2004

Recent Tax Developments in Virginia: 2003-2004

William L.S. Rowe

Mark C. Van Deusen

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William L. S. Rowe
Mark C. Van Deusen
Hunton & Williams LLP
951 East Byrd Street
Richmond, Virginia 23219
(804) 788-8410 (Rowe phone)
(804) 788-8349 (Van Deusen phone)
(804) 788-8218 (fax)

Email: wrowe@hunton.com
mvandeusen@hunton.com

HB 5018, passed during the Special Session of the General Assembly, contains the "tax increases" that were necessary to reach the long-delayed budget package. Note that under the Constitution of Virginia, these changes became effective generally September 1, 2001 (fourth month after adjournment of the Special Session) and not July 1, which is the usual effective date of legislation passed during the Regular Session.

I. CORPORATE INCOME TAX

A. 2004 Legislation - **Regular Session**

1. Qualified Equity/Debt Investment Credit. HB 282 cuts back on the income tax credit previously allowed for certain qualified equity and subordinated debt investments. Limits the credit to Virginia companies with less than $3 million in revenue and excludes companies that have obtained more than $3 million in aggregate gross financings.

2. Conformity. SB 526 provides that Virginia law will conform to federal tax law as in existence on December 31, 2003. The days of "automatic, moving date conformity" appear to be gone.

3. Minimum Tax on Electric Suppliers. SB 681 imposes a minimum income tax of 1.45% of gross receipts (adjusted for the state's portion of the electric utility consumption tax billed to consumers).

2004 Legislation - **Special Session**

- Income tax reforms: Delaware Investment Holding Companies (DHC's)
  - Require add-back of royalty and intangible expenses paid to related entities
    - o "Safe harbors" and exceptions

            - Income deducted on Virginia return is taxable to recipient by Virginia, another state or foreign country
            - At least 1/3 of revenue is received from unrelated parties and transactions with related parties are on comparable terms
            - Expenses are "passed through" from unrelated parties and do not have tax avoidance as principal purpose
    - Administrative appeal procedure
        - Pay tax first
        - Fee to pay state's experts
        - Must show business purpose other than avoidance of taxes
        - No judicial appeal (sic!)
    - Require add-back of interest paid to related entities
        - Only if debt is related to acquisition, use or disposition of intangible property
        - Safe harbors for entities with substantial lending activities and at least 5 full-time employees
            - Interest paid is subject to tax by Virginia, another state or foreign country
            - Debt arose before entities were related
            - Lender has more than $2 million in annual revenue from unrelated parties
            - Expense passed through from unrelated party
            - Systematic funds management by group
            - Financing related to business expansion
            - Debt restructuring
            - Pass-through of acquisition indebtedness
    - Same administrative appeal procedures as for intangibles add-back

- Pass-through reporting for income taxes (January 1, 2004)
    - S Corps, LLC's, Partnerships, etc.
    - Entity required to file return if it has Virginia source income
    - Owners (stockholders, members, partners) liable for tax
    - This is an audit enhancement measure
        - Owners are already taxable under Virginia law
        - Electronic Filing to improve Virginia's ability to locate owners
        - Penalties to force reporting compliance

B. Court Decisions

1. General Motors Corporation vs. Commonwealth. Rec. No. 032533, 2004 Va. LEXIS 123, at *1 (Va. Sept. 17, 2004). Notwithstanding a long standing regulation on point, the Supreme Court of Virginia holds that "costs of performance" for a financial corporation do include amounts paid to

independent contractors and unrelated third parties. The Court follows what it deems to the "plain meaning" of the statute. **Observation: Because the Department of Taxation has long defined Virginia's nexus rules in terms of having positive apportionment factors in Virginia, this decision may require the Department to rethink that test.**

C. Rulings of the State Tax Commissioner

1. Alternative Accounting Method. P.D. 03-3 (January 30, 2003). The Commissioner granted an out-of-state corporation that owned a limited partnership interest in a Virginia limited partnership permission to use a separate accounting basis for its partnership investment under the following facts: (i) the 3-factor apportionment formula resulted in taxpayer having Virginia source income even though the partnership reported a loss; (ii) the taxpayer held less than a 10% interest in profits and capital interests; (iii) all general partners were unrelated parties; and (iv) no evidence demonstrated that the partnership interest was designed primarily to avoid Virginia tax.

2. S Corporation Apportionment. P.D. 03-29 (April 1, 2003). Virginia S Corporation received income from a joint venture the activities of which were conducted primarily outside Virginia. No deduction of that income was permitted under Allied Signal because recipient is a Virginia corporation. This Virginia source income is then taxable as such in the hands of its non-resident Virginia stockholder.

3. Foreign Source Income. P.D. 03-28 (April 1, 2003). Several adjustments were made to the way auditor adjusted deduction for foreign source income. "Technical fees" were allowed because they were "incidental to the transfer of technical information" - - that is, patents and other property items. Dividends are deductible under the usual rules, net of expenses; not as foreign source income in gross. Finally, taxpayer's failure to provide auditor with requested information that would have permitted consistent treatment of numerator and denominator in the property factor held to foreclose taxpayer's ability to correct that error on appeal. It appears that the taxpayer refused to provide this information even during the appeal.

4. Foreign Source Income. P.D. 03-65 (August 19, 2003). The subtraction for foreign source income is, under the Department's long-time interpretation, limited to income from property. Accordingly, the use of copyrighted materials to promote overseas events was treated as royalty income and excludable as foreign source income. Income from advertising services and sale of merchandise is not excludable.

   A number of adjustments required by the taxpayer were denied based on lack of substantiation.

5. Foreign Source Income. P.D. 04-10 (April 1, 2004). Taxpayer successfully proved that various items of foreign source income and related deductions

were being double counted by the Department's auditors. 1987-89 audit closed.

6. Foreign Source Income. P.D. 04-10 (Apr. 1, 2004). Taxpayer's income from a "foreign sales corporation" was eligible for the Virginia foreign source subtraction during the taxable years in which the income of foreign sales corporations was excluded from income under the Internal Revenue Code. In addition, Commissioner adjusted assessments related to foreign source income based on information provided by the taxpayer.

7. Nexus. P.D. 03-35 (April 12, 2003). Wholly owned subsidiaries that operated solely to hold and issue securities were held to be includable within the Virginia combined return because their affairs were conducted primarily by officers located at the parent corporation's headquarters in Virginia. There is no indication in the ruling that these subsidiaries were taxable anywhere else.

8. Nexus. P.D. 04-85 (Aug. 27, 2004). Commissioner held that taxpayer provided sufficient proof that corporation relocated all of its activities to another state on January 1, 1992, and, therefore, was not required to file an income tax return for the 1992 tax year. Accordingly, assessment made against president of corporation as the responsible officer was abated.

9. LLC Member Nexus. P.D. 03-39 (April 18, 2003). Even though an LLC did not have nexus with Virginia, Virginia source income of that LLC will be taxable as such to members who otherwise have nexus with Virginia. This assumes that LLC is taxed as a partnership for federal tax purposes.

10. Financial Corporation Nexus/Limitations. P.D. 03-46 (April 28, 2003). Financial corporation having no other nexus with Virginia owned interest in partnership in Virginia. After partnership was sold, corporation had no costs of performance in Virginia related to the financial source income in Virginia. Auditor's attempts to treat certain interest income as having a Virginia source was overturned. Taxpayer's attempt to claim a refund was also rejected because no amended return was filed within the three year limitation. **Observation**: The Commissioner did not treat the audit as holding open the taxpayer's right to a refund for the years under audit, and the taxpayer's protest of the audit adjustments was not filed within the three year limitation. Would the result be the same if the taxpayer had asserted its overpayments as a set off against audit adjustments?

11. Check the Box. P.D. 04-83 (November 3, 2003). LLC was formed to hold various real estate interests, including a general partnership interest in real property within Virginia. LLC requested permission to be treated as a corporation for Virginia tax purposes (to insulate its members from Virginia nexus). Denied. The check the box election for federal tax purposes is binding for Virginia as well.

12. Allocable Income/Partnerships. P.D. 03-76 (October 30, 2003). It was not correct for a partnership, which sold a Virginia business, to allocate those income items to Virginia. Only dividends are allocated, and all remaining income is apportioned. This income as well as the proportionate share of factors passes through the partnership return to the partners.

13. Sale of Stock. P.D. 03-23 (March 21, 2003). Corporation A, a non-Virginia corporation which qualified as a "financial corporation," owned a 25% interest in a corporation that had Virginia operations and property. Corporation A sold this stock to an unrelated corporation, and the sale and related efforts occurred outside of Virginia. Held: no sale income was apportioned to Virginia because the costs of performance occurred outside Virginia.

14. Apportionment/Salaries Paid by Parent Corporation. P.D. 04-58 (Aug. 20, 2004). Commissioner held that salaries for executives of a wholly owned subsidiary that were paid by the parent corporation were improperly included in the subsidiary's payroll factor. Virginia does not recognize a common paymaster arrangement, and the Department's longstanding policy prohibits wages paid by a parent corporation from being included in the payroll factor of a subsidiary.

15. Sales Factor/Contracts. P.D. 03-78 (November 13, 2003). Receipts from the sale of contracts held not in the numerator of sales factor because taxpayer established that greater proportion of the costs associated with this sale were incurred outside Virginia.

16. Delaware Investment Holding Company. P.D. 03-56, P.D. 03-57 (August 8, 2003). Retailer in Virginia assigned its receivables to a Delaware entity having no Virginia tax nexus, and that entity then made loans to the Virginia entities. Commissioner held that Delaware and Virginia entities should be combined for purposes of calculating corporate income tax. Commissioner rejected proof offered by taxpayer that financing transactions were conducted on an arm's length basis. Loans were held not to meet arm's length standard because the terms of those loans did not reflect the same business terms (e.g., collateral, payment schedule) that would be negotiated between unrelated parties. Note that the two rulings appear to reflect taxable years before and after the January 1, 1993 effective date of 23 VAC 10-120-361.

17. Delaware Investment Holding Company. P.D. 03-60 (August 8, 2003). Taxpayer had two investment subsidiaries located in Delaware. One owned all the stock of a foreign sales corporation ("FSC") and one owned certain patents that had been purchased from a third party. Neither subsidiary had any physical location in Delaware, any employees, or any significant expenses. Loans were not evidenced by written agreements. Payments on the loans were not made so that the annual loan balance simply increased with the interest payable. Finally, there were indications that the parent corporation was taking certain tax benefits associated with the patents. The Commissioner

holds that the subsidiaries' "lack economic substance" and that the transactions themselves "lack substance." He also concludes that the taxpayer has not proved that transactions between the related entities were conducted on an arm's length basis.

This ruling also involves a number of income items that the taxpayer argued should be excludable from Virginia apportionable income under *Allied Signal*. Those claims were generally denied for lack of proof. It also appears that the Department continues its questionable practice of looking to the use of income to determine if the asset producing that income serves an operational function.

18. Delaware Investment Holding Company. P.D. 03-73 (October 15, 2003). Delaware subsidiary was formed to insulate trademark and other intangibles from creditors. Commissioner required accounts of this subsidiary to be consolidated with corporate entities taxable in Virginia. Subsidiary had no employees or office space in Delaware, relied on affiliates to provide its accounting and other functions and also to "protect" its intangible assets. Subsidiary held to "lack economic substance."

19. Interest Calculation. P.D. 03-43 (April 24, 2003). Once a return is filed and overpayment applied to the subsequent year's liability, those overpayments cannot be used to offset obligations in the previous year's return. Virginia does not conform to the federal concept of a zero rate of interest on overlapping underpayments and overpayments of tax. "Conformity does not extend to terms, concepts, or principles not specifically provided in Title 58.1 of the Code of Virginia." **Query**: Is this an unnecessary overstatement? Is it consistent with the extensive legislative history supporting Virginia's enactment of "double barreled conformity"?

20. Tax Offsets/Merger. P.D. 03-63 (August 19, 2003). Surviving corporation in a merger is liable for the debts of the corporation that was merged into it. Thus, the Department properly offset surviving corporation's tax refund with unpaid assessment of corporation with which it merged.

