

# INSTRUCTIONS FOR PREPARING

## FORM 502

### VIRGINIA PASS-THROUGH ENTITY RETURN OF INCOME

### RETURN FOR 2007



COMMONWEALTH OF VIRGINIA  
DEPARTMENT OF TAXATION  
RICHMOND, VIRGINIA

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## WHAT'S NEW

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### **Advancement of Virginia's Fixed Date Conformity with the Internal Revenue Code**

The 2007 General Assembly enacted legislation that moved Virginia's fixed date conformity with the Internal Revenue Code from December 31, 2005 to December 31, 2006. At the time these instructions went to print, the only required adjustments for "fixed date conformity" were: (i) the special 30% and 50% bonus depreciation allowance for certain assets under the IRC, and (ii) the 5-year net operating loss (NOL) carry back allowed for net operating losses generated in taxable year 2001 or 2002. If federal legislation is enacted that results in changes to the Internal Revenue Code for the 2007 taxable year, taxpayers may be required to make adjustments to their Virginia returns that are not described in the instruction booklet. Supplemental instructions will be posted on our website at [www.tax.virginia.gov](http://www.tax.virginia.gov). See pages 5 and 6 for additional information.

### **Subchapter S Corporations Subject to the Bank Franchise Tax**

Shareholders of S corporations that are subject to bank franchise tax may be able to deduct their share of the income or gain of the S corporation or may be required to add back their share of the losses or deductions of the S corporation. These taxpayers may also be required to add back any distributions made by the S corporation. The pertinent information is to be provided to the shareholder(s) by the S corporation in a separate schedule.

### **Deductions**

The Virginia Public School Construction Grants Program and Fund (code 43) and the Tobacco Quota Buyout Program (code 48) deductions must be claimed as deductions on the shareholder's individual income tax return. See instructions.

### **Neighborhood Assistance Act Tax Credit**

Effective July 1, 2007, the annual fiscal year cap for tax credits allowed under the Neighborhood Assistance Act is increased from \$8 million to \$12 million. One million dollars of the increase is allocated for education programs and \$3 million for providing grants to private schools for students with disabilities. The tax credit percentage for donations made by corporations and individuals is reduced from 45 percent to 40 percent. Also, individuals may claim a tax credit for the donation even though a charitable contribution deduction is claimed.

### **Coming in 2008 – Withholding Tax.**

Beginning on or after January 1, 2008, a pass-through entity that has taxable income for the taxable year derived from or connected with Virginia sources and any portion of which is allocable to a nonresident shareholder is required to pay withholding tax. The tax is five percent of the nonresident owner's share of income from Virginia sources for each of the nonresident owners. The withholding tax payment is due on the filing due date of the pass-through's 2008 return.

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- Use the Tax Policy Library
- E-mail Customer Services
- Review publications and bulletins
- Read filing information and FAQs

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## Forms and Information

Tenemos servicios disponible en Español.

**Customer Service Inquiries**  
**Department of Taxation**  
**P.O. Box 1115**  
**Richmond, Virginia 23218-1115**  
**Phone: (804) 367-8037**  
**FAX: (804) 367-0985**

**Forms Request Unit**  
**Department of Taxation**  
**P.O. Box 1317**  
**Richmond, Virginia 23218-1317**  
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Forms and Information can also be found on our Website - [www.tax.virginia.gov](http://www.tax.virginia.gov).

# INSTRUCTIONS FOR PREPARING FORM 502 VIRGINIA PASS-THROUGH ENTITY RETURN OF INCOME

## GENERAL INFORMATION

### Pass-Through Entities Required to File

Effective for taxable years beginning on or after January 1, 2004, every pass-through entity doing business in Virginia or having income from Virginia sources is required to file a return of income for each taxable year with the Department of Taxation.

Pass-through entities include Subchapter S corporations, general partnerships, limited partnerships, limited liability partnerships (LLPs), limited liability companies (LLCs), electing large partnerships and business trusts. A pass-through entity is any entity that is recognized as a separate entity for federal income tax purposes and the owners of which report their distributive or pro rata shares of the entity's income, gains, losses, deductions and credits on their own income tax returns. Unlike ordinary corporations ("C" corporations), a pass-through entity typically does not pay income tax itself; rather, the entity's income and related items are reported by the owners on their own returns and the tax is computed and paid at the owner level.

The Virginia pass-through entity return of income is Form 502. Previously S corporations were required to file their Virginia income tax return on Form 500S. Beginning with taxable year 2004, S corporations will file Form 502 instead of 500S. Partnerships (including LLCs and other entities treated as partnerships for federal income tax purposes) will also file Form 502; this is a new filing requirement.

A single-member LLC that is disregarded as a separate entity for federal income tax purposes will be similarly treated for Virginia income tax. Its income, gains, losses and deductions will be included with those of its owner on the owner's income tax return; the disregarded entity is not required to file Form 502.

Estates and trusts will continue to file with Virginia using Form 770, even in years in which some or all of the estate's or trust's income is passed through to beneficiaries.

An owner of a pass-through entity may be an individual, a corporation, a partnership or any other type of entity that is treated as a shareholder, partner or other member of a pass-through entity for federal income tax purposes.

An owner of a pass-through entity may itself be a pass-through entity and have other pass-through entities as its owners so that income, gains, losses and deductions may pass through several levels of ownership before reaching an owner that is actually taxable. All pass-through entities subject to filing in Virginia must file their own returns regardless of the ownership hierarchy that may exist. There are no "consolidated" or "multilevel" pass-through entity returns. See page 3 for information regarding filing a unified return for nonresident individual owners.

A pass-through entity has Virginia source income if it has:

1. Any items of income, gain, loss or deduction related to either:
  - a) the ownership of real or tangible personal property in Virginia, or
  - b) a business, trade, profession or occupation carried on in Virginia; OR
2. Any income or gain from intangible property to the extent such property is used by the entity in a business, trade, profession or occupation in Virginia.

If a pass-through entity does not conduct its entire business within Virginia, then it will determine the Virginia-source portion of its total income through allocation and apportionment (see below). In general, a non-Virginia entity will have income from Virginia sources if it has enough activity or presence in Virginia to make any apportionment factor (property, payroll or sales) positive. It may therefore be deemed to have Virginia source income under the apportionment formulas even if no specific portion of its gross or net income is separately identifiable as being derived directly from Virginia.

### Investment Pass-Through Entities

Previous rulings have held that pass-through entities that are established solely to invest in intangible personal property, such as stocks and bonds, and that have no employees and no real or tangible property, are not considered to be carrying on a trade or business. Thus, the income from the intangible property held by an investment pass-through entity is not income from Virginia sources, and these types of pass-through entities will not be required to file the new Form 502.

### Period Covered by Return

A pass-through entity's taxable year for Virginia is the same as its taxable year for federal income tax purposes.

### Accounting Methods

A pass-through entity's accounting methods for its Virginia return of income are the same as its accounting methods for federal income tax purposes.

