiness income or loss allocable to the Commonwealth, determined under Article 10

(§ 58.1-400 et seq.);

f. Its income or loss allocated or apportioned in an earlier year, required to be taken into account as Commonwealth source income during the income year, other than a net operating loss; and

g. Its net operating loss carryover or carryback. If the taxable income computed pursuant to this section results in a loss for a taxpayer member of the combined group, that taxpayer member has a Virginia net operating loss (NOL), subject to the net operating loss limitations and carryforward and carryback provisions. Such NOL is applied as a deduction in a prior or subsequent year only if that taxpayer has Virginia source positive net income, whether or not the taxpayer is or was a member of a combined reporting group in the prior or subsequent year.

2. Except where otherwise provided, no tax credit or post-apportionment deduction earned by one member of the group, but not fully used by or allowed to that member, may be used in whole or in part by another member of the group or applied in whole or in part against the total income of the combined group; a post-apportionment deduction carried over into a subsequent year as to the member that incurred it, and available as a deduction to that member in a subsequent year, will be considered in the computation of the income of that member in the subsequent year, regardless of the composition of that income as apportioned, allocated, or wholly within the Commonwealth.

B. Determination of taxpayer's share of the business income of a combined group apportionable to the Commonwealth.

The taxpayer's share of the business income apportionable to the Commonwealth of each combined group of which it is a member shall be the product of (i) the business income of the combined group, determined under subsection C, and (ii) the taxpayer member's apportionment percentage, determined under Article 10 (§ 58.1-400 et seq.), including in the property, payroll, and sales factor numerators the taxpayer's property, payroll, and sales, respectively, associated with the combined group's unitary business in the Commonwealth, and including in the denominator the property, payroll, and sales of all members of the combined group, including the taxpayer, which property, payroll, and sales are associated with the combined group's unitary business wherever located. The property, payroll, and sales of a partnership shall be included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group in accordance with subdivision C 2 c and the denominator of which is the amount of the partnership's total unitary income.

C. Determination of the business income of the combined group.

The business income of a combined group is determined as follows:

1. From the total income of the combined group, determined under subdivision 2, subtract any income and add any expense or loss, other than the business income, expense or loss of the combined group.

2. Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes. The income of each member of the combined group shall be determined as follows:

a. For any member incorporated in the United States, or included in a consolidated federal corporate income tax return, the income to be included in the total income of the combined group shall be the taxable income for the corporation after making appropriate adjustments under Article 10 (§ 58.1-400 et seq.).

b. (1) For any member not included in subdivision 2 a, the income to be included in the total income of the combined group shall be determined as follows:

(a) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(b) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(c) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required by Title 58.1.

(d) Except as otherwise provided by regulation, the profit and loss statement of each member of the combined group, and the apportionment factors related thereto, whether United States or foreign, shall be translated into the currency in which the parent company maintains its books and records.

(e) Income apportioned to this state shall be expressed in United States dollars.

(2) In lieu of the procedures set forth in subdivision 2 b (1) and subject to the determination of the Director that it reasonably approximates income as determined under Title 58.1, any member not included in subdivision 2 a may determine its income on the basis of the consolidated profit and loss statement, which includes the member and which is prepared for filing with the Securities and Exchange Commission by related corporations. If the member is not required to file with the Securities and

Exchange Commission, the Commissioner may allow the use of the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor. If above statements do not reasonably approximate income as determined under Title 58.1, the Commissioner may accept those statements with appropriate adjustments to approximate that income.

c. If a unitary business includes income from a partnership, the income to be included in the total income of the combined group shall be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income.

d. All dividends paid by one to another of the members of the combined group shall, to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report, in the current or an earlier year, be eliminated from the income of the recipient. This provision shall not apply to dividends received from members of the unitary business that are not a part of the combined group.

e. Except as otherwise provided by regulation, business income from an intercompany transaction between members of the same combined group shall be deferred in a manner similar to 26 C.F.R. 1.1502-13. Upon the occurrence of any of the following events, deferred business income resulting from an intercompany transaction between members of a combined group shall be restored to the income of the seller, and shall be apportioned as business income earned immediately before the event:

(1) The object of a deferred intercompany transaction is (i) resold by the buyer to an entity that is not a member of the combined group, (ii) resold by the buyer to an entity that is a member of the combined group for use outside the unitary business in which the buyer and seller are engaged, or (iii) converted by the buyer to a use outside the unitary business in which the buyer and seller are engaged; or

(2) The buyer and seller are no longer members of the same combined group, regardless of whether the members remain unitary.

f. A charitable expense incurred by a member of a combined group shall, to the extent allowable as a deduction pursuant to Internal Revenue Code § 170, be subtracted first from the business income of the combined group (subject to the income limitations of that section applied to the entire business income of the group), and any remaining amount shall then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the income limitations of that section applied to the nonbusiness income of that specific member). Any charitable deduction disallowed under the foregoing rule, but allowed as a carryover deduction in a subsequent year, shall be treated as originally incurred in the subsequent year by the same member, and the rules of this section shall apply in the subsequent year in determining the allowable deduction in that year.

g. Gain or loss from the sale or exchange of capital assets, property described by Internal Revenue Code § 1231(a)(3), and property subject to an involuntary conversion, shall be removed from the total separate net income of each member of a combined group and shall be apportioned and allocated as follows.