21. AlliedSignal/Stock. P.D. 04-51 (Aug. 16, 2004). Commissioner allowed taxpayer to use an alternative method of allocation and apportionment to allocate the capital gain the taxpayer realized on the sale of a minority interest in a Virginia corporation. Taxpayer acquired the minority interest to foster an operational relationship with the corporation pursuant to which the taxpayer would receive the exclusive manufacturing rights for one of the corporation's products. Taxpayer never manufactured any of the corporation's products nor paid any royalty to the corporation. Commissioner found that the taxpayer provided ample evidence that there was not a unitary relationship under the U.S. Supreme Court's decision in *Allied-Signal*. Accordingly, the taxpayer was allowed to allocate the capital gain on the sale of its minority interest in the corporation out of its Virginia apportionable income for the year of sale.

22. <u>AlliedSigna/Stock</u>. P.D. 04-92 (Aug. 31, 2004). Commissioner addressed whether taxpayer could subtract the sales of various assets from its Virginia taxable income under an alternative method of allocation and apportionment. Taxpayer sold common stock investments in a number of different corporations in which it held a minority interest of less than 9%. Commissioner found that there was no unitary relationship between taxpayer and any of the corporations in which it owned a minority interest. However, Commissioner noted that taxpayer's long-term debts increased significantly during the years under audit, despite reporting cash at less than zero on its balance sheet. Commissioner found that taxpayer presented no data indicating that the proceeds from the stock sales were not necessary for, or related to, the operational requirement of scheduled debt service or operating expenses, and, thus, taxpayer had not shown that its minority interest in the eight corporations could be fairly characterized as a passive investment. Therefore, Commissioner denied the request for an alternative allocation method for this investment. Taxpayer was allowed an alternative method with respect to the sale of preferred stock in a corporation taxpayer had previously spun off. Taxpayer had a right to elect one member of the corporation's board of directors, but otherwise had limited interaction with the corporation. The corporation requested the redemption of taxpayer's preferred stock. Commissioner found that circumstances surrounding the redemption and the proceeds generated from the investment resulted from activities unrelated to taxpayer's operational function. Commissioner did not allow an alternative allocation method for the sale of stock in a wholly owned subsidiary that engaged in activities similar to taxpayer's. Commissioner found that no unitary connection existed between taxpayer and the corporation, but taxpayer provided no evidence to show why it decided to invest in the corporation. In addition, Commissioner found that the reasons given for divesting of the investment suggested that taxpayer consider the corporation a core business function at one time. Accordingly, Commissioner found that taxpayer had not met its burden of showing that an alternative allocation method was required. Similarly, Commissioner found that taxpayer had not met its burden of showing that a sale of one of taxpayer's divisions was subject to an alternative allocation method. Taxpayer requested the alternative method because the division had no assets located in Virginia. Because the division was not a separate entity, Commissioner held that it would normally be considered to be directly related to the day-to-day operations of taxpayer and fully integrated into taxpayer's unitary operations. Finally, Commissioner denied taxpayer's request to allocate the gain as the result of the termination of licensing agreements. Commissioner found that the licensed products were in the same product line as those of taxpayer's, and taxpayer provided no evidence that would indicate that the product manufactured and sold under the licensing agreements was not directly related to taxpayer's primary business operations.

23. <u>Combined Return</u>. P.D. 04-63 (Aug. 24, 2004). Taxpayer granted permission to file a combined Virginia corporation income tax return for several

subsidiaries that had previously filed separate Virginia corporation income tax returns.

24. Audits/Failure to Respond. P.D. 04-88 (Aug. 31, 2004). Taxpayer, a technology company based in Illinois, objected to auditor consolidating the taxable income of a wholly-owned subsidiary that did not file a Virginia corporation income tax return. The auditor noticed a large inter-company receivable reported by the subsidiary. The taxpayer failed to respond to two letters sent by the auditors requesting additional information regarding the substance of the transaction. Lacking an explanation from the taxpayer, the auditor consolidated the taxable income of the taxpayer and the subsidiary. Taxpayer objected that the subsidiary lacked nexus with Virginia and could not be consolidated because the taxpayer lacked an agency relationship with the corporation. Commissioner noted that Virginia Code § 58.1-446 authorizes the Department to deem income of an affiliate to be Virginia income even if the affiliate does not have nexus. Commissioner noted that the taxpayer failed on two separate occasions during the audit to substantiate the transactions between it and the subsidiary and further failed to respond to a subsequent information request submitted in connection with the appeal. Commissioner held that the burden of proof was on the taxpayer to show that the transactions between it and the subsidiary did not improperly reflect Virginia taxable income. Because the taxpayer had not provided the requested information, the auditor's adjustments were upheld.

II. INDIVIDUAL INCOME TAX

A. 2004 Legislation

- "Tax reforms" - - primarily for individuals (January 1, 2004)
  - Non-filing level increased from $5,000 to $7,000 ($14,000 married couple)
  - Standard deduction increased from $5,000 to $6,000 to address "marriage penalty"
  - Personal and dependent exemption increased from $800 to $900
  - Phase out of age 65 deductions
  - Eliminate "cliff" effect of low income credit

B. Rulings of the State Tax Commissioner

1. Credit for Taxes Paid to Other States. P.D. 03-21 (March 20, 2003). Taxpayer was a domiciliary resident of Virginia but an actual resident of California; he earned and received business income in California. Because of his actual resident status, California law did not permit taxpayer to claim a credit for Virginia tax. Consequently, Virginia allowed him to claim the credit for California tax.

2. Credit for Taxes Paid to Other States. P.D. 04-37 (July 27, 2004). Taxpayer was an actual resident of Virginia but a domiciliary resident of Connecticut.

Taxpayer worked in Virginia and traveled outside Virginia for 15-20 days per year for business purposes. Connecticut allows a credit for income tax paid to Virginia for the days the taxpayer was present in Virginia, but does not allow a credit for income tax paid to Virginia for the days the taxpayer traveled outside of Virginia. Commissioner allowed the taxpayer to claim a credit for the income taxes paid to Connecticut for income earned during the periods when the taxpayer works outside of Virginia. The credit may not exceed the income tax paid to Connecticut for the period when the taxpayer works outside both Virginia and Connecticut and may not exceed the Virginia income tax attributable to that same period.

3. <u>Earned or Business Income Credit/Gambling</u>. P.D. 04-59 (Aug. 18, 2004). Taxpayer, who filed a nonresident individual tax return in another state, was denied a credit for the income taxes paid to the other state for the substantial amount won by the taxpayer from horse racing and pari-mutual wagering. Commissioner held that the gambling winnings did not constitute earned or business income for the purpose of claiming the credit under Virginia Code § 58.1-332(A). To qualify for the credit, the taxpayer must be engaged in a continuous and regular course of business. In the context of gambling, this requires that the activities be pursued fulltime, regularly, and for production of income for one's livelihood before such activities can be considered a trade or business. Taxpayer was employed fulltime in Virginia and indicated that he spent 25 hours per week on gambling activities. However, taxpayer previously declined to obtain a professional gambler's license. Commissioner found that the husband was not engaged in a continuous and regular business of gambling.

4. <u>Non-Business Real Estate</u>. P.D. 03-32 (April 11, 2003). Prior to January 1, 2000, no Virginia income tax credit was allowed for taxes paid to another state with respect to non-business real estate sold in that other state.

5. <u>Virginia Land Preservation Tax Credit</u>. P.D. 03-12 (February 27, 2003). This credit is equal to 50% of the fair market value of Virginia land or an interest in Virginia land that is for certain uses related to land preservation. The credit can be transferred from one taxpayer to another; there is no limit on the number of transfers. However, a transferee taxpayer may not use the credit for any taxable year prior to that in which he acquired the credit, even if he acquired the credit prior to the due date of the prior year return (e.g., a credit transferred after 12/31/02 but prior to the deadline for filing the 2002 return may not be used against the 2002 tax liability). *See also* P.D. 03-13 (March 4, 2003).

6. <u>Land Conservation Incentives</u>. P.D. 03-55 (August 7, 2003). This ruling corrects erroneous dictum in previous Department rulings that incorrectly suggested that only "private foundations" could receive donations for which tax benefits are allowed under the Virginia Land Conservations Incentive Act of 1999.

7. Conservation Credits. P.D. 03-77 (October 31, 2003). The amount of a credit allowed for a conservation easement is not tied to the federal deduction, nor is the value of that credit beyond the Commonwealth's ability to audit. Thus, when these credits are transferred, transferees can have their taxes affected by an audit of the transferor which originally claimed the credit.

8. Real Property Tax Credits. P.D. 04-32 (July 14, 2004). The Real Property Improvement Tax Credit is applicable to owners or tenants of real property located in an enterprise zone. There is a $125,000 limitation in any five year period. When the qualified zone resident is a pass through entity, the limitation applies at the entity level which means that a person who is an owner of multiple pass through entities may claim credits of more than $125,000.

9. NOLs. P.D. 03-66 (August 14, 2003). Taxpayer owned Virginia business conducted through a limited partnership and attempted to use net operating losses of that business to offset gain when the business was later sold. Because federal law did not allow any NOL carryforward to the year of gain, Virginia disallowed the NOL deduction as well. The Commissioner notes that NOLs in each of the loss years had already served to offset the non-resident taxpayer's income payable to his state of residence. Thus, he was seeking a double deduction.

10. Domicile. P.D. 03-47 (January 1, 2003). This document records the holding in *Barbara B. Woods v. Commonwealth*, Cir. Ct. Wise County (Case No. L-97422). Mrs. Woods was held to have retained her Virginia domicile notwithstanding that she had lost her job in Virginia, moved to Tennessee for new employment and was living with her son in an apartment building in Tennessee. She continued to retain her voting rights in Virginia and to hold a Virginia drivers license. Her husband obtained employment in Virginia and lived in a mobile home owned by the wife in Virginia. Finally, the couple retained their home in Virginia which, though vacant, remained fully furnished and with utilities operating. Trial court holds that Mrs. Woods has not demonstrated her intent to sever her relationships with Virginia.

11. Domicile. P.D. 03-48 (April 30, 2003). Taxpayer seeks an advance ruling that he will not be a domiciliary of Virginia because he intends to move to a foreign country. Commissioner holds that taxpayer must show (i) actual abandonment of Virginia domicile and (ii) acquisition of a new domicile. No advance ruling is given since taxpayer is still in the process of taking actions that will establish these elements.

12. Domicile. P.D. 03-90 (November 14, 2003). Taxpayer held not to be a Virginia resident even though he owned a home in Virginia, had a Virginia drivers license, and received mail and other financial documents at this address. He previously was a resident of another state and moved to a foreign country where he established a very clear domicile. The facts given did not indicate an intent by him to abandon that domicile in another country.

13. Domicile/Disability Payments. P.D. 04-57 (Aug. 18, 2004). Taxpayer failed to meet his burden of proof to show that he established domicile outside of Virginia for the year under audit. In 1999, taxpayer purchased a home in Virginia, surrendered his driver's license from another state and obtained a Virginia driver's license, titled and registered three vehicles in Virginia, and had his financial statements sent to his Virginia home. Although taxpayer spent significant time outside of Virginia, Commissioner found sufficient evidence to show that taxpayer obtained a Virginia domicile during 1999. Taxpayer's income was primarily disability income received from another state's retirement system. Commissioner rejected taxpayer's claim that it was unconstitutional for Virginia to tax that income, but noted that the disability income received may be subject to a subtraction in determining Virginia taxable income pursuant to Virginia Code § 58.1-322(C)(4a) or (4b).