### Allocation and Apportionment

If a pass-through entity's entire business is conducted within Virginia, then all of its income is Virginia source income; no income is allocated to another state, and the entity's Virginia apportionment is 100%. If a pass-through entity conducts its business in Virginia and elsewhere in a manner such that its income would be subject to a tax on net income in Virginia and at least one other state, the entity must allocate and apportion its income in the same manner as provided in Virginia law for corporations. This applies to all types of pass-through entities (partnerships, LLPs, LLCs, S corporations). Dividends received are to be allocated to the state of commercial domicile, but all other income must be apportioned, typically, based on the entity's property, payroll and sales.

An entity may not apportion its income based on divisional or separate accounting or any other alternate method unless it has requested and received permission to do so in advance from the Department of Taxation.

The effect of the pass-through entity's apportionment may vary from one owner to another, depending on the entity types of the owners. For instance:

- a Virginia resident individual owner is taxable on all of his or her pass-through entity income regardless of the entity's apportionment;
- a nonresident individual owner uses the entity's Virginia apportioned income in determining his or her own Virginia nonresident percentage; and
- a corporate owner may need to include the pass-through entity's property, payroll and sales factors in determining its own apportionment percentage.

See Schedule 502A and its instructions for more information about allocation and apportionment. Also see the instructions for lines 4 - 7 on page 4.

### **When and Where to File**

The pass-through entity return must be filed with the Department of Taxation no later than the 15th day of the fourth month after the close of the entity's taxable year. Original and any amended returns should be mailed to **Virginia Department of Taxation, P.O. Box 1500, Richmond, VA 23218-1500.**

### **Extension of Time to File**

For taxable years beginning on and after January 1, 2005, an automatic extension of time to file is granted to the date six months after such due date or 30 days after the extended date for filing the federal income tax return, whichever is later.

### **Penalties**

A pass-through entity that is required to file a return but fails to do so by the extended due date is liable for a penalty of \$200 for each month or part of a month that the return is late, for up to six months.

If a PTE does not file Form 502 on or before the extended due date, then the automatic extension is not valid and the late filing penalty is assessed as if no extension had been granted.

If the failure to file continues for more than six months, the Department of Taxation may assess the pass-through entity a penalty equal to six percent of the Virginia taxable income the owners derive from the entity. The Department may estimate this taxable income using any method it deems reasonable and with any information in its possession. The six percent penalty will be reduced by any monthly penalty already assessed, or the six percent penalty may be assessed instead of the monthly penalty. The six percent penalty will also be reduced to the extent any owner has paid Virginia tax on his or her share of the entity's income for the same tax year.

The minimum penalty for failure to file on time is \$200.

### **Signature**

The return must be signed by an officer of the S corporation, a general partner, or an authorized limited liability company member, as appropriate for the type of entity. An owner's signature on the return shall be prima facie evidence that

the owner is authorized to sign on behalf of the pass-through entity. If the return was prepared wholly or in substantial part by a person other than an owner or an employee of the entity, that person must also sign.

### **Virginia Schedules and Attachments**

In addition to the Form 502, the return must include a VA Schedule VK-1, Owner's Share of Income and Virginia Modifications and Credits, for each owner. Schedule 502A, Allocation and Apportionment, is also usually required. In order to claim certain tax credits, specific documentation must be attached to the return; see the CREDITS section for more information. If an entry is made on line 19 for state income tax paid, a supporting schedule must be attached. If the entity and the qualifying nonresident owners elect, a Form 765, Virginia Unified Nonresident Income Tax Return may be filed also, but that is a separate return and not an attachment to Form 502 (more information below).

A copy of the pass-through entity's federal return of income, as filed with the Internal Revenue Service, is required to be attached to the Virginia return. The required attachment includes the federal Form 1120S, Form 1065 or Form 1065B, with Schedule K and all Schedules K-1. If the federal return is so voluminous that it is impractical to include a complete copy with the Virginia return, attach the Form 1120S, Form 1065, or Form 1065B along with the Schedule K and a statement that the complete return will be made available upon request.

### **Order of Attachments**

- Form 502
- Schedule 502A, if applicable
- Schedule VK-1
- Schedule 500AB, if applicable
- A Copy of Your Federal Return

### **Report of Change in Federal Return**

If the amount of any item of distributive or pro rata income or deduction on the pass-through entity's federal return of income is changed or corrected by the Internal Revenue Service or other competent authority, or through renegotiation of a contract with the United States, the entity must notify the Department of Taxation within one year of the federal change. If a pass-through entity amends its federal return of income in any manner that would affect its Virginia return or the Virginia returns or tax liabilities of its owners, the entity must file an amended Virginia return with full disclosure of the federal amendment.

### **Amended Returns**

If for any reason it becomes necessary for a pass-through entity to amend a previously filed Virginia return, it should prepare a new Form 502 with all attachments (including Schedules VK-1) with the corrected figures and with "amended" marked in the place provided on the front of the return. The amendment must include an explanation of the changes made.

If a pass-through entity files its return (Form 502) and later finds it did not include all Schedules VK-1 with the return but no other changes to the return are necessary, the entity should not file an amended Form 502. Rather it should just submit the additional Schedules VK-1 to the Department of Taxation with a cover letter that includes the notation "Additional Schedules



VK-1 / Attach to Previously Filed Return.”

**Unified Return for Nonresident Individual Owners**

When a pass-through entity is required to file a Virginia return of income, the owners of the entity will usually have a Virginia filing requirement also. For owners who are not residents of Virginia and who have no other Virginia source income, filing may be simplified through the use of a unified nonresident income tax return. This allows the qualified owners to join in one return filed on their behalf by the pass-through entity; these owners are thereby relieved of the requirement that each file a return and pay tax separately.

A unified return is not required. It is an option that may be elected by the entity and the individual nonresident owners who qualify to participate, as an alternative to those owners filing separately. In addition, certain estates and trusts which qualify and have income passed through to their nonresident beneficiaries may elect to file a unified return. Because of its simplified computation, the tax due on a unified return may be greater than the total tax due if the participating owners filed their own individual returns, but the owners may find that the convenience of unified filing outweighs any additional tax. See Form 765, Virginia Unified Nonresident Income Tax Return - For Qualified Owners of a Pass-Through Entity or nonresident beneficiaries of an estate or trust, and its instructions for more information.

The unified return is an individual income tax return apart from the pass-through entity’s return. Form 765 may not be filed unless the entity has also filed its Form 502 or if a trust or estate, its Form 770. Do not mail the Form 765 with Form 502 or Form 770 as the case may be. If filing Form 765, mail separately to the address provided in the Form 765 Instructions.

Note that automatic extensions of time to file Form 502 or Form 770 and Form 765 are separate and independent of each other. A payment may be required for an extension for Form 765 if 90% of the liability has not been paid by the original due date.

Form 765 may be downloaded at our Website, **www.tax.virginia.gov**, or requested by calling our Forms Request Unit at (804) 440-2541.

**LINE-BY-LINE INSTRUCTIONS**

**Taxpayer Information**

**Fiscal year or short period filers:** Enter the beginning and ending dates for the pass-through entity’s fiscal or short year.