(1) For each class of gain or loss (short-term capital, long-term capital, Internal Revenue Code § 1231, and involuntary conversions), all members' business gain and loss for the class shall be combined (without netting between such classes), and each class of net business gain or loss separately apportioned to each member using the member's apportionment percentage determined under subsection B.

(2) Each taxpayer member shall then net its apportioned business gain or loss for all classes, including any such apportioned business gain and loss from other combined groups, against the taxpayer member's nonbusiness gain and loss for all classes allocated to the Commonwealth, using the rules of Internal Revenue Code §§ 1231 and 1222, without regard to any of the taxpayer member's gains or losses from the sale or exchange of capital assets, § 1231 property, and involuntary conversions that are nonbusiness items allocated to another state.

(3) Any resulting state source income (or loss, if the loss is not subject to the limitations of Internal Revenue Code § 1211) of a taxpayer member produced by the application of the preceding subsections shall then be applied to all other state source income or loss of that member.

(4) Any resulting state source loss of a member that is subject to the limitations of § 1211 of the Internal Revenue Code shall be carried forward by that member, and shall be treated as state source short-term capital loss incurred by that member for the year for which the carryover applies.

h. Any expense of one member of the unitary group that is directly or indirectly attributable to the nonbusiness or exempt income of another member of the unitary group shall be allocated to that other member as corresponding nonbusiness or exempt expense, as appropriate.

§ 58.1-423.5. Designation of surety.

As a filing convenience, and without changing the respective liability of the group members, members of a combined reporting group may annually elect to designate one taxpayer member of the combined group to file a single return in the form and manner prescribed by the department, in lieu of filing their own respective returns, provided that the taxpayer designated to file the single return

consents to act as surety with respect to the tax liability of all other taxpayers properly included in the combined report, and agrees to act as agent on behalf of those taxpayers for the year of the election for tax matters relating to the combined report for that year. If for any reason the surety is unwilling or unable to perform its responsibilities, tax liability may be assessed against the taxpayer members.

§ 58.1-423.6. Water's-edge election; initiation and withdrawal.

A. Water's-edge election. Taxpayer members of a unitary group that meet the requirements of subsection B may elect to determine each of their apportioned shares of the net business income or loss of the combined group pursuant to a water's-edge election. Under such election, taxpayer members shall take into account all or a portion of the income and apportionment factors of only the following members otherwise included in the combined group pursuant to § 58.1-423.3, as described below:

1. The entire income and apportionment factors of any member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States;

2. The entire income and apportionment factors of any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States are 20 percent or more;

3. The entire income and apportionment factors of any member that is a domestic international sales corporation as described in Internal Revenue Code §§ 991 to 994, inclusive; a foreign sales corporation as described in Internal Revenue Code §§ 921 to 927, inclusive; or any member that is an export trade corporation, as described in Internal Revenue Code §§ 970 to 971, inclusive;

4. Any member not described in subdivisions 1 through 3, shall include the portion of its income derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and its apportionment factors related thereto;

5. Any member that is a "controlled foreign corporation," as defined in Internal Revenue Code § 957, to the extent of the income of that member that is defined in § 952 of Subpart F of the Internal Revenue Code ("Subpart F income") not excluding lower-tier subsidiaries' distributions of such income that were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that income; any item of income received by a controlled foreign corporation shall be excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code § 11;

6. Any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto; and,

7. The entire income and apportionment factors of any member that is doing business in a tax haven, where "doing business in a tax haven" is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in subsection G of § 58.1-423.2, the activity of the member shall be treated as not having been conducted in a tax haven.

B. Initiation and withdrawal of election.

1. A water's-edge election is effective only if made on a timely-filed, original return for a tax year by every member of the unitary business subject to tax under Title 58.1. The Director shall develop rules and regulations governing the impact, if any, on the scope or application of a water's-edge election, including termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the taxpayer members, and any other similar change.

2. Such election shall constitute consent to the reasonable production of documents and taking of depositions in accordance with the laws of the Commonwealth relating to discovery.

3. In the discretion of the Director, a water's-edge election may be disregarded in part or in whole, and the income and apportionment factors of any member of the taxpayer's unitary group may be included in the combined report without regard to the provisions of this section, if any member of the unitary group fails to comply with any provision of this article or if a person otherwise not included in the water's-edge combined group was availed of with a substantial objective of avoiding state income tax.

4. A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter for a period of 10 years. It may be withdrawn or reinstituted after withdrawal, prior to the expiration of the 10-year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10-year period, a taxpayer may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the

expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election shall be in place for an additional 10-year period, subject to the same conditions as applied to the original election.

2. That the provisions of this act shall be effective on January 1, 2013.