14. Domicile/Incarcerated Taxpayer. P.D. 04-60 (Aug. 23, 2004). Taxpayer, who was incarcerated in another state during all of the 2000 tax year, was held to be a resident of Virginia. Taxpayer was incarcerated for two years in another state, and claimed that he established a residency in that state by voluntarily moving to prison and receiving mail and telephone calls there. Commissioner found that taxpayer took no action to establish domicile in the other state, specifically the taxpayer took no action to obtain property, register with any government agency or seek employment in the other state or file an income tax return in the other state. Further, taxpayer stated that he was uncertain as to where he would live after being released from prison. Accordingly, taxpayer was required to file a Virginia income tax return for the 2000 tax year. In addition, Commissioner was not required to an abate and assessment based on erroneous telephone advice the taxpayer's accountant received from the Department advising that the taxpayer did not need to file a tax return for the 2000 taxable year. Because that statement was not in writing, abatement was not required by Virginia Code § 58.1-1835.

15. Nonresident Consulting Fees. P.D. 03-41 (April 18, 2003). As sole employee of an out-of-state corporation, taxpayer provided consulting services to Virginia corporation. Commissioner held that effect of these contractual arrangements was to understate the Virginia taxable income of this non-resident individual. Taxpayer did not establish that compensation paid by out-of-state corporation was reasonable or that consulting fees paid to out-of-state corporation were reasonable.

16. Reallocation of Income. P.D. 04-23 (June 2, 2004). Taxpayers, a husband and wife who were domiciled in another state, owned a 49% interest in a Virginia S corporation. The husband established an S Corporation in his home state for the purpose of providing consulting services to the Virginia S corporation. The Virginia S corporation and the home state corporation entered into an oral agreement for those services. On audit, the Department determined that the transactions between the Virginia S corporation and the home state S corporation improperly reduced the taxpayer's Virginia income.

Relying on Virginia Code § 58.1-446, Commissioner found that taxpayers were not independent from the Virginia S corporation and the intercompany consulting fees did not reflect a fair market intercompany transaction. Commissioner upheld the auditor's determination that all the income from the home state S corporation was Virginia source income. Commissioner also rejected the husband's claim that his income should be allocated based on the number of days he worked inside Virginia as compared with the number of days he worked outside Virginia. Commissioner did adjust the auditor's assessment to account for the fact that the husband performed some work for the Virginia S corporation while he was in his home state.

17. <u>Coalfield Employment Credit/Accountant's Error</u>. P.D. 04-91 (Aug. 31, 2004). Taxpayers' accountant inadvertently failed to attach Form 306 to claim the Coalfield Employment Enhancement Tax Credit to each of taxpayers' returns. The failure to attach the form was due to a problem with the accountant's computer software program. Commissioner held that attaching Form 306 was required in order to claim the credit. The failure to properly attach the Form 306, even though the failure was due to the tax preparation software, constitutes the failure to follow procedures for claiming the credit, and no relief was available.

18. <u>Limitations Period</u>. P.D. 03-6 (February 3, 2003). Refund claim was denied when Department had no record of having received taxpayers 1997 return and taxpayers did not claim the 1997 refund until June 2001, after the expiration of the 3-year limitations period.

19. <u>Estimated Taxes: Penalty</u>. P.D. 03-40 (April 1, 2003). Taxpayer could not avoid penalty for underpayment of estimates by paying an estimate in fourth quarter that exceeded tax liability for year.

20. <u>CPA Fraud</u>. P.D. 03-62 (August 19, 2003). CPA failed to file Virginia income tax returns. His argument that he was not a "person" required to file such returns rejected. His complaints that the Department did not properly notify him of its audit intentions were rejected. His complaint that the Virginia audit results varied from federal audit results was rejected. 100% fraud penalty was applied.

21. <u>Bankruptcy</u>. P.D. 03-72 (October 15, 2003). Taxpayers recognized income from cancellation of indebtedness as a result of their partnership in a business that filed for bankruptcy. Because this item was included in their federal taxable income, it was subject to Virginia taxation as well.

22. <u>USPS</u>. P.D. 03-85 (November 4, 2003). Employees of the United States Postal Service are not deemed to be "federal employees" entitled to certain deductions for their salary for Virginia income tax purposes.

23. <u>Depreciation</u>. P.D. 04-31 (July 12, 2004). Taxpayer, a non-resident of Virginia, sold a rental property located in Virginia and claimed a subtraction

for depreciation not previously deducted on prior Virginia returns. Commissioner upheld the Department's disallowance of the subtraction for depreciation not previously deducted. Commissioner found that there was no provision in Virginia law allowing a subtraction for depreciation related to the gain on the sale of rental property.

III. RETAIL SALES & USE TAXES

A. 2004 Legislation - **Regular Session**

1. Telephone Calling Cards. HB 246 makes telephone calling cards subject to sales and use tax, but exempts them from all other state and local utility taxes.

2. Challenging Nexus. HB 1463 and SB 668 give Virginia courts jurisdiction to grant a Virginia business a declaratory judgment as to whether it can be required to collect another state's sales and use tax. Legislation does not address how the Virginia court will obtain jurisdiction over the foreign state.

3. Software. SB 632 codifies the Department of Taxation's policy that software and other information services delivered electronically via the Internet is exempt from Virginia sales and use taxation.

2004 Legislation - **Special Session**

- General sales tax increase
  - ½% rate increase: 4 ½ % to 5%
  - Exemptions repealed for certain industries
    - Public utilities
      - Electric
      - Telephone
      - Motor carriers
    - Cost to be passed on to customers in increased rate

- Sales and use tax on food reduced 1.5%
  - Reduction not apply to vending machine sales
  - Restaurant meals, "deli" sales at grocery stores, etc. still subject to higher "meals tax"

- Tobacco taxes increased
  - From current per cigarette rate of $0.00125 to
    - August 1, 2004 - - $0.010
    - July 1, 2005 - - $0.015
  - 10% on other tobacco products sold at wholesale
  - Revenues added to Virginia Health Care Fund

B. Court Decisions

1. Circuit City Stores, Inc. v. Department of Tax'n, Case No. LR-1204-3 (Richmond City Cir. Ct., July 29, 2004). Circuit Court held that the Department of Taxation had the burden of proving that a written Notice of Assessment was delivered to a taxpayer under Virginia Code § 58.1-634. Taxpayer claimed that the Department erred in failing to assess a sales and use tax prior to the expiration of the statute of limitations. Taxpayer had received a report of field audit and had applied to the Department for correction of the audit findings. The Department twice denied the taxpayer's application for correction. The Court found that the Department failed to prove that the assessment was ever delivered to the taxpayer or even to a post office for mailing. The Department relied upon a computer entry in an attempt to prove that the notice was delivered. The Circuit Court, however, found that the evidence of the computer entry was not relevant to the issue of whether the specific Notice of Assessment was physically delivered to taxpayer. In addition, the Department's testimony regarding the normal procedures for mailing assessments did not, in the Circuit Court's opinion, show what "*actually*" happened in this particular case. The Circuit Court rejected the Department's argument that the taxpayer must have received the Notice of Assessment because it appealed the audit corrections to the Department.

C. Opinions of the Attorney General

1. Date of Assessment/Court Correction of Erroneous Assessment. Op. No. 03-113, 2004 Va. AG LEXIS 9 (Feb. 4, 2004). Attorney General determined that the "date of assessment" for purposes of determining when the time limitations for appeals of personal property taxes begins to run is the date on which the assessment is mailed to the taxpayer. Attorney General relied upon the determination of a data assessment under the BPOL tax to make this determination. Attorney General further held that if a commissioner of revenue had made a final determination of a taxpayer's administrative appeal, the commissioner of the revenue could not administratively change the assessment, unless he or she determined that the assessment was erroneous. Lacking an administrative remedy, the only way to change the assessment is through the courts. Attorney General held that Virginia Code § 58.1-3984(B) requires that the commissioner of the revenue apply to the Circuit Court on behalf of the taxpayer for exoneration or relief if he or she determines that an assessment is "improper or is based on an obvious error…." Furthermore, Attorney General held that a taxpayer had one year from the date of a final determination of its personal property tax appeal to seek judicial correction of such determination under Virginia Code § 58.1-3984(A).

D. Rulings of the State Tax Commissioner

1. Audio Visual/R&D. P.D. 03-2 (January 18, 2003). Taxpayer developed and sold on-line games to internet service providers. It claimed an exemption for its computer hardware and software used in its business under both an R&D

exemption and the audio visual exemption. The Commissioner denied the R&D exemption because the taxpayer could not establish that the usage of computers by employees for administrative, e-mail and similar activities was "de minimis." When the auditors requested an opportunity to review the taxpayer's place of business, that request was denied. The segment of the business was then sold just before the taxpayer's appeal. Thus, the Commissioner held that there was no way for the taxpayer to meet its burden of proof and no audit record on which it could rely. With respect to the audio visual exemption, the Commissioner concluded that computer games do not qualify because they are not like taped radio programs, feature films, movies and similar works.

2. R&D. P.D. 03-91 (November 14, 2003). Taxpayer provided laboratory research and testing to customers and the FDA to help customers determine new ways to arrest disease. Held to qualify for R&D exemption.

3. Software/R&D. P.D. 03-64 (August 18, 2003). No R&D exemption was allowed for software that was used in the development of software products because the same software was also used to manage development activities and for other administrative activities. Thus, the use was not "exclusive" or "de minimis."

4. R&D. P.D. 04-8 (March 19, 2004). Taxpayer contested assessment of equipment in its "prototype lab." Commissioner holds that equipment used only 60% - 70% for prototype production is not used exclusively in research and development and is not exempt on that basis. He further holds that the prototype lab, which helped design new products and adjust prototypes until ready for production was used "pre-production" and not exempt.

5. Government Purchases/Credit Cards. P.D. 03-94 (December 12, 2003). The Department is able to determine from credit card numbers whether the account is an official government account and exempt. Vendors should maintain copies of invoices or receipts showing credit card number to establish exempt transaction.

6. Government Purchases. P.D. 03-58 (August 12, 2003). Statutory provisions expressly permitted IDA to purchase materials to construct the Virginia Advanced Shipbuilding and Carrier Integration Center free of sales and use tax. That facility was constructed largely with funds appropriated by the General Assembly. Commissioner holds that materials purchased directly by contractors and not by the sponsoring IDA are subject to tax.

7. Real Estate Construction/IDA. P.D. 03-75 (October 27, 2003). Taxpayer subcontracted to provide pile driving construction services for an IDA project. Commissioner holds that tangible personal property used by this subcontractor was not exempt based on ultimate sale of the *real estate* to a governmental entity. Taxpayer was not entitled to rely on an ST12 "resale exemption" which, on its face, did not accurately reflect facts of transaction.

8. Medical Devices. P.D. 03-1 (January 15, 2003). Manufacturer sought exemption for medical devices as a drug. This exemption was denied because the product was a medical device, not a drug. Even so, the Commissioner acknowledged that sales to nonprofit hospitals and nonprofit licensed nursing homes are exempt. *See Chesapeake General Hospital v. Commonwealth.*

9. Spas/Medical Exemption. P.D. 03-30 (April 9, 2003). Hot tubs cannot be sold exempt of the tax under the medical related exemptions even if prescribed by licensed physicians. They do not meet the statutory requirements of being customarily used for medical purposes and not useful for other reasons.

10. Drugs/For-Profit Hospitals. P.D. 04-49 (Aug. 13, 2004). Taxpayer entered into pharmaceutical service agreements with a number of for-profit hospitals and one for-profit nursing home to provide pharmacy services. Under the contract, taxpayer sells prescription drugs, non-prescription drugs and medical and pharmaceutical supplies to the hospitals that are dispensed to the patients on prescriptions or work orders of licensed physicians. Company bills the hospitals a monthly base line fee for the pharmacy services and the drugs and supplies provided under the agreement. Commissioner held under the "true object" test, the agreement is for the drugs and supplies, the monthly charge by taxpayer to the hospitals is taxable including any services provided. Therefore, taxpayer may purchase drugs and supplies sold pursuant to the agreement under a resale exemption. Commissioner also examined whether a number of exemptions applied to the drugs and supplies sold by the taxpayer to the hospitals. Although Commissioner recognized that many of the items sold to the hospitals qualified for exemptions and the fee charged to the hospitals was therefore not fully taxable, Commissioner rejected taxpayer's allocation formula for determining which portion of the monthly fee represents the taxable drugs and supplies sold by the taxpayer to the hospitals.