Enter the pass-through entity’s name, address and federal employer identification number (FEIN).

**Check boxes:** Mark the appropriate box for any condition that applies:

- the name or address shown represents a change that should be reflected in the Department’s records;
- the return is an amendment of a previously filed return;
- the return is the final return that the entity will have to file with Virginia (i.e., the entity has been dissolved or no longer operates in Virginia);
- a Virginia Unified Nonresident Individual Income Tax Return,

Form 765, will be filed for the same tax year;

- the entity is an electing large partnership;
- the entity’s fiscal year has changed;
- the entity is subject to Bank Franchise Tax. If this box is checked, the S-corporation will provide the shareholders with the pertinent information concerning their allocable share of the income or gain, losses or deductions or the value of any distributions paid or distributed to the shareholder by the S corporation.

**Entity type:** (Note: A proper entry in this field is required.) Enter the code that corresponds to the type of entity filing this return.

<u>type</u>	<u>code</u>
S corporation	SC
general partnership	PG
limited partnership	PL
limited liability company	LL
limited liability partnership	LP
other	OB

**NAICS code:** Enter the 6-digit NAICS (North American Industry Classification System) code. More information on NAICS can be found at [www.census.gov/pub/epcd/www/naics.html](http://www.census.gov/pub/epcd/www/naics.html).

**Number and Types of Owners**

Enter the total number of owners. The total number of owners should be the same as the number of Schedules K-1 filed with the pass-through entity’s federal return (see federal Form 1120S, page 1, line G, or Forms 1065 or 1065B, page 1, line I.)

Enter the total number of individual owners who are not residents of Virginia. If the residency status is not known, enter the number of individual owners with home addresses not in Virginia.

**Distributive or Pro Rata Income & Deductions**

**Line 1 - Total of taxable income amounts.**

Enter the total of all the various categories of taxable income shown in the “Income” section of the pass-through entity’s federal Schedule K. It may be helpful to use the worksheet below to summarize the income, but note that the worksheet lines may not correspond exactly to every item on the Schedule K. If you are an “electing large partnership”, see the note following line 3 on page 4.

Ordinary income (loss) from trade or business	_____
Net income (loss) from rental real estate	_____
Net income (loss) from other rental activity	_____
Interest income	_____
Dividend income	_____
Royalty income	_____

Other portfolio income	_____
Net short term capital gain (loss)	_____
Net long-term capital gain (loss)	_____
Net Section 1231 gain (loss)	_____
Other taxable income	_____
Total of taxable income amounts (This is a Virginia calculation; there is not a total on the federal Schedule K.)	_____

Caution: The federal Schedule K does not include a total taxable income amount, and the correct amount to enter on Form 502 is not necessarily the sum of all entries in the "Income" section of Schedule K. Schedule K may have entries that overlap for a particular category of income (for instance, a yearly amount and the amount through a certain date, because of a midyear federal law change). For each category of income, include only the yearly total in the Virginia computation; do not omit, duplicate or count any amounts twice.

**Line 2 - Total of deductions.**

Enter the total of the various categories of deductions shown in the "Deductions" section of the pass-through entity's federal Schedule K. This may include charitable contributions, the Section 179 expense deduction and "other."

**Line 3 - Tax-exempt interest income.**

Enter the total tax-exempt interest income shown in the "Other" section of the pass-through entity's federal Schedule K.

**Electing large partnerships:** An electing large partnership, which files federal Form 1065B, combines items of income, gain, loss and deduction before reporting to the partners, rather than reporting such items separately to partners as do other partnerships. The Schedule K for Form 1065B is therefore significantly different from Schedule K for Forms 1065 and 1120S. From the Schedule K (Form 1065B), combine total taxable income (loss) from passive loss limitation activities (without regard to general or limited partner allocation), taxable income (loss) from other activities, qualified dividends from other activities, and any net capital gain or other taxable income from Schedule K not included in the above amounts. Enter the result on line 1, Total of taxable income amounts. Leave line 2 blank. Enter the amount of tax-exempt interest income from Schedule K on line 3.

**Lines 4 - 7 Allocation and Apportionment**

All pass-through entities must complete this section. If the pass-through entity conducted its business entirely within Virginia, and no income is allocated or apportioned elsewhere, then leave lines 4 and 5 blank, repeat the amount from line 1 on line 6, and enter "100%" on line 7. In all other cases, complete Schedule 502A first to determine the entries for lines 4 - 7 as described below. See Schedule 502A and its instructions for more information on who is eligible to allocate and apportion income and how to do it.

Virginia law provides that dividends received are to be allocated to the state of commercial domicile, and that all other income must be apportioned as directed in Code of Virginia §§ 58.1-408 - 58.1-420. Virginia law does not allow for subtractions

from apportionable income based on separate or divisional accounting or for exclusion of non-Virginia investment income. Except as provided below, an alternative method of allocation and apportionment may not be used without prior written approval from the Department of Taxation.

Some entities may be entitled to an alternative method of allocation and apportionment if they can demonstrate that the application of Virginia's apportionment law to their particular facts for the taxable year would be contrary to the principles set forth in *Allied Signal, Inc. v. Director, Division of Taxation*, 112 S. Ct. 2251 (1992).

In *Allied Signal, Inc.*, the Court reaffirmed the continued validity of apportionment of any income received directly by the taxpayer, including investment income such as capital gains, unless the capital transaction serves an investment function that is completely unrelated to any operational activities carried on in the state. The Court also reinforced the principle that investment income may be included in apportionable income if there is a unitary relationship between the taxpayer and the entity in which the taxpayer has invested. However, the Court made it clear that the absence of a unitary relationship does not necessarily preclude apportionment.

Such an adjustment for unrelated investment function income is only available to a multistate entity that is entitled to allocate and apportion its income, and that proves by clear and cogent evidence that the assets producing the income serve an investment function unrelated to operational functions. If investment function income is excluded from apportionable income, the denominator of the relevant apportionment factors must also be adjusted to exclude items related to the investment assets.

Any entity that qualifies for an alternative method of allocation and apportionment for this type of income is required to add back any loss included in federal taxable income that is attributable to the acquisition, ownership, management, stewardship, sale or exchange of investment assets that are unrelated to the taxpayer's operational function. If the entity previously claimed a subtraction for nonapportionable investment function income with respect to any investment assets, an addition is required for any subsequent losses generated by such assets.

**Burden of Proof:** As a prerequisite to claiming an adjustment on lines 3b and 3d of Schedule 502A (which effectively allocates income other than dividends) the entity must be able to demonstrate that the application of Virginia law to its particular facts will be unconstitutional. The burden is on the entity to prove by clear and cogent evidence that the capital investment was completely separate from its operations, and that the taxpayer's investment function was located outside of Virginia. The entity must also demonstrate that the classification of the capital asset and its income for Virginia purposes is consistent with the manner in which the income has been allocated and apportioned with other state tax authorities. The entity will be under a particularly heavy burden of proof in cases where the asset was clearly operational at any time. Objective evidence is required; an unsubstantiated statement as to the entity's intent, purpose or state of mind will be insufficient to meet the burden. An

entity claiming this exclusion for nonapportionable income must attach a statement to the return stating the nature of the adjustment and the basis for the position that relief is in accordance with *Allied-Signal*. The entity should include with the return all evidence necessary to support its position. For additional information, see Virginia Tax Bulletin 93-4 (also designated Public Document (“PD”) 93-93B).