11. Occasional Sale/Division. P.D. 03-4 (January 31, 2003). Sale of a division that was part of an "umbrella division" did not qualify for the occasional sale exemption. Although there were separate books and records, the sold division did not derive revenue from its own customers. It apparently operated solely as a profit center within the larger division.

12. Occasional Sale. P.D. 04-14 (May 3, 2004). Company sold all of its tangible assets and accounts receivable, retaining only property relating to its trade name and cash. Transaction qualified for the occasional sale exemption.

13. Exemptions/Occasional Sale. P.D. 04-14 (May 3, 2004). Sale of assets used to manage a medical clinic and accounts receivables from that clinic were exempt as an occasional sale. Subsidiary sold to an affiliate medical office equipment, furnishings, phone and computer equipment, and accounts receivable. Subsidiary retained property pertaining to its trade name, the trade name of its parent, and cash. Subsidiary's federal income tax return showed that it sold more than 80% of its assets to the affiliate. Commissioner held

that that sale constituted an exempt occasional sale because subsidiary had sold substantially all of its assets.

14. Occasional Sale. P.D. 04-56 (Aug. 20, 2004). Commissioner held that a sale of a taxpayer's division qualified for the occasional sale exemption as the sale of all or substantially all the assets of a business. The division operated as separate and distinct from the seller's primary business, maintaining separately housed assets, separate employees, separate marketing and advertising campaigns, separate customer base, and making 95% of its sales to unrelated third parties. All sales made to the seller were at arm's length and at the same price charged to third parties. The division did not maintain a separate bank account but did segregate its checking transactions by using a different style of check, a separate signature authorization list, and separate deposit and serial numbers.

15. Occasional Sale. P.D. 04-55 (Aug. 20, 2004). Taxpayer sold its distribution equipment division in April 1992 and sold its mining and construction division in October 1993. Commissioner held that the sale of both divisions qualified as the sale of all or substantially all the assets of a business and, therefore, were exempt occasional sales.

16. Audits/Burden of Proof. P.O. 03-81 (November 3, 2003). Taxpayer's appeal was denied on all counts because it failed to provide documentation supporting its position. It was unable to show that monthly use tax payments tied to assessed invoices in the audit; invoices did not separately state charge for labor and parts; invoices did not show that Virginia tax had been paid on taxable transactions.

17. Audits/Burden of Proof. P.D. 03-82 (November 3, 2003). Taxpayer was liable for unpaid sales tax even though documentation with vendors stated that the price "includes all taxes." There was no separate statement of sales tax on the invoice.

18. Audits Exemption Certificate. P.D. 04-18 (June 1, 2004). Taxpayer liable for sales tax on purportedly exempt retail sales. Taxpayer provided a list of tax exempt registration numbers for the sales. However, taxpayer could not show that the tax-exempt registration numbers corresponded to specific exempt sales. Lacking such proof, Commissioner held that the taxpayer failed to provide the necessary documentation to substantiate the sales as exempt.

19. Exemption Certificates. P.D. 04-3 (January 22, 2004). Retailer which takes an exemption certificate is obligated to determine whether the transactions in question are consistent with the type of certificate. Certificates were held not to be taken "in good faith" in the case of sales to a church of hand tools, duct tape, and light switches; to a farmer of personal items of family use; etc.

20. Certificates of Exemption. P.D. 04-50 (Aug. 15, 2004). Taxpayer was not held liable on audit for sales with respect to which it had on file at the time of

sale a certificate of exemption upon which it relied in good faith. Taxpayer was held liable for tax for sales with respect to which it (i) obtained a certificate of exemption after the commencement of the audit and the auditor determined that the items purchased were not entitled to the exemption; (ii) did not have an exemption certificate on file; (iii) had an incomplete exemption certificate; (iv) had a substitute exemption certificate that did not contain all of the information required by the Department; (v) had a government exemption certificate on file, but with respect to which the taxpayer provided no evidence that the sales were made from public funds; and (vi) had an exemption certificate on file, but the items were not covered by the wording of the exemption certificate.

21. Audit Methodology/Restaurant. P.D. 04-64 (Aug. 24, 2004). Taxpayer, a restaurant owner whose records were destroyed in a flood, objected to the markup used by an auditor to estimate taxpayer's sales and use tax liability. Auditor used standards provided by the National Retail Association to determine the cost of goods sold. Taxpayer claimed that its cost of goods sold was higher than the national average because it was in an economically depressed area and had lower prices to establish itself in the area. In addition, taxpayer's costs were higher because it purchased a significant quantity of perishable goods from local retail grocery stores rather than from traditional wholesale channels. Commissioner held that taxpayer had not provided sufficient evidence to refute the markup used on audit.

22. Audit. P.D. 04-84 (Aug. 27, 2004). Commissioner upheld auditor's detailing of erroneously accrued tax on expensed purchases from audit sample. Auditor had detailed the contested transactions because taxpayer's treatment was not consistent throughout the entire audit.

23. Audits/Burden of Proof. P.D. 04-33 (July 15, 2004). Taxpayer held liable for assets shown on its fixed assets depreciation schedule for which it could not establish that the sales tax had been paid. In addition, relying on an audit sample, Commissioner refused to remove items from the assessment on which a vendor initially failed to charge the sales tax. Taxpayer claimed that it had subsequently contacted the vendor and paid the sales tax on the contested items.

24. Audits/Statute of Limitations. P.D. 04-24 (June 2, 2004). Commissioner denied taxpayer claim that audit assessment was time barred by the statute of limitations. Taxpayer extended the statute of limitations to October 31, 2001, and the taxpayer received the final copy of the audit and bill in a package postmarked November 6, 2001. The department's automated system showed that the assessment was posted on October 26, 2001, and that the assessment was dated October 31, 2001. Relying on the Department's procedure regarding the mailing of assessments, Commissioner found no basis to abate any part of the taxpayer's assessment. **Comment: But see** the holding in *Circuit City Stores, Inc. v. Department of Tax'n,* Case No. LR-204-3 (Richmond City Cir. Ct., July 29, 2004) to the contrary. Commissioner also

found that graphic design services were taxed under the "true object" test, because the graphic design services would have been of no use without the transfer of prints, film and other materials in connection with the services. In addition, Commissioner held that the taxpayer failed to prove that other graphic design services and purchases were exempt.

25. Audit Methodologies. P.D. 04-75 (Aug. 25, 2004). Commissioner upheld auditor's audit methodology in which it determined the amount of sales tax for untaxed sales for which valid exemption certificates were not obtained by applying an error factor to taxpayer's gross sales. Taxpayer contended that the sample should be based on exempt sales rather than gross sales. Commissioner held that use of gross sales as a sample population would skew the sample results. Commissioner also refused to allow the taxpayer to rely on an exemption certificate that had an invalid registration number because the exemption certificate was not provided and relied upon by the taxpayer in good faith at the time of the sale. Taxpayer was allowed the benefit of an exemption certificate with an invalid registration date because further research indicated that the customer was registered under another account at the time the sale was made. Taxpayer was also not allowed a credit for untaxed sales in which the buyers had self assessed and paid the use tax.

26. Audits/Penalties. P.D. 04-86 (Aug. 30, 2004). Commissioner denied taxpayer's claim that audit methodology was improperly applied. Commissioner also rejected taxpayer's claim that penalty should not apply because taxpayer misunderstood the taxation of purchases made for real property contracts with churches and government entities. Because the taxpayer's compliance ratio was below the applicable threshold, the penalty was imposed.

27. Audits/Refunds. P.D. 04-43 (Aug. 12, 2004). Commissioner ruled that taxpayer was not entitled to exemption for (i) items not directly used in its manufacturing production process, (ii) labor provided in connection with modification of canned software that was not separately stated in the invoice for said software, and (iii) installation labor for property that taxpayer claimed became realty upon its installation, because taxpayer's internal documents classified the property as equipment rather than realty. In addition, Commissioner held that to the extent taxpayer erroneously paid sales tax, the Department's general preference was that the refund be obtained through the dealer. However, if the vendor is no longer in business or does not cooperate with the refund request, taxpayer should contact the Department. Comment: Although putting taxpayers through a bureaucratic run around may reduce refunds, why should the Department, as a matter of law, deny refunds that a court in litigation would order?

28. Registration. P.D. 04-4 (January 23, 2004). Member of an affiliated group was treated as a "prohibited source" and not allowed to bid on Virginia contract because one of its affiliates, which sold to customers in Virginia, was not registered to collect the sales and use tax. That affiliate had no physical

presence in Virginia and, under the rules usually applied by the Department, was not required to register as a dealer. Commissioner's position is that recent legislation permits him to "do indirectly what he cannot do directly" under *Quill.*

Observation. It is questionable that legislation intended the double standard that the Commissioner is applying here.

29. Audits/Burden of Proof. P.D. 04-15 (May 12, 2004). Charitable entity raised a number of errors in appealing its audit assessment but, according to Commissioner, failed to provide documentation or proof supporting its positions.

30. Hotel/Package Fees. P.D. 03-93 (December 10, 2003). Resort hotel charged a "package fee" for rooms and other activities such as golf. Commissioner holds that "attrition fees" paid when rooms were not used was taxable. For purposes of this audit only, Commissioner allowed certain internal accounting records to be used to establish amounts attributable to nontaxable transactions such as golf rounds.

31. Sampling Method. P.D. 03-33 (April 11, 2003). Taxpayer erroneously subtracted its cash shortages from gross sales in determining its sales tax liability. This was corrected using sampling methodology. Taxpayer's complaint that sample period focused on a month with a higher than average error ratio was rejected.

32. Estimations/Bad Debts and Sales. P.D. 03-16; P.D. 03-17 (March 11, 2003). Taxpayer apparently relied on various estimation procedures in computing its taxable sales and allocating bad debt to Virginia. Taxpayer did not carry its burden of proving that the difference between its "register sales" and "reported sales" was attributable to employee discounts. Moreover, the taxpayer's methodology did not allocate each bad debt to each Virginia location. Nevertheless, it appears that the Commissioner is willing to let the taxpayer prove its case with the auditor (suggesting that the taxpayer did not previously exhaust his audit remedies).

33. Retailer/Bad Debts and Gifts. P.D. 03-86 (November 12, 2003). Commissioner denied bad debt deduction because retailer did not establish proof of each bad debt but, instead, used a sampling technique. Gift transactions were also subjected to tax when purchase documentation was made in Virginia but shipped to customers out of state.

Comment. This ruling illustrates two very aggressive and questionable positions of the Department. If the Department is going to conduct audits on a sample basis, how can it deny taxpayers the same ability to establish deductions on a sampling basis? Although the Department's position with respect to the taxability of gifts shipped out of state is longstanding, this case involved gifts that were transferred from warehouses outside of Virginia to customers outside of Virginia. How can it be said that any title to these goods passed to anyone in Virginia?

34. Retailer/Bad Debts & Gifts. P.D. 03-88 (November 13, 2003). Same.

35. Credit Card/Bad Debt Deductions. P.D. 03-49 (May 14, 2003). Commissioner reaffirms previous ruling that disallowed any bad debt deductions with respect to credit card receivables.

36. Corporate Officer Liability. P.D. 03-51 (June 26, 2003). Commissioner previously held that value of furnishings were subject to sales and use tax when a motel was sold. Occasional sale exemption did not apply. Corporate officer who failed to file returns with respect to this sale held personally liable for the tax. Six year period of limitations applied because no return was filed.

37. Refunds/Statute of Limitations. P.D. 03-52 (July 3, 2003). After having paid an audit assessment, taxpayer then conducted a "reverse audit" and sought to offset overpayments against underpayments. Commissioner held that this refund request was made outside the three year period of limitations and was not made during the audit itself.

38. True Object/Driving School and Go-Cart Course. P.D. 03-59 (August 13, 2003). Commissioner holds that taxpayer operates an entertainment facility and that charges for use of equipment and vehicles is part of the service. Tax is paid on the purchase of tangible personal property but not on the charges for use of the facilities and course.

39. Government Contracts/True Object. P.D. 03-70 (October 3, 2003). Contract with Virginia Port Authority, a governmental entity, was held to be contract for services associated with "planning, integration and implementation of maritime and port security systems projects." As a result, resale exemption denied for tangible personal property provided in connection with contract.

40. Government Contracts. P.D. 04-74 (Aug. 25, 2004). Subcontractor not entitled to government exemption for purchases made in connection with the construction of the Virginia Advanced Shipbuilding and Carrier Integration Center ("VASCIC"). Prime contractor had issued taxpayer a completed Form ST-12 exemption certificate indicating that its purchases were exempt from sales and use tax because they were used for consumption by a political subdivision of the Commonwealth, an industrial development authority. Commissioner held that the government exemption did not apply because the credit of the industrial development authority was not bound directly and the subcontractor had not been officially designated as a purchasing agent for the Industrial Development Authority. Commissioner found that the specific exemption in Virginia Code § 58.1-609.1(4) for the VASCIC facility did not apply to the subcontractor. Rather, that exemption was designed to preserve the use of the government exemption only by the industrial development authority.

41. Government Contracts. P.D. 04-53 (Aug. 18, 2004). Taxpayer awarded contract by the U.S. Navy that was classified as a cost-plus, fixed-fee, indefinite delivery/indefinite quantity contract, pursuant to which the work will be accomplished via individual task orders. Because of the broadly worded statement of work and the nature of the repairs, Commissioner had no conclusive evidence of whether the true object of the contract was the provision of services or the sale of tangible personal property to the government. Accordingly, the application of the retail sales and use tax will be based on the individual delivery or task orders and not the underlying contract. Where the true object of the task order is for the provision of services, taxpayer will be deemed to be the taxable user or consumer of tangible personal property used in performing its services. Conversely, when the true object of the task order is for the sale of property to the federal government, the taxpayer may purchase the property exempt of the taxable resale period.

42. Government Contracts. P.D. 04-78 (Aug. 25, 2004). Taxpayer liable for use tax on cost of materials used to fabricate panels under a subcontract for construction on a building owned by a tax exempt federal credit union. Commissioner denied taxpayer's claim that the sales were exempt because of the tax exempt status of the owner and the designation of the general contractor as the purchasing agent for the owner. Commissioner held that the exemption for government contractors did not apply because, although the general contractor was contractually authorized to bind the credit of the tax exempt owner, taxpayer as subcontractor enjoyed no such designation. Taxpayer held to be a using and consuming contractor because it provides panels as part of its contract to provide fabrication, erection and installation services with respect to real property.

43. True Object Test. P.D. 04-65 (Aug. 24, 2004). Taxpayer held liable on drums it purchased as part of contract to operate and maintain hazardous waste accumulation facilities for the government. Under the "true object" test, Commissioner found that the taxpayer's contract with the government was for waste management and removal services, and the purchase of the drums was incidental to that contract. Commissioner also found that the exemption for property use by government entities did not apply, because the government's credit was not directly bound to the vendor for payment of the drums purchased by taxpayer under the contract. Accordingly, taxpayer was considered the user and consumer of all the items purchased in providing services to the government.

44. Sales Price/Computer Training. P.D. 03-31 (April 9, 2003). The taxable "sales price" includes all charges for the sale of tangible personal property. This includes even separately stated charges for services that are billed as part of the same contract. If services are separately contracted for (versus a separate invoice or separate statement on the same invoice), it may be possible to exclude the services from the tax base.

45. Sales Price/Royalties. P.D. 03-37 (April 15, 2003). Royalties paid by persons who purchased tangible personal property were held to be part of the "sale price." The Department will recognize transactions as being independent only if there are two or more contracts which are separately negotiated and can stand alone. In this case, the license fees were not independent of the sale of the underlying systems.

46. Software Modifications/Separate Contracts. P.D. 03-61 (August 19, 2003). Taxpayer entered into two contracts, one for the purchase of prewritten software and one for the modification of that software. The Commissioner, in dictum, holds that the two contracts must be considered a single transaction because they have the same subject matter and were signed on the same day. He then acknowledges, however, that the separate contract satisfied the statutory exemption for "separately charged labor or services rendered in connection with the modification of prewritten programs." **Query**: Why is the Commissioner going out of his way to attack the validity of separate contracts in this ruling? Note that the authority cited by the Department deals with rules of construction applicable to related contracts, not to whether the related contracts are in fact separate contracts. Note also that the Department's traditional policy on what constitutes a separate taxable transaction turns on whether there is "separately bargained for consideration." *See Commonwealth v. United Airlines*, 219 Va. 274 (1978) (meals included in the price of a ticket were not resold by airlines because there was no separately bargained for consideration - - that is, passengers could not take a reduced fare by rejecting the meal).

47. License Fees/Laser Surgery. P.D. 03-74 (October 27, 2003). Although set out in separate agreements, fees paid for the right to utilize patented surgical procedures were held to be subject to taxation. The license agreements were directly linked to the sale of the laser surgical system.

48. Vessels in Foreign Commerce. P.D. 03-44 (April 24, 2003). Ship repairs to a yacht that is chartered for foreign excursions may or may not be exempt. Taxpayer given additional time to establish that principal purpose was such commercial trips, not personal entertainment.

49. Manufacturing. P.D. 04-73 (Aug. 24, 2004). Taxpayer not entitled to manufacturing exemption for uni-plant used to purify and bottle water. Taxpayer sold coffee, office products, cleaning supplies, and other items at retail to business customers. Uni-plant removed chlorine and other impurities from municipal water, added oxygen, and bottled the water in jugs. Although taxpayer's use of the uni-plant constituted manufacturing, the manufacturing exemption did not apply because the manufacturing activity was only an incidental part of the taxpayer's retail business and the taxpayer's manufacturing activities were not industrial in nature.

50. Manufacturing/Brewery. P.D. 03-71 (October 15, 2003). Commissioner holds that a restaurant's microbrewery does not qualify for the direct use

manufacturing exemption because more than 50% of its production is sold to customers on the premises of the restaurant.

51. Manufacturing. P.D. 04-70 (Aug. 24, 2004). Taxpayer, a manufacturer of dry masonry products, rented portable silos delivered to a customer's job site for use in mixing mortars. Rental agreement with customers provided that the rental fee for the portable silo would be waived for each week materials were purchased for the silo. Commissioner held that the portable silo served a dual purpose: for rental and for use by the taxpayer when withdrawn from the rental inventory and provided to customers at no charge. Accordingly, no use tax applied when the silos were used on a "no charge basis," but the tax must be collected and remitted when the silo is returned to the rental inventory. Commissioner also held that the manufacturing exemption did not apply because the portable silos were not used at the plant site and were not used directly in the production of dry mortar for sale or resale. Rather, the portable silos were used by the customers at the job site to mix the dry mortar with water to obtain the desired consistency for use in the construction project.

52. Fabricators. P.D. 04-22 (June 2, 2004). Taxpayers held liable for use tax on labor charges to fabricate tangible personal property for use in their Virginia construction contracts. Taxpayers purchase steel from out-of-state suppliers and directed the shippers to ship the steel to out-of-state fabricators. The steel is fabricated by third parties into products used in Virginia construction sites. Commissioner found that exemption for fabricators of tangible personal property did not apply because taxpayers did not perform the fabrication services themselves. Rather, taxpayers contracted with parties to provide the fabricated materials used in Virginia real property construction projects.

53. Direct Use/Laundry. P.D. 03-80 (November 3, 2003). No direct use exemption was allowed for chemicals used to clean and maintain a boiler or for equipment used at a plant site separate from the laundry itself.

54. Direct Use/Equipment Components. P.D. 04-2 (January 13, 2004). Manufacturer of truck parts was assessed tax on various components of its production equipment. Commissioner held that the following were effectively components of production equipment and exempt: bake oven to cure paint; floor plates, steel and grout that were affixed to machines but not permanently affixed to the real estate. By contrast, however, no exemption was allowed for a paint booth which did not "create a special environment essential to the production process." No exemption allowed for bar coding equipment utilized to read bar code information. Bar coding equipment that placed labels on products, however, was exempt.

55. Direct Use/Mining. P.D. 04-34 (July 27, 2004). Taxpayer engaged in the construction of gas pipelines was not entitled to claim the exemption applicable to property used directly in drilling of natural gas or oil for (i) administrative supplies and (ii) grass seed used to restore land on right of ways disturbed by the insulation of a gas pipeline. Taxpayer was entitled to

the exemption for repair and replacement parts used directly in mining and/or mineral processing.

56. Direct Use/Public Utilities. P.D. 04-25 (June 2, 2004). Commissioner determined that state-regulated public utility was entitled to an exemption for certain items used directly in the rendition of its public service, but was not entitled to the exemption for other items that were not directly used for that function. In addition, taxpayer was not allowed a credit for the taxes it had erroneously paid on exempt items. **Comment:** This ruling is remarkable because it ignores the taxpayer's arguments that the items in question were exempt under the Department's own regulations that recognize a different test of "directly used" in public service versus manufacturing which was the standard applied. Recent legislation that removes the public service exemption has probably saved the Department litigation on this ruling.

57. Direct Use/Public Utilities. P.D. 04-48 (Aug. 13, 2004). Taxpayer held liable for sales tax on electronic receiver transmitter ("ERT") units affixed to gas meters and used to read customer usage and broadcast that data to mobile or fixed meter readings systems. ERT units were purchased by taxpayer for, and delivered to, out-of-state meter manufacturers who installed them on meters prior to delivery in Virginia. Commissioner held that sale of ERT units were taxable because they were purchased separate from the meters. Had the meter and the ERT unit been purchased as a single unit the transaction would have qualified for the public utility exemption. Commissioner also noted that the ERT units were not an exempt component part of utility machinery. ERT units served only a billing function and were not used in an exempt distribution activity.

58. Direct Use/Mining/Safety Equipment. P.D. 04-76 (Aug. 25, 2004). Mining company held liable for sales and use tax on certain safety equipment required by federal and state law. The fact that federal and state law required taxpayer to incorporate items into its safety plan does not mean the property is used directly in mining operations. Commissioner allowed taxpayer an exemption for reflective tags that were attached to clothing and hardhats worn by miners. In addition, Commissioner rejected taxpayer's claim that penalty should not be applied because taxpayer had undergone a complete rearrangement of its audit staff which resulted in various clerical errors made in its compliance with the retail sales and use tax. Commissioner held that rearrangement of administrative staff reflected common business conditions and was not a mitigating circumstance warranting waiver of the penalty.

59. Direct Use/Manufacturing/Testing and Quality Control. P.D. 04-71 (Aug. 24, 2004). Taxpayer, a manufacturer of rocket motors, was not entitled to manufacturing exemption for testing equipment that was not used on the "production line." Federal government regulations required testing to be performed at a specified distance from workers and surrounding community, which required that the production line quality controls be physically separated from the rest of the production line. Commissioner held that the

manufacturing exemption only extended to equipment and supplies used for testing and quality control if those activities are actually performed during the manufacturing process on the production line. Exemption did not apply in this instance because the rocket motor testing occurred away from the production line and was conducted on a completed rocket.

60. Direct Use/Industrial Processing. P.D. 04-87 (Aug. 30, 2004). Commissioner held that taxpayer, a cigarette manufacturer, was subject to use tax on its purchase of Tersa Bale Heads except to the extent the Tersa Bale Heads were used more than 50% of the time in the process of reclaiming tobacco from out-of-date and damaged cigarettes. The Tersa Bale Heads are primarily used to facilitate the transportation and storage of tobacco leaf to the taxpayer's Virginia facility, where the tobacco is stored and aged before being shipped to taxpayer's cigarette manufacturing facility to be manufactured into cigarettes, Commissioner held that the taxpayer's Virginia facility was not engaged in industrial processing and that the Tersa Bale Heads were not used directly in industrial processing because the taxpayer's primary activity at that location was tobacco storaging and warehousing, not industrial processing. Commissioner recognized that the taxpayer's tobacco reclamation activities at its Virginia location constituted industrial processing. Commissioner held that Tersa Bale Heads used 50% or more of the time in its exempt reclamation process would be exempt from tax. Commissioner also held that the materials were not exempt under the packaging materials exemption, because the taxpayer was not engaged in industrial manufacturing or processing at its Virginia facility. The exemption for packaging materials requires that the property be used at a single plant site and must be used directly in industrial manufacturing or processing. Commissioner held that the use of Tersa Bale Heads to transport and store tobacco was not industrial processing.