#### Other alternate method of allocation or apportionment

If any pass-through entity believes that the method of allocation or apportionment specified by the Department of Taxation will subject it or its owners to taxation on a greater portion of the entity’s net income than is reasonably attributable to business or sources within Virginia, it is entitled to file with the Department a statement of its objections and of such alternative method of allocation or apportionment as it believes to be proper under the circumstances, with such detail and proof and within such time as the Department may reasonably prescribe. If the Department concludes that the method of allocation or apportionment employed is, in fact, inapplicable or inequitable, it shall redetermine the allocation or apportionment by such other method as seems best calculated to assign to the state for taxation the portion of the income reasonably attributable to business and sources within the state, not exceeding, however, the amount which would be arrived at by application of the statutory rules for allocation or apportionment.

The policy of the Department of Taxation is that the statutory method is the most equitable method of determining the portion of income that is attributable to business activity in Virginia. Permission to use an alternative method of allocation and apportionment will be granted only in extraordinary circumstances.

#### **Line 4.**

Enter the amount from Schedule 502A, Part A, line 2.

#### **Line 5.**

Enter the amount from Schedule 502A, Part A, line 3e.

#### **Line 6.**

Enter the amount from Schedule 502A, Part A, line 4.

#### **Line 7.**

Enter the apportionment percentage from Schedule 502A. For most filers, that will be from Schedule 502A, Part B, line 1f, but certain businesses that use a special apportionment method will refer to Schedule 502A, Part B, lines 2 - 5.

#### **Virginia Additions**

Additions should be allocated among owners in proportion to each owner’s percentage of ownership or participation in the pass-through entity or as provided in the partnership agreement or other entity document. However, each owner may only claim the additions allowed on the owner’s Virginia income tax return. That is, an individual owner reports only additions applicable to individual income tax and a corporate owner reports only those additions applicable to Virginia corporate income tax.

#### **Line 8. Fixed Date Conformity – Depreciation.**

Enter the amount that should be added to federal taxable

income based upon the recomputation of allowable depreciation. If depreciation was included in the computation of your Federal Taxable Income and one or more of the depreciable assets received the special 30% or 50% bonus depreciation deduction for federal purposes in any year from 2001 through 2007 inclusive, then depreciation must be recomputed for Virginia purposes as if such assets did not receive the special 30% or 50% bonus depreciation deduction for federal purposes in any year from 2001 through 2007 inclusive. If the total 2007 Virginia depreciation is less than 2007 federal depreciation, then the difference must be recognized as an addition on Line 2(a). For further instructions, see Virginia Tax Bulletins 02-3, 03-01, 04-02, 05-01, 06-01 and 07-01 at [www.tax.virginia.gov](http://www.tax.virginia.gov) or call (804) 367-8037.

#### **Line 9. Fixed Date Conformity — Other.**

##### **(1) Disposed Asset**

If an asset was disposed of in 2007 and such asset received the special 30% or 50% bonus depreciation deduction for federal purposes in any year from 2001 through 2007 inclusive, and a gain or loss was recognized for federal purposes, then the gain or loss must be recomputed as if such asset did not receive the special 30% or 50% bonus depreciation deduction for federal purposes in any year from 2001 through 2007 inclusive. The adjustment will be the difference in the federal and Virginia basis of the asset when sold. If the federal basis of the asset is greater than the Virginia basis (resulting in a lower gain reported for federal purposes), then the difference between the bases is an addition on the Virginia return. For further instructions, see Virginia Tax Bulletins 02-3, 03-01, 04-02, 05-01, 06-01 and 07-01 which are available on the Department’s Website: [www.tax.virginia.gov](http://www.tax.virginia.gov) or call (804) 367-8037.

##### **(2) Other Changes Not Listed**

Please refer to the Supplemental Fixed Date Conformity Instructions on the Department’s website, [www.tax.virginia.gov](http://www.tax.virginia.gov) for information on any other additions due to federal tax legislation passed after the printing deadline for these instructions. The Department’s website will also reflect any action by Virginia’s General Assembly to advance the date of conformity to the Internal Revenue Code that may take place before the due date for your return. Enter any amounts described in the Supplemental Fixed Date Conformity Instructions. Also, please attach a schedule and explanation of such additions.

#### **Line 10.**

Enter 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 this state or any other taxing jurisdiction, to the extent deducted in determining any federal taxable income. Income tax of any sort and by any name is not an allowable deduction in determining Virginia taxable income. Note that this item may be related to the income tax paid on line 19, but is defined differently and is not necessarily the same amount.

#### **Line 11.**

Enter interest income received, 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 or agency of any such other state unless created by compact or agreement to which this state is a party.

**Line 12 - Other.**

Enter the two digit code listed below, followed by the amount, for any additions to federal taxable income in the categories listed below. If you have more than three additions on lines 12a - 12c, enter the code "00" and the total addition amount on Line 12a. Attach an explanation of each addition to your return.

**Code**

- 10.** Interest on federally exempt U.S. obligations. Enter the amount of interest or dividends exempt from federal income tax, but taxable in Virginia, less related expenses. (58.1-402 B.2.) (Sec. 58.1-322 B.2.)
- 13.** The deduction for bad debts allowed in computing federal taxable income for a state or federal savings and loan association. (Sec. 58.1-403 1.)
- 14.** The amount of unrelated business taxable income as defined by Section 512 of the Internal Revenue Code. (Sec. 58.1-402 B.5.)
- 15.** Royalty addback for intangible expenses. See Form 500 Instructions for additional information. Attach Schedule 500AB to Form 502 (Sec. 58.1-402 B.8a.)
- 16.** Interest addback for intangible expenses. See Form 500 Instructions for additional information. Attach Schedule 500AB to Form 502 (Sec. 58.1-402 B.8a.)
- 99** Other. (Attach Explanation). This must include the amount of losses or deductions of an S Corporation subject to the bank franchise tax or the amount of any distributions from such an S Corporation. This addition will be claimed as a negative deduction (code 112) on Line 8a of the shareholder's Schedule ADJ See worksheet on page 21 of the individual income tax instructions.

**Virginia Subtractions and Deductions**

Subtractions should be allocated among owners in proportion to each owner's percentage of ownership or participation in the pass-through entity or as provided in the partnership agreement or other entity document. However, each owner may only claim the subtractions allowed on the owner's Virginia income tax return. That is, an individual owner may only claim subtractions applicable to individual income tax, while a corporate owner may claim only those subtractions applicable to Virginia corporate income tax.