61. Direct Use/Packaging. P.D. 03-79 (November 03, 2003). Taxpayer argued that wooden pallets on which it shipped concrete blocks were exempt because blocks were wrapped in plastic. Commissioner acknowledges that plastic wrapping that attaches product to pallets can result in exemption for both the wrapping and the pallets because, in that instance, the pallet and wrapping together form exempt packaging. In this case, plastic wrapping did not encompass the pallets. Wrapping was exempt, pallets were not.

62. Telecommunications Company. P.D. 03-84 (November 4, 2003). Commissioner held that company that provided voice and data communications from Virginia location to overseas locations was not a "telecommunications company" exempt from Virginia sales taxation because it met none of the statutory requirements. Commissioner further held that this was not illegal discrimination because this company did not compete in the same markets as exempt entities.

63. Affiliated Transactions. P.D. 04-1 (January 13, 2004). Medical practice owned certain office furniture, fixtures and equipment in a separate legal entity which leased it to the practice. These transactions were held to be

taxable. A credit was allowed for the sales tax paid to vendors on the purchase of the property.

64. Foreign Shipments. P.D. 04-11 (April 2, 2004). Mail and packages destined for American diplomats overseas are first delivered to a facility in Virginia and then shipped to the ultimate recipients. Commissioner holds that entity providing this trans-shipment service (without opening the packages) is not subject to any Virginia sales or use tax on the contents of those packages because there is no "sale" to which that agency is a party.

65. Software. P.D. 04-38 (July 28, 2004). Commissioner ruled on the taxation of software sold to licensed stock brokers by taxpayer with no offices in Virginia. In general, Commissioner held that hardware and software transferred in a tangible form was subject to the retail sales and tax. Software delivered through an electronic means was not taxable. Commissioner also held that taxpayer would have no taxable income in Virginia if software was exclusively sold by downloading through the Internet. Furthermore, Commissioner held that no Virginia nexus would be established if taxpayer had employees who occasionally or frequently traveled to Virginia to provide technical assistance or to install trading software. On the other hand, taxpayer would have Virginia nexus if it leased or rented computer software or had an employee who traveled occasionally or frequently to Virginia to make sales calls and proposals.

66. Real Estate. P.D. 04-27 (June 10, 2004). Taxpayer held liable for sales tax on components that make up its car wash system. Commissioner rejected the taxpayer's claim that the components are permanently affixed to the realty and that the vendor who installed the component was liable for the tax on the cost of the components as a real property construction contractor. Commissioner found that all of the components either were not affixed to the real property or could be easily removed without damaging the building. In addition, taxpayer did not show any attempt to treat components as real property. In particular, Commissioner noted that the taxpayer had failed to show that the component parts were included in the mortgage on the real property and failed to show how the carwash system was classified for federal tax depreciation purposes. **Comment:** Recent rulings by the Commissioner have held that classification for federal tax purposes is irrelevant to whether property is real or personal for state tax property purposes. Moreover, annexation of property to the use of the building (versus ability to remove without significant damage) is one of the key tests under Virginia case law.

67. Real estate Security System. P.D. 04-77 (Aug. 25, 2004). Taxpayer, a contractor and retailer of security systems, held liable for tax on installed monitored security systems that became real property upon installation. Under 23 VAC 10-210-230, a person selling, leasing, and installing monitored systems is deemed to be the user and consumer of all personal property used in providing the service. Taxpayer charged customers a 2.5% tax on real property installation contracts and remitted the tax to the state in which the

work was performed, even though the materials and equipment were initially delivered in Virginia. Commissioner held that taxpayer was liable on all equipment delivered to it in Virginia. In addition, taxpayer would receive no credit for taxes paid in error to other states. Commissioner also denied taxpayer's claim for release based on instructions on the application of the retail sales and use tax provided by representatives of the Department. Absent specific written documentation regarding the instructions, Commissioner would not grant relief.

68. Cable Installation. P.D. 03-87 (November 12, 2003). Company engaged in the installation of telecommunications and computer systems cabling was held to be a real estate contractor, taxable on all of its purchases. Ohio case law to the contrary not followed.

69. Inventory Samples. P.D. 04-15 (May 12, 2004). Taxpayer liable for sales tax on product samples used to determine if the product was suitable for sale. Taxpayer's purchase and subsequent evaluation of samples resulted in a taxable use. Taxpayer also failed to provide documentation to remove other items from audit assessment.

70. Factor or Export Agent. P.D. 04-11 (Apr. 2, 2004). Agency not liable for mail order purchases of products that are delivered through its mail facility in Virginia and subsequently shipped through the agency's international mail and package system to its staff and their families assigned to diplomatic and consular missions throughout the world. Although agency is not itself a factor or export agent, the mail order sales involve transactions between the mail order companies and the diplomatic or consular staff and their families. Agency is not subject to the sales tax for mail order purchases made by its staff and their families.

71. Manufacturer's Discounts. P.D. 04-42 (Aug. 11, 2004). Taxpayer operated a convenience store in Virginia and had contracts with tobacco manufacturers to participate in cigarette buy-down programs. Under the buy-down programs, the retailer sold certificates at a discounted price during a defined period of time and was reimbursed by the manufacturer for the difference between the regular retail price and the net buy-down selling price. Commissioner held that that retailer was required to report taxable sales using the discounted sales price based on the transaction with the customer. This net selling price represents the total amount for which the cigarettes were sold at retail.

72. Vendor Freight Charges. P.D. 04-61 (Aug. 23, 2004). Taxpayer paid a freight-in charge to its vendors when it purchased property for resale. Taxpayer passed on the freight-in charge to its customers as a separate charge on the sales, but did not collect sales tax on the separately stated freight-in charge. Commissioner held that sales tax applied to the freight-in charge. The freight-in charge was a cost of the property sold and was subject to the sales tax even though separately stated on the invoice.

73. Out-of-State Sale. P.D. 04-62 (Aug. 23, 2004). Taxpayer's temporary storage of products for out-of-state customers was not subject to the sales tax. Taxpayer entered into storage agreements with out-of-state customers under which it placed in storage for a 90-day period a supply of printed forms. Taxpayer invoiced customers only upon request for shipment of the forms, and the title to the printed forms remained with the taxpayer until the customer was invoiced. In the event of default by the customer, taxpayer reserved the right to sell the remaining forms to mitigate damages. Commissioner held that deferred storage arrangements involved the placement of the product in a resale inventory and the sale of the products did not take place until the taxpayer invoiced the products to the customers. Because transfer of title and possession of the product occurred outside the Commonwealth, no taxable event occurred in Virginia, and, therefore, the transaction qualifies as an exempt sale and interstate commerce.

74. Affiliate Lease. P.D. 04-52 (Aug. 18, 2004). Taxpayer, a professional corporation made up of individual dentists, made payments to its principals through leasing arrangements to compensate the dentists for equipment they owned prior to incorporating. Taxpayer claimed that the lease agreements were created as a reimbursement mechanism because the dentists did not want to contribute the equipment to the professional corporation for fear of not being able to retrieve the equipment if the practice were dissolved. Commissioner held that the arrangement constituted a taxable lease of tangible personal property for a consideration. Commissioner relied upon the fact that the underlying documents governing the transaction clearly reflected that it was a lease agreement, with the dentists referred to as the lessor and the taxpayer referred to as the lessee.

75. Resale. P.D. 04-79 (Aug. 25, 2004). Taxpayer, an asphalt manufacturing contractor, purchased asphalt equipment and a wheel loader in 2000. Taxpayer booked the contested items as assets and depreciated them on its books, but never actually used the equipment to produce asphalt. In 2002, taxpayer transferred the equipment to a related entity. Commissioner found that the taxpayer made a taxable use of the equipment, even though it was never used in taxpayer's business, because taxpayer exercised rights of ownership over the property when the property was delivered into Virginia. Commissioner held that the industrial manufacturing exemption did not apply, because taxpayer did not actually use the equipment, but rather it was used by another legal entity. Furthermore, the resale exemption did not apply because taxpayer took title to the property and depreciated it as assets on its books for the years under audit.

76. Advertising. P.D. 04-72 (Aug. 24, 2004). Cigarette manufacturer held liable for sales and use tax on video purchased for display to potential distributors at trade shows, plant tours and potential retail and distribution outlets. Commissioner held that the advertising exemption did not apply because the video did not qualify as media advertisement. The video was not used to

promote the company's products to the general public but only to potential distributor and retailers. In addition, the video was not exempt as part of an exempt service under the "true object" test. Although the production of the video includes a variety of personal services, Commissioner held that the "true object" of the transaction was to obtain a completed video.

77. Hotel Redemption Point Program. P.D. 04-68 (Aug. 24, 2004). Taxpayer operated a nationwide hotel system that granted award points to customers that frequently stayed at its hotels. Commissioner held that sales and use tax did not apply to transactions in which the customer redeemed points in return for complimentary accommodations, because there was no charge for the room. When points were used to reduce the charge of a room by 50%, the sales and use tax applied only to the portion of the room charge that was not subject to the 50% discount. Similarly, when points were used for a free room upgrade, the sales tax applied only to the actual amount charged to the reward point participant for the room.

78. Exemptions/Agricultural. P.D. 04-69 (Aug. 24, 2004). Commissioner held that the agricultural exemption did not apply to the following items sold by a retailer of greenhouse supplies: greenhouse covers and locks, gloves and overalls used as protection when applying chemicals to plants, whole punches used to insert holes in irrigation materials for watering, ground cover used to place chemicals or fertilizers in fields to promote wheat growth, and jute staples that hold down the ground cover.

79. Broadcasting/Internet Service Providers. P.D. 04-89 (Aug. 31, 2004). Commissioner held that broadcasting exemption did not apply to equipment taxpayer purchased to facilitate the provision of Internet service to its customers by another party. At the time at issue, the taxpayer's customers were directed to the homepage of an Internet service provider ("ISP") who provided Internet service to taxpayer's customers. Taxpayer held an ownership position in the ISP, but the ISP was a separate entity that served as taxpayer's supplier of Internet services. The ISP also served several other cable operators. Attorney General Opinion 00-005 (Mar. 15, 2000) held that the exemption for broadcasting equipment applied to "equipment used in providing internet services directly to end-users and to equipment used to enable other companies to provide Internet access service to end-users." (Emphasis added) Commissioner rejected the Attorney General's interpretation of the exemption for broadcasting equipment. Commissioner held that "under a strict interpretation" the statutory language for the broadcasting exemption makes clear that the exemption is available only to those who offered propriety or other content in electronic mail as part of a package to end-user subscribers. The proprietary contact and electronic mail were provided to end-users by the ISP and not by the taxpayer. **Query**: Who is going to represent the Department if this one is litigated?

IV. BUSINESS LICENSE TAX

A. Opinions of the Attorney General

1. Telephone Company. Op. No. 03-005, (February 18, 2003). Virginia Code § 58.1-3731 permits a locality to tax all legal entities meeting the definition of a "telephone company" even if they are not a "public service corporation." Thus, a telephone company organized as an LLC and holding a certificate of convenience and necessity granted by the SCC was taxable under § 58.1-3731. **Observation**: When the tax statutes that cross reference § 58.1-3731 are considered, the conclusion in this opinion becomes questionable. The underlying issue is whether a locality can tax a reseller of telephone services at greater than the .0036 rate applicable to business services. Virginia Code § 58.1-3731 provides for a rate of .050 and permits certain localities to utilize a grandfathered rate that is many times higher. Although not published in the Code, the grandfathering provisions clearly are limited to "public service corporations."

2. Telephone Companies. P.D. 04-6 (February 20, 2004). Limited partnership that "resells commercial mobile radio services and cellular telephone services" to end users claim that it was not subject to locality's 50¢ tax rate. Commissioner's ruling is not clear. On the one hand, ruling appears to accept proposition that taxpayer is not a "public service corporation" regulated by the SCC; but it appears to consider possibility that the fact an affiliated entity is a regulated telephone company somehow affects the separate tax status of this entity.

   Observation. The tax status of separately incorporated or organized "telephone service resellers" is an issue throughout Virginia. Localities want to treat these entities as if they were telephone companies, which they are not. Commissioner's ruling misses an opportunity to stop these attempts and put these telephone resellers on an equal footing with their competitors.

3. Cellular Telephone Service. P.D. 04-17 (May 21, 2004). Locality attempted to tax cellular telephone service at 3% rate which is almost 10 times higher than the .0036 rate applicable to business and personal services. Commissioner holds that a cellular phone service is a "telephone company" within the meaning of state law, but it did not meet the locality's definition of "conducting a telephone exchange in the city and using and occupying the streets ...". Accordingly, the Commissioner rules that the locality is unable to use its "grandfathered rate" and must use the default business services rate. **Comment**: Note that by construing the local ordinance (which the Department usually says it will not do), the Commissioner avoided ruling on whether a cellular telephone company is a "public service corporation" subject to a rate of .0050.

4. Real Estate Brokers and Agents. Op. No. 02-146 (January 27, 2003). The Attorney General opined that the amendment to Va. Code § 58.1-3732.2

applies to a real estate broker if the agents receive their full commission from the broker less an adjustment for the business license tax paid by the broker and the agents pay a desk fee to the broker. He further opined that the amendment does not have retroactive effect.

B. Rulings of the State Tax Commissioner

Classification

1. Professional Service. P.D. 03-18 (March 11, 2003). S corporation provided "chelation therapy and vitamin and nutritional counseling." It was staffed by nurses, and its operations were overseen by a doctor who practiced medicine through a different corporation. Because the taxpayer advertised in the telephone book category of "Physicians & Surgeons - Medical, M.D." and operated under the supervision of a doctor, it was properly classified as a professional service.

2. Yard Sales/Internet Merchant. P.D. 03-68 (August 29, 2003). Liability for a BPOL tax depends on whether a person is engaged in a course of dealing such that he is "engaged in business." Thus, a person who conducts an occasional yard sale on an irregular basis is not "engaged in business" and is not subject to the BPOL tax; but someone who does this on most weekends in the spring, summer and fall is licensable as an itinerant merchant.

3. Wholesale Merchant. P.D. 04-13 (April 23, 2004). Company selling on a discounted basis from a "standard price list" to commercial, industrial and governmental consumers is a wholesale merchant. It is taxable on goods delivered from its local warehouse even though sales of those goods may be negotiated by a sales staff located elsewhere. It is entitled, however, to a deduction to the extent that these purchases delivered from the Virginia warehouse are subject to an income tax in any other state.\

4. Telephone Company. P.D. 04-17 (May 21, 2004). Cellular telephone company was assessed at a 3% rate by locality. Commissioner holds that definition of a "telephone company" under the locality's ordinance was limited to entities with a telephone exchange which does not define a wireless company. Accordingly, the .0036 rate applied.

5. Manufacturing. P.D. 04-21 (June 2, 2004). Taxpayer was in the business of converting lye soap stock into an edible feed stock, oil and glycerin. This was done by combining the original soap stock with sulfuric acid and heat. The resulting endothermic reaction produced an edible fatty acid and glycerin. The Commissioner rules that this is the transformation of the raw material into a substantially different product and is, therefore, manufacturing. Accordingly, the locality must give the Taxpayer the benefit of the machinery and tools rate and is prohibited from imposing a BPOL tax with respect to sales made at wholesale at the place of manufacture.

6. Insurance Agents. P.D. 04-44 (August 12, 2004). Although insurance companies are totally exempt from BPOL taxation, their agents are taxable on all business activities other than those producing direct insurance premium income. Separate lines of business are, therefore, subject to BPOL taxation. For example, a title insurance agent was not taxable with respect to its title insurance premium income, but was taxable with respect to fees for real estate settlements. Rental car agencies issuing certificates of self insurance are not regulated by the SCC and are not exempt.

Apportionment

1. Professional Corporation. P.D. 03-11 (February 24, 2003). Taxpayer sought a refund of BPOL taxes erroneously paid by a professional corporation based on former Virginia Code § 13.1-554 and various administrative interpretations of the Commissioner and Attorney General. Locality refused. Commissioner reversed locality. **Observation**: The statutory distinction between professional corporations and other businesses for license tax purposes was changed effective July 1, 2002

2. Audit Methodology: Income Tax Returns. P.D. 03-15 (March 10, 2003). Service business had offices in Virginia and throughout the United States and world. Locality asserted the right to tax "Virginia sales" as shown on income tax return notwithstanding taxpayer's ability to show receipts by office. Locality's use of income tax apportionment methodology was wrong. Commissioner notes that apportionment of sales for income tax purposes is based on a different methodology than is used for BPOL purposes. **Observation**: Note the importance of the taxpayer's being able to show correct receipts in addition to demonstrating that the locality's methodology was wrong.

3. Audit Methodology: Income Tax Apportionment. P.D. 03-5 (February 3, 2003). County asserted that taxpayer had to report taxable gross receipts for business license tax purposes based on the "subtraction method," that is, business was taxable based on all receipts reported on the Virginia income tax return as "Virginia receipts" less receipts reported for BPOL tax purposes to any other Virginia locality. Commissioner reversed. There is an express statutory methodology for determining the situs of receipts for business license tax purposes, and the use of either income tax or sales tax methodologies is inappropriate.

4. Worldwide Apportionment. P.D. 04-26 (June 2, 2004). Company was subject to tax only with respect to those services which were performed at a definite place of business in the County or were directed or controlled from within the County. Those services controlled from outside Virginia were not subject to local taxation. When a lump sum fee was received for services provided at multiple locations, including a location within Virginia, "it is incumbent upon the Taxpayer to 'unbundle' the technical support gross receipts using a methodology such as an allocation based upon the relative cost of doing

business for these two activities against the total gross receipts for the search contracts in which the technical support services are bundled. The burden is upon the Taxpayer to make this allocation."

5. Situs of Receipts/Administrative Office. P.D. 04-41 (August 10, 2004). Company providing management services to hospitals maintained a local office where employees could meet and occasional seminars for clients were provided. All services to clients, however, were staffed by the company's out-of-state offices and supervised through those offices. Receipts from these services, therefore, were "sitused" to the out-of-state offices and were not subject to local BPOL taxation.

6. Payroll Apportionment. P.D. 04-80 (August 25, 2004). Locality improperly utilized numerator of sales factor in Virginia corporation income tax returns to assess BPOL tax. When it is impossible to determine where work on national contracts is performed or the place from which it is controlled and directed, it is appropriate to use payroll apportionment. Only affiliates with definite places of business in the taxing locality should be included in the apportionment calculation.

7. Multi State Business. P.D. 04-46 (August 12, 2004). Taxpayer had multiple offices in Virginia as well as other states. Its accounting system permitted it to attribute to a particular Virginia locality all receipts directed or controlled by the office in that locality. Accordingly, taxpayer correctly reported those receipts as taxable (including receipts for services performed by persons in that office working in other Virginia localities on a temporary basis), reduced by receipts from business conducted in other states where the taxpayer filed income tax returns. Sales or services performed by out-of-state branches in the locality could not be included in the tax base of the office in that locality. Nor could locality use income tax apportionment to increase its tax base.

8. Apportionment. P.D. 04-90 (August 31, 2004). Office established by taxpayer for convenience of customers and where work was actually performed for customers was a definite place of business to which gross receipts were properly apportioned. In applying payroll apportionment, deductions for interstate receipts and pass through federal contracts should be made before payroll apportionment is applied.

9. Out-of-State Gross Receipts. Op. No. 03-123, 2004 Va. AG LEXIS 4 (Jan. 13, 2004). Attorney General held that Virginia Code § 58.1-3732(B)(2) permits a licensee to deduct from its base of taxable gross receipts the gross receipts attributable to business conducted in another state or foreign country where such licensee is liable for or subject to income or other tax based on income. Attorney General noted that qualification for that deduction did not depend on whether the gross receipts for the business conducted out-of-state were fully or partially taxable. Rather, it is only required that the licensee "is liable for" an income or income-tax measured on gross receipts; the BPOL tax

statutes do not require that the gross receipts be taxed in whole, in part, or even taxed at all by the other state or foreign country.

Exclusions, Exemptions and Reductions

1. Contractor. P.D. 04-5 (February 17, 2004). Contractor with its office in the city also had a contract outside the city. Commissioner holds that the value of this contract can be deducted from taxable receipts only if company is required to pay tax on that contract to another jurisdiction.\

2. Computer Services/R&D. P.D. 04-20 (June 1, 2004). Taxpayer's appeal to the Commissioner was largely rejected for lack of documentation and substantiation. The deduction provided by Virginia Code § 58.1-3732(B)(1) applies to the original cost of computer hardware and software that a contractor is required to purchase and resell to a state or governmental entity. Goods purchased for an inventory that is then resold to a governmental entity do not qualify for the deduction. To qualify for the deduction for research and development activities under section 58.1-3706(D)(1), the taxpayer must establish the deduction by providing "identifiable federal appropriations" for the project.

3. Real Estate Agent. P.D. 04-47 (August 13, 204). 2002 legislation allowing certain deductions for amounts paid to real estate agents by brokers was not declaratory of existing law. Change in law became effective July 1, 2002.

4. Data Management/Manufacturing. P.D. 04-45 (August 13, 2004). Company was engaged in sophisticated data management where it took high volumes of documents from clients scanned and indexed them and returned a tangible product in the form of a CD-ROM, DVD ROM, etc. Commissioner holds that this is not manufacturing because there is no substantial change in the form of the tangible product. Commissioner declines to follow sales tax precedents saying that manufacturing for one state tax purpose is not always manufacturing for another.

   Observation. These statements by the Commissioner are questionable. The concept of "Manufacturing" is defined by the case law in Virginia, and what is recognized as manufacturing for sales tax purposes should be judged under the same tests for local property and business license tax purposes.

5. Agency. P.D. 04-66 (August 23, 2004). Taxpayer could not exclude from taxable gross receipts "pass through" payments from customers used to purchase mailing lists. Because taxpayer did not segregate client funds in appropriate fiduciary accounts, no agency relationship was approved.

7. Agency. P.D. 04-81 (August 25, 2004). Taxpayer was entitled to exclude accounts it managed for clients because contracts clearly established an agency relationship and bank and accounting records clearly accounted for client's funds separately. Locality had assessed tax because taxpayer had not

treated the agency receipts consistently on its federal income tax return, but amended returns were filed. Observation: Although the Attorney General has stated that federal tax returns must reflect the agency treatment, what substantive impact can such returns have on whether there is in fact an agency relationship or not? This would appear to be an unnecessary requirement in the Department's agency test, especially since taxpayers are allowed to fix the failure by filing amended returns.

Procedure

1. Tax Pass Through. P.D. 03-45 (April 25, 2003). BPOL tax is a cost of doing business that cannot be passed on directly to customers. The General Assembly has authorized only motor vehicles dealers to make a separate statement of this tax to customers.

2. Procedure. P.D. 04-47 (August 13, 2004). The fact that locality had previously audited the taxpayer for the same years did not preclude the Commissioner of Revenue from subsequently reauditing and issuing a new assessment within the three year period of limitation.

3. Beginner's Convention. P.D. 04-82 (August 25, 2004). Local ordinance did not employ a "beginner's convention" that would allow locality to tax actual receipts in second year of business. Accordingly, locality was required to tax based on prior year's receipts.