**Line 14. Fixed Date Conformity – Depreciation.**

Enter the amount that should be subtracted from federal taxable income based upon the recomputation of allowable depreciation. If depreciation was included in the computation of your Federal Taxable Income and one or more of the depreciable assets received the special 30% or 50% bonus depreciation deduction for federal purposes in any year from 2001 through 2007 inclusive, then depreciation must be recomputed for Virginia purposes as if such assets did not receive the special 30% or 50% bonus depreciation deduction for federal purposes in any year from 2001 through 2007 inclusive. If the total 2007 Virginia depreciation is more than

2007 federal depreciation, then the difference must be recognized as a subtraction on Line 4(a). For further instructions, see Virginia Tax Bulletins 02-3, 03-01 and 04-02 ,05-01, 06-01 and 07-01 at [www.tax.virginia.gov](http://www.tax.virginia.gov) or call (804) 367-8037.

**Line 15. Fixed Date Conformity — Other.**

**(1) Disposed Asset**

If an asset was disposed of in 2007 and such asset received the special 30% or 50% bonus depreciation deduction for federal purposes in any of years 2001 through 2007, and a gain or loss was recognized for federal purposes, then the gain or loss must be recomputed as if such asset did not receive the special 30% or 50% bonus depreciation deduction for federal purposes in any of years 2001 through 2007. The adjustment will be the difference in the federal and Virginia basis of the asset when sold. If the federal basis of the asset is lower than the Virginia basis (resulting in a greater gain for federal purposes), then the difference between the two bases is a subtraction on the Virginia return. For further instructions, see Virginia Tax Bulletins 02-3, 03-01, 04-02, 05-01, 06-01 and 07-01 at [www.tax.virginia.gov](http://www.tax.virginia.gov) or call (804) 367-8037.

**(2) Other Changes Not Listed**

Please refer to the Supplemental Fixed Date Conformity Instructions on the Department's Website, [www.tax.virginia.gov](http://www.tax.virginia.gov) for information on any other subtractions due to federal tax legislation passed after the printing deadline for these instructions. The Department's Website will also reflect any action by Virginia's General Assembly to advance the date of conformity to the Internal Revenue Code that may take place before the due date for your return. Enter any amounts described in the Supplemental Fixed Date Conformity Instructions. Also, please attach a schedule and explanation of such subtractions.

**Line 16.**

Enter the amount of income (interest, dividends and gain) derived from obligations or 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 included in federal adjusted gross income but exempt from state income taxes under the laws of the United States. This includes, but is not limited to, stocks, bonds, treasury bills and treasury notes. It does not include interest on refunds of federal taxes, equipment purchase contracts or normal business transactions.

**Line 17- Other.**

Subtractions may be claimed for any of the following items listed below to the extent any such items are included in federal taxable income. For each subtraction claimed, enter the subtraction code and amount. If you have more than four subtractions on Lines 17a - 17e, enter the code "00" and the total subtractions amount on 17a and attach an explanation of each addition to your return.

**Code**

- 10** Any amounts included under the provisions of Section 78 of the Internal Revenue Code. (Sec. 58.1-402 C.5)
- 11** The amount of any refund or credit for overpayment of income taxes imposed by this state or any other taxing

jurisdiction. (Sec. 58.1-402 C.4)

**12** Any amount included therein by the operation of Section 951 of the Internal Revenue Code (subpart F income). (Sec. 58.1-402 C.7) .

**13** Any amount included in federal taxable income that is foreign source income and defined as follows:

- 1) Interest other than interest derived from sources within the United States;
- 2) Dividends other than dividends derived from sources within the United States;
- 3) Rents, royalties, license, and technical fees from property located or services performed without the United States or from any interest in such property, including rents, royalties, or fees for the use of or the privilege of using without the United States any patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like properties; and
- 4) Gains, profits, or other income from the sale of intangible or real property located without the United States.

In determining the source of income for purposes of subtraction 14 above, the provisions of Section 861, 862 and 863 of the Internal Revenue Code shall be applied. (Sec. 58.1-402 C.8)

**14** The amount of any dividends received from corporations in which the taxpaying corporation owns fifty percent more of the voting stock, to the extent included in federal taxable income and to the extent not otherwise subtracted from federal taxable income. (Sec. 58.1-402 C.10)

**15** The dividends of a Domestic International Sales Corporation, fifty 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 provision of the income tax laws of this state. (Sec. 58.1-402 C.3.)

**16** The amount that could have been deducted by a gas supplier, pipeline distribution company or gas utility company as a net operating loss carryover or net capital loss in arriving at taxable income except that such loss or portion thereof had been carried back for federal purposes to a taxable year before it became subject to Virginia income tax. To the extent that the recomputed loss is carried back more than two years, it may be subject to the modification for deconformity. (58.1-403 (9)).

**17** A gas supplier, pipeline distribution company, gas utility company, or electric supplier (except an electric cooperative) that was subject to the state license tax on gross receipts in 2000, and became subject to Virginia income tax in 2001, may amortize its Virginia tax basis over 30 years. The Virginia tax basis is the aggregate adjusted book basis less aggregate adjusted tax basis of assets placed in service prior to the first day of the taxable year that the company became subject to Virginia income tax. (58.1-440.1).

**20** The amount of income derived from Virginia obligations or the sale or exchange of Virginia obligations that are included in federal adjusted gross income. (Sec. 58.1-402 C.2.) (Sec 58.1-322 C.2.)

**21** The amount of wages and salaries eligible for the Federal Work Opportunity Tax Credit that are not deducted for federal tax purposes. (Sec. 58.1-402 C.6) (Sec 58.1-322 C.6.)

**22** The amount of intangible expenses and costs or interest expenses and costs added to the federal taxable income of a corporation shall be subtracted from federal taxable income of the related member if the related member is subject to Virginia income tax on the same amount. See Form 500 Instructions for additional information. Attach Schedule 500AB to Form 502 (Sec. 58.1-402 C. 21.)

**41** The amount of income received as a result of payments made under the Tobacco Master Settlement Agreement, the National Tobacco Grower Settlement Trust and the Tobacco Loss Assistance Program. (Sec. 58.1-402 C.18.) (Sec 58.1-322 C.27.)

**42** The amount of gain from the sale or exchange of land or an easement when such property is devoted to open-space use. To the extent a subtraction is taken under this section, no tax credit for donating land for its preservation shall be allowed for three years following the year in which the subtraction is claimed. (Sec 58.1-402 C.16.) (Sec 58.1-322 C.22.)

**43** The amount contributed to the Virginia Public School Construction Grants Program and Fund that has not been claimed as a deduction on the corporation's federal income tax return. (58.1-402 C. 15.) (Sec 58.1-322 D.8.) **Note:** This deduction will be claimed as a deduction (code 107) on Line 8 of Schedule ADJ of the shareholder's individual income tax return.

**45** The indemnification payments received by qualified contract poultry growers and table egg producers as a result of the depopulation of poultry flocks because of avian influenza in 2002. Indemnification payments made to owners of poultry who contract with poultry growers do not qualify for this subtraction. (Sec. 58.1-402 C. 19.) (Sec 58.1-322 C.30.)

**47** Any gain recognized as a result of the Peanut Quota Buyout Program of the Farm Security and Rural Investment Act of 2002. If payments were received in installments, the gain from the 2004 installment may be subtracted. (Sec. 58.1-402 C. 20.) (Sec 58.1-322 C.29.)

**48** The amount of payments received in the preceding year in accordance with the Tobacco Quota Buyout Program of the American Jobs Creation Act of 2004 to the extent included in federal taxable income. For example, on the 2007 return the taxpayer may subtract the portion of such payments received in 2006 that is included in the taxpayer's 2006 federal taxable income; while payments received in 2007 may generate a subtraction on the 2008 Virginia return. If the taxpayer chose to accept payment in installments, the gain from the installment received in the preceding year may be subtracted. If, however, you opted to receive a single payment, 10% of the gain recognized

for federal purposes in the year that the payment was received may be subtracted in the following year and in each of the nine succeeding taxable years. **Note:** This deduction will be claimed as a deduction (code 108) on Line 8 of Schedule ADJ of the shareholder's individual income tax return.

- 99** Other. (Attach Explanation). This must include the amount of income or gain of an S corporation subject to bank franchise tax. This deduction (code 112) will be claimed on Line 8 of the shareholder's Schedule ADJ. See worksheet on page 21 of the individual income tax instructions.

## TAX CREDITS

Tax credits based on a PTE's activities are passed through to the owners, generally in proportion to each owner's percentage of ownership or participation in the entity (although the legislation for a particular credit may allow for other allocation). When the credit is subject to a limitation, the limitation applies to the total credit of the pass-through entity (the aggregate of the owners' shares), not to each owner's share separately.

Pass-through entities do not use or compute credit carryovers. A pass-through entity passes through to each owner the owner's share of each credit earned by the pass-through entity for that year. Each owner must then determine, with respect to its own situation and its own tax for that year, the manner in which it can use its credits (including carryovers).

For most credits, specific documentation must be attached to the return of the pass-through entity and the return of the owner. See the instructions for Schedule CR, 500CR or visit our Website, [www.tax.virginia.gov](http://www.tax.virginia.gov), for more information about each credit and its required documentation. Without proper documentation, the credit will not be allowed.

State Income Tax Paid: Many states follow the federal tax treatment of pass-through entities and apply income tax to the entity's income only at the owner level. Some states, however, may not recognize the federal S corporation election or may otherwise impose an income tax directly on a pass-through entity. If the pass-through entity properly paid a direct state income tax, owners who are individuals may qualify to claim the "credit for tax paid to another state" on their Virginia individual income tax returns, based on their proportional shares of the tax paid by the pass-through entity.

The credit for tax paid to another state is based only on an income tax on earned or business income or gain on the sale of an asset. Other taxes do not qualify, including any franchise, license, excise, unincorporated business or occupation tax, or any tax characterized as such by the taxing jurisdiction, even if the tax is based on earned or business income. A tax that would be illegal or unauthorized in the taxing jurisdiction if it were characterized as an income tax or commuter tax does not qualify.

If the pass-through entity paid a direct state income tax for which an individual owner could claim the credit for tax paid to another state based on his or her proportional share, enter

the total amount of such tax paid by the entity, and attach a schedule identifying each taxing jurisdiction with a description of the tax and the amount paid. Note that this entry may be related to the addition modification on line 10 of Form 502, but it is defined differently and is not necessarily the same amount.

Do not include any taxes paid by the entity that reflect another state's income tax withholding requirement on behalf of specific owners, or that were paid in connection with another state's equivalent to Virginia Form 765 (unified nonresident return) on behalf of specific owners. These amounts may be shown with appropriate descriptions on the VK-1 of each specific owner affected thereby, but should not be included in the amount on Line 19, which will be distributed to all owners based on each owner's participation percentage.

Enterprise Zone Taxable Income: The Enterprise Zone general tax credit and investment tax credit are limited by the tax on income derived from the Enterprise Zone; they cannot be applied to tax on other income. If claiming either of these credits, enter the amount of taxable income from the Enterprise Zone (this is the portion of the total of taxable income amounts from line 1 above that relates to activity within the Enterprise Zone).

### Lines 19 - 38.

These credits must be allocated among owners in proportion to each owner's percentage of ownership or participation in the pass-through entity.

- State Income Tax Paid (See above)
- Neighborhood Assistance Act
- Enterprise Zone Act (See above)
- Conservation Tillage Equipment
- Fertilizer & Pesticide Application Equipment
- Recyclable Materials Processing Equipment
- Rent Reduction Program
- Vehicle Emissions Testing Equipment and Clean-Fuel Vehicle
- Major Business Facility
- Clean Fuel Vehicle Job Creation
-  Day-care Facility Investment
- Low-income Housing
- Agricultural Best Management Practices
- Worker Retraining
- Waste Motor Oil Burning Equipment
- Riparian Forest Buffer Protection for Waterways
- Virginia Coal and Production Incentive

### Lines 39 - 41.

These credits may be allocated among owners in proportion to each owner's percentage of ownership or participation in the pass-through entity, or as the owners may mutually agree, or as provided in the partnership agreement or other entity document.

- Historic Rehabilitation
- Land Preservation
- Qualified Equity & Subordinated Debt Investments

**Lines 42 - 44.**

These three credits provide for refunds of amounts that exceed the tax due.

- Coalfield Employment Enhancement
- Virginia Coal and Production Incentive  
Enterprise Zone Real Property Improvement

\* Each pass-through entity must attach Form PTE with the letter of application when applying for this credit.

All pass-through entities distributing this credit to its owner(s), shareholders, partners or members must give each a Schedule VK1, Owner's Share of Income and Virginia Modifications and Credits.



## INSTRUCTIONS FOR VIRGINIA SCHEDULE VK-1 OWNER'S SHARE OF INCOME AND VIRGINIA MODIFICATIONS AND CREDITS

Schedule VK-1 is prepared by the pass-through entity to show each owner's distributive or pro rata share of the entity's income, Virginia modifications and Virginia credits, and other information necessary for an owner to be able to include the effect of participation in the entity in the owner's income tax return. Schedule VK-1 does not replace federal Schedule K-1; it is a supplement to the federal schedule for those state tax issues that require additional information. The pass-through entity will prepare a Schedule VK-1 for each owner; a copy should be given to each owner, and a copy included with the entity's Virginia return of income (Form 502) filed with the Department of Taxation.

Date owner acquired interest in pass-through entity: Enter in mm-dd-yyyy format.

Owner's entity type. Enter the code that corresponds to the owner's entity type.

<u>Entity type</u>	<u>code</u>
Individual Who Was A Virginia Resident	RES
Individual Who Was Not A Virginia Resident	NON
General Partnership	PG
Limited Partnership	PL
Limited Liability Company	LL
Limited Liability Partnership	LP
S Corporation	SC
C Corporation	CC
Trust or Estate	TE
Other	OB

Owner's participation type. Enter the code that corresponds to the owner's type of membership or participation in the pass-through entity:

<u>Participant type</u>	<u>code</u>
General Partner	GPT
Limited Partner	LPT
LLC/LLP Member	LLM
S Corporation Shareholder	SHR
Other	OTR

Owner's participation percentage. For an S corporation shareholder, enter the owner's percentage of stock ownership for the tax year, as shown on the owner's federal Schedule K-1 (Form 1120S), line H. For a partner or other recipient of federal Schedule K-1 (Form 1065), enter the ending percentage for the partner's profit share as shown on the K-1, under line L.

For a partner in an electing large partnership, the federal Schedule K-1 (Form 1065B) does not indicate a participation percentage, but the partnership must determine such a percentage in order to distribute Virginia modifications and credits among the owners. The percentage should be determined in a manner substantially similar to the profit sharing percentage at the end of the year provided for a regular partnership, unless there is compelling reason otherwise.

The participation percentages as shown on Schedules VK-1 for all owners of the pass-through entity should equal 100% in the aggregate.

The participation percentage should be entered as a percent with two decimal places. For instance, the participation percentage for an S corporation shareholder who holds one-third ownership is entered as "33.33 %."

### Lines 1 - 44

These items on Schedule VK-1 correspond to related items with the same line numbers on the pass-through entity's return, Form 502. In general, Form 502 shows the pass-through entity's total amount for the item, while each Schedule VK-1 shows one owner's share of the item. The owner's share of an item is usually determined by the owner's participation percentage (see above), but some partnership agreements may provide for special allocations. The entries on each line of the Schedules VK-1 for all owners of the pass-through entity should equal, in the aggregate, the corresponding entry on Form 502, except for line 7.

Line 7. The entry on line 7 will be the same for all owners of the entity and the same as line 7 of Form 502 (the pass-through entity's Virginia apportionment percentage).

Additions, subtractions and credits should be allocated among owners in proportion to each owner's percentage of ownership or participation in the pass-through entity or as provided in the partnership agreement or other entity document. However, each owner may only claim the additions, subtractions or credits allowed on the owner's Virginia income tax return. That is, an individual owner may only claim additions, subtractions or credits applicable to individual income tax, while a corporate owner may claim only those additions, subtractions or credits applicable to Virginia corporate income tax.

The Virginia Public School Construction Grants Program and Fund (code 43) and the Tobacco Quota Buyout Program (code 48) deductions must be claimed as deductions on the shareholder's individual income tax return. The deduction for an S-Corporation subject to Bank Franchise Tax is reported as an "other" addition or subtraction on Schedule VK-1 and as a positive or negative deduction on the shareholder's individual income tax return.

# Instructions For Schedule 502A Allocation And Apportionment Of Income For Pass-Through Entities

A pass-through entity must determine the extent to which its income is from Virginia sources. This determination is made in the same manner as provided by law for corporations (Code of Virginia §§ 58.1-405 through 58.1-421), with such accommodation as may be necessary considering the differences between regular taxpaying corporations and pass-through entities (PTE).

## When Income Is All From Virginia Source

If a PTE conducts its entire business within Virginia, then all of its income is Virginia source income.

A PTE is presumed to be doing business entirely within Virginia unless it is subject to (or would be subject to if it were a regular taxpaying corporation) one of the following taxes in another state: 1) a tax imposed on net income; 2) a franchise or other tax measured by net income; 3) a franchise tax for the privilege of doing business. An entity is "subject to" such a tax if it carries on sufficient activity within a state that the state has jurisdiction to impose the tax, whether or not the state actually imposes the tax. The activities must be considered in the light of Public Law ("P.L.") 86-272 (15 USCA § 381 - 384). If federal law would prohibit the state from imposing the tax because the entity's activities in the state did not exceed a certain type or extent, then the state does not have jurisdiction, and the entity is not subject to the state's tax for purposes of allowing the entity to allocate and apportion income away from Virginia. In addition, an entity is not subject to a tax in a state if it voluntarily pays the tax but is not required to do so by the laws of that state, or if it pays a fee for qualification, organization or the privilege of doing business in the state but either 1) does not actually engage in business in the state, or 2) engages in some business in the state, not sufficient for nexus, and the tax or fee bears no relation to the entity's activities in the state.

## When Income Is From Virginia and Other States

If a PTE's income is not all Virginia source, as defined above, and the entity conducts its business in Virginia and in one or more other states, then the portion of total income that is Virginia source income is determined through allocation and apportionment. *Allocation* is the assignment of income, or a piece of income, wholly to one state or another. *Apportionment* is the division of income among states according to the ratio of activities in one place to activities everywhere.

## Who Must Use Schedule 502A

Schedule 502A is used to show the amount of allocated income and to determine the apportionment percentage.

If the pass-through entity's income is all from Virginia, then the entity does not allocate and apportion income; the Virginia apportionment percentage is 100%, and Schedule A is not required. In all other cases, the PTE must prepare a Schedule 502A and attach it to Form 502. The owners may also need a copy of Schedule 502A from the PTE in order to prepare their own returns properly (see the next section).

## Effect of Schedule 502A on Owners of the Pass-Through Entity

A PTE does not calculate a net taxable income amount for each owner. Rather, it determines each owner's distributive share of various types of income, gains, losses, deductions and credits. Each owner then uses that information as applicable, plus the PTE's allocation and apportionment information from Schedule 502A, in determining its Virginia taxable income. How each owner uses the PTE's information will vary, however, depending on the owner's entity type. Refer to the Form 502 instructions for information.

## Allocable and Apportionable Income

Virginia law provides that dividends received are to be allocated to the state of commercial domicile, and that all other income must be apportioned as directed in Code of Virginia §§ 58.1-408 - 58.1-420. Virginia law does not allow for subtractions from apportionable income based on separate or divisional accounting or for exclusion of non-Virginia investment income.

## LINE INSTRUCTIONS

### Part A Lines 1-4 - Allocable Income

For a discussion of what may and may not be included in this section, see **Allocable and Apportionable Income**, page 4 of Form 502 instructions.

**Line 1** – Enter the taxable income amount from Form 502, line 1.

**Line 2** – If commercial domicile is in Virginia, enter dividends.

**Line 3** – If business's commercial domicile is not in Virginia, enter dividends received on line 3a, the amount of nonapportionable investment function income on line 3b, and nonapportionable investment function loss on line 3d.

**Line 4** – Enter apportionable income. If domiciled in Virginia, subtract Line 2 from Line 1. If not domiciled in Virginia, subtract Line 3e from Line 1.

### Part B Lines 1-5 - Apportionment Factors

All income except the allocable income as entered in Part A is apportioned according to one of the methods described below. Motor carriers, railways, financial companies and some construction companies use the special methods in Part C on lines 2 - 5. Most entities will use the general three-factor method on line 1, based on property, payroll and sales.

**Line 1 – Three-Factor Method:** Most pass-through entities are generally required to use the three-factor formula of property, payroll and double-weighted sales. The sum of the property factor, payroll factor and twice the sales factor is divided by four (or four less the number of factors with no denominator) to arrive at the final apportionment percentage. See specific instructions below.

**Line 1a – Property factor:** The property factor is a fraction, the numerator of which is the average value of the company's real and tangible personal property owned and used or rented and used in this state during the taxable year, and the denominator of which is the average value of all the company's real and tangible property owned and used or rented and used during the taxable year and located everywhere; to the extent that such property is used to produce Virginia taxable income and is effectively connected with the conduct of a trade or business within the United States and income derived is includible in federal taxable income.

Property owned by the company is valued at its original cost plus the cost of additions and improvements. Property rented by the corporation is valued at eight times the annual rental rate. The average value of property is determined by averaging the value at the beginning and ending of the tax period, but the Department of Taxation may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the corporation's property.

**Line 1b – Payroll factor:** The payroll factor is a fraction, the numerator of which is the total amount paid or accrued in this state during the taxable period by the company for compensation, and the denominator of which is the total compensation paid or accrued everywhere during the taxable period; to the extent that such payroll is used to produce Virginia taxable income and is effectively connected with the conduct of a trade or business within the United States and income derived is includible in federal taxable income.

"Compensation" means wages, salaries, commissions and any other form of remuneration paid or accrued to employees for personal services. Compensation is paid or accrued in this state if: (a) the employee's service is performed entirely within the state; or (b) the employee's service is performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state; or (c) some of the service is performed in the state and: (i) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state; or (ii) the base of operations or the place

from which the service is directed or controlled is not in any state in which some part of the service is performed, but the employee's residence is in this state.

Any distribution to a partner that is self-employment income pursuant to IRC § 1401 et seq. shall be treated as salary for purposes of the payroll factor.

**Line 1c & 1d – Sales factor:** The sales factor is a double-weighted element in the three factor formula of sales, property and payroll. The sales factor is a fraction, the numerator of which is the total sales of the company in this state during the taxable period, and the denominator of which is the total sales of the company everywhere during the taxable period, to the extent that such sales are used to produce Virginia taxable income and are effectively connected with the conduct of a trade or business within the United States and income derived is includible in federal taxable income. "Sales" means all gross receipts of the company other than dividends; except that in the case of the sale or other disposition of intangible property only the net gain is included. Net gain is determined on a per transaction basis.

Sales of tangible personal property are in this state if the property is received in this state by the purchaser. In the case of delivery by common carrier or other means of transportation, the place at which such property is ultimately received after all transportation has been completed is considered the place at which such property is received by the purchaser. Direct delivery in this state, other than for purposes of transportation, to a person or firm designated by a purchaser, constitutes delivery to the purchaser in this state, and such direct delivery outside this state to a person or firm designated by the purchaser does not constitute delivery to the purchaser in this state, regardless of where title passes, or other conditions of sale.

Sales, other than sales of tangible personal property, are in Virginia if: (a) the income-producing activity is performed in Virginia; or (b) the income-producing activity is performed in and outside of Virginia and a greater proportion of this activity is performed in Virginia than in any other state, based on costs of performance.

**Line 1e –** Add the percentages in Lines 1a through 1d.

**Line 1f –** Divide Line 1e by 4 or 4 reduced by the number of factors, if any, with no denominator.

### **PART C. Other Apportionment Factors**

**Line 2 - Motor carriers:** Motor carriers of property or passengers, using highways of this state, must, unless they meet one of the two exceptions referred to below, apportion their net apportionable income to Virginia using the ratio of vehicle miles in this state to total vehicle miles everywhere. "Vehicle miles" means miles traveled by vehicles, owned or operated, hauling property or carrying passengers for a charge or fare. For a carrier meeting either of the exceptions, check the appropriate box on line 2 and enter "0%" in column C.

**Exception 1:** – A carrier which neither owns nor rents real or tangible personal property inside this state except vehicles, makes no pickups or deliveries inside this state, and travels no more than 50,000 "vehicle miles" inside this state; provided that the Virginia "vehicle miles" are less than 5% of total vehicle miles.

**Exception 2:** – A carrier which neither owns nor rents real or tangible personal property inside this state except vehicles, and which makes no more than twelve round trips into this state during the taxable year, either hauling property or carrying passengers; provided that the Virginia "vehicle miles" are less than 5% of total vehicle miles traveled during the taxable year.

**Line 3 – Railway companies:** Railway companies shall determine their net apportionable income to this state by multiplying Virginia taxable income of such company, excluding the income allocable under Sec. 58.1-407, by the use of the ratio of revenue car miles in this state to total revenue car miles everywhere. For the purposes

of this section the words "revenue car mile" in the case of railway carriers of property or passengers shall mean the movement of a unit of loaded car equipment a distance of one mile. The loaded car miles shall be determined in accordance with the Uniform System of Accounts for Railroad Companies of the Interstate Commerce Commission.

**Line 4 – Financial companies:** A financial company is one that is a) not exempted from the imposition of tax under the provisions of Sec. 58.1-401 (i.e., banks) and b) derives more than seventy percent of its gross income from the classes of income enumerated in items 1 through 4 below, without reference to the state where the income is earned, including, but not limited to, small loan companies, sales finance companies, brokerage companies and investment companies:

1. Fees, commissions, other compensation for financial services rendered;
2. Gross profits from trading in stocks, bonds, or other securities;
3. Interest; and
4. Dividends that are included in Virginia taxable income.

In computing the amounts referred to in items 1 through 4 above, any amount received by a member of an affiliated group (determined under Section 1504(a) of the Internal Revenue Code but without reference to whether any such corporation is an includible corporation under Section 1505(b) of the Internal Revenue Code) from another member of such group will be included only to the extent the amount exceeds related expenses of the recipient.

The Virginia taxable income of a financial company, as defined in Sec. 58.1-402, excluding income allocable under Sec. 58.1-407, shall be apportioned within and without this state in the ratio that the business within Virginia is to total business of the company. Business within this state shall be based on cost of performance in Virginia over cost of performance everywhere.

#### **"Cost of Performance Factor":**

- (a) The cost of performance is the cost of all activities directly performed by the company for the ultimate purpose of obtaining gains or profit, except activities performed by the company for the ultimate purpose of obtaining dividends allocable under the provisions of Sec. 58.1-407.
  - (i) Such activities do not include those performed on behalf of a company, such as performed by an independent contractor.
  - (ii) The cost of performance does not include the cost of funds (interest, etc.), but does include the cost of activities required to procure loans or other financing.
- (b) Activities constituting the cost of performance are deemed performed at the situs of real and tangible personal property or the place at which or from which activities are performed by employees of the company.
- (c) Cost of performance of a financial institution within and without Virginia shall be determined without regard to the location of borrowers, location of property in which the financial company has only a security interest, or the cost to the financial company of the funds which it lends.

**Line 5 – Construction companies:** Construction companies that have elected for federal income tax purposes to report income on the completed contract basis shall apportion income within and without this state in the ratio that the business within this state is to total business of the company. The business within and without this state is based upon "sales" as defined by Sec. 58.1-302, to the extent included in taxable income and is determined as provided by Sec. 58.1-414 through 58.1-419.