4. Written Ruling. P.D. 04-83 (August 25, 2004). Taxpayers who obtain written rulings from localities are entitled to rely on them. Oral advice, however, is not sufficient.

5. Refund Claims. P.D. 04-67 (August 20, 2004). Locality tried to deny refund claims based on the fact that taxpayer misclassified itself on its original returns. State Tax Commissioner had previously ruled that the taxpayer's printing business was a manufacturing business. Taxpayer had requested a refund from locality and submitted proof that its business in prior years was identical to that determined to be a manufacturing business subsequently. State Tax Commissioner holds that locality must make the refunds. **COMMENT**: This and similar rulings demonstrate that informal appeal system to State is helping taxpayers deal with arbitrary local assessors.

V. PROPERTY TAXES

A. 2004 Legislation

1. Property of Electric Suppliers. Makes explicit what was implicit in prior law, that locality may tax generating equipment of certain electric suppliers at less than the local real estate tax rate.

B. Court Decisions

1. The Daily Press v. Newport News, 265 Va. 304 (2003). Business of newspaper was conducted in three areas: (i) office building where editors, reporters, photographers and administrative staff worked; (ii) pre-press area where machines were used to make a negative that was used to make the press plate; and (iii) the press room. Trial Court held that property in all three areas (except the administrative equipment) was taxable as machinery & tools used in creating the newspaper. Supreme Court reversed holding that the only place manufacturing occurred was in the press room. The Daily Press manufactures newspapers, not the news.

2. Shoosmith Bros. Inc. v. County of Chesterfield, Rec. No. 032572, 2004 Va. LEXIS 125, *1 (Va. Sept. 17, 2004). The Supreme Court of Virginia holds that the capitalization of income approach is appropriate for assessing the value of an owner operated sanitary landfill. The Court rejected the taxpayer's argument that this valuation methodology improperly assessed the intangible value of the business, and also rejected the argument that such an income approach cannot be used when the business in question depends on nontransferable licenses. The County's assessment methodology was consistent with published appraisal literature.

3. Alderson v. County of Alleghany, 2003 Va. LEXIS 83 (Record No. 022578, September 12, 2003). The Supreme Court of Virginia rejected an attempt by residents of the Town (formerly City) of Clifton Forge to avoid personal property tax for 2001 as a consequence of Clifton Forge's reversion to town status. The County's tax day was January 1, 2001, but the reversion was not effective until July 1, 2001. The General Assembly enacted legislation which created two 6-month tax years and validated the County's assessment of tax at the City's rate for the first short year and at the County's rate for the second short year. The Court rejected the taxpayers' argument that the special legislation violated either the uniformity requirement or the *ex post facto* prohibition of the Virginia Constitution.

4. Shenandoah Associates v. County of Shenandoah, 2003 Va. Cir. LEXIS 89 (Shenandoah County Cir. Ct., Law Nos. CL 98-132 & CL 01-140; July 2, 2003). Trial Judge held that the County's failure to consider the fact that restrictions on certain property rendered the property not freely marketable

constituted the disregard of controlling evidence. He further held that the taxpayer overcame the presumption that the assessment was correct. Specifically, the property, a housing facility for the elderly and handicapped, was subject to a deed of trust under which the debtor has no right to prepayment unless HUD approved such prepayment. The deed of trust prevented conveyance or encumbrance of the property, and the loan on the property was not assumable. *See also Woodstock Assoc. v. Shenandoah County*, 2003 Va. Cir. LEXIS 88 (Shenandoah County Cir. Ct., Law Nos. CL 98-131 & CL 01-139; June 19, 2003).

C. Opinions of the Attorney General

1. Exemption from Tax. Op. No. 03-49 (August 5, 2003). The Attorney General opined that the local property tax exemptions granted by the General Assembly 2003, either by designation or by classification, prior to January 1, 2003, were not repealed by the amendment of Va. Const., Art. X, § 6(a)(6) or by the enactment of Va. Code § 58.1-3651. He further opined that the localities lack any authority to repeal an exemption enacted by the General Assembly. Rather, the General Assembly has the authority to repeal any law that it has passed.

2. Exemption from Tax. Op. No. 03-043 (August 5, 2003). The Attorney General opined that the Va. Code § 58.1-3221 partial real estate tax exemption for rehabilitated property is available when a registered historic structure has been demolished so long as the property owner claiming the exemption is not the person responsible for the demolition.

D. Opinions of State Tax Commissioner

1. Personal Property v. Realty. P.D. 04-9 (March 26, 2004). The fact that taxpayer made certain elections under MACRS has no bearing on whether its property should be classified as real estate or tangible personal property for local tax purposes. Locality's attempt to play "catch 22" with taxpayer rebuffed.

2. Truck Valuation. P.D. 03-96 (December 17, 2003). Extended dispute between locality and truck company over the proper method for valuing its heavy trucks. National pricing guide suggested that city's valuation methodology was very wrong. City successfully established that its cost less depreciation methodology reflected actual sales information for vehicles and that difference in national pricing guide information reflected that those guides did not include federal excise tax as part of cost basis. City's methodology upheld.

3. Machinery and Tools/Valuation. P.D. 04-16 (May 14, 2004). Locality assessed machinery and tools at 25% of original cost. Taxpayer was required by its accounting firm to recognize an impairment in the value of its property which was written down to fair market value. In a remarkable opinion, the

Commissioner holds that fair market value is determined based on the statutory requirement of assessment at cost or percentages of cost. As long as locality uniformly applies this procedure, it has also complied with state law requiring assessments at fair market value "to be ascertained as prescribed by general law". As long as the locality's resulting assessment is less than the actual fair market value of the property (after recognition of the impairment to value), taxpayer has no complaint.

Comment: The Commissioner's ruling effectively reads out of the Constitution the requirement that assessments be at fair market value. It also ignores *Fray v. Curlpaper*, 212 Va. 148 (1971) which rejected a locality's argument that as long as its assessed value (after using a fractional assessment ratio) was less than actual fair market value, taxpayers could not make a complaint based on fair market value.

4. M&T/Capital. P.D. 04-39 (August 2, 2004) The Commissioner holds the following assets are properly classified as machinery and tools: items used to service equipment that is directly used in manufacturing; waste treatment facility that treats water used in various stages of manufacturing; laboratory equipment utilized in formulating water and oil mixtures for the manufacturing process; cranes and forklifts used to move work in process during manufacturing. The following items were held to be capital: machinery used to package completely manufactured product; equipment used for general maintenance and cleaning of the plant; forklifts in the shipping area. Whether assets that are idle on the tax day are taxable as machinery and tools or capital is a factual issue that turns on the reason the equipment is idle, the length of time it is expected to remain idle.

5. M&T/Contracts. P.D. 04-54 (August 18, 2004) Taxpayer mistakenly included in its original costs of an electric generating facility certain "out-of-market contracts". The Commissioner rules that such contracts are intangible property, not tangible personal property, and the cost of intangible property should not be included in the original costs of the equipment.

6. Personal Property/Time Shares. P.D. 04-19 (June 1, 2004). The Taxpayer is an owner's association of a time share condominium. Based on organizational documents, it was found that furnishings in each time share unit belonged to the Taxpayer which, accordingly, was taxable with respect to that property. Appliances, however, were owned by the individual unit owners. Moreover, such appliances are deemed "fixtures" under Virginia law and are taxable as part of the real estate. The owners' association, therefore, was not taxable with respect to such appliances.

7. Exemptions/Cemetery. Op. No. 04-002, 2004 Va. AG LEXIS 13 (Mar. 30, 2004). Association owned a family cemetery consisting of a small parcel, which contained the family cemetery, and a large parcel, which surrounded the burying grounds. The association asked that the large parcel be exempt from taxation based on court orders. Attorney General held that the large

parcel would be exempt from taxation if it was not "operated for profit" within the meaning of Article X, § 6(a)(3) of the Virginia Constitution.

8. Exemptions/Local Ordinances. Op. No. 04-019, 2004 Va. AG LEXIS 26 (May 10, 2004). Attorney General ruled that a newly elected board of supervisors may repeal ordinances, adopted by a prior board pursuant to Virginia Code § 58.1-3651, exempting property from taxation by designation. Attorney General held that Virginia Code § 58.1-3651 places no restriction on the repeal of such ordinances. Therefore, those ordinances are subject to amendment or repeal in the same manner as they were adopted. Comment: Once having determined that a charity meets the statutory requirements for exemption, on what basis will a locality reverse that determination?

9. Exemptions/Government Property. Op. No. 04-057, 2004 Va. AG LEXIS 37 (July 21, 2004). Attorney General held that no portion of proposed construction of military family housing at the Fort Story army base under the Military Housing Privatization Initiative would be subject to local real property tax. The lease of property to a limited liability company in which the federal government would own at least a 90% membership interest did not cause that property to be subject to local real estate property tax. In addition, no portion of the property or the leasehold interest would be taxable, because the Military Housing Privatization Initiative specifically provided that the government's conveyance or lease of any property or facilities under the initiative would not be subject to the federal government's waiver of sovereign immunity to allow state and local taxation of such property.

10. Car Tax Relief. Op. No. 03-114, 2004 Va. AG LEXIS 7 (Feb. 4, 2004). Attorney General held that the display of a commercial advertising design on a passenger vehicle for more than 50% of the time does not alone disqualify the vehicle from relief under the Personal Property Tax Relief Act. The placement of commercial advertising on the exterior of a vehicle creates a rebutable presumption that the taxpayer uses the vehicle for business purposes, which renders it ineligible for tax relief under the Personal Property Tax Relief Act. The taxpayer may refute that rebutable presumption with adequate evidence of the vehicle's actual usage. A commercial advertising display, therefore, is one of the factors that a commissioner of revenue should consider in determining whether the vehicle qualifies for relief under the Personal Property Tax Relief Act.

VI. MISCELLANEOUS TAX ISSUES

A. 2004 Legislation - **Regular Session**

2. Local Settlements. HB 237 authorizes local tax officials to settle tax assessments based on (i) legal uncertainty or (ii) doubtful collectibility.

3. Rulings on Local Taxes. HB 295 confirms that the State Tax Commissioner has the authority to issue advisory opinions concerning "local business taxes."

4. Administrative Appeals. HB 298 prohibits a locality from denying permits and licenses to any business that is pursuing an administrative appeal of a tax assessment.

5. Local Tax Appeals. Expands the group of local tax assessments that can be appealed to the State Tax Commissioner to include airplanes, boats, campers, recreational vehicles and trailers.

2004 Legislation - **Special Session**

- Recordation tax increase for deeds, mortgages, etc.
  - Each "bracket" increases by 10¢ per $100 of consideration or value
  - Generally from 15¢ to 25¢ - 67% increase - at first bracket

B. Opinions of the Attorney General

1. Recordation Tax. Op. No. 03-047 (June 26, 2003). Because the federal Farm Credit Act exempts federal land credit associations from federal, state or local taxation, deeds of trust of a federal land credit association are not subject to the recordation tax.

2. Electric Utility Consumption Tax. Op. No. 03-018 (May 13, 2003). As a general matter, activities of members of the Pamunkey and Mattaponi Indian tribes that take place on the reservations are not subject to state or local tax. Accordingly, the Va. Code § 58.1-2900 local electric utility consumption tax cannot be collected from tribal members who live on the Indian reservation for electricity used on the reservation.

C. Rulings of the State Tax Commissioner

1. 90 Day Appeals Limitation. P. D. 03-53 (July 15, 2003). **IMPORTANT POLICY CHANGE.** The Department of Taxation announces a change in policy to the effect that a **complete** administrative appeal must be filed within ninety days of the date of an assessment. A form, which is available at the Department's website, is also provided for use in all appeals. **Observation:** For over 20 years the Department has recognized the importance of resolving issues administratively, without forcing them to litigation. It is not known why the Department has chosen at this time to deviate from this fair and traditional policy.

2. Returns. P.D. 04-29 (June 24, 2004). Limited liability company with both Virginia resident and non-resident members requested a ruling that the non-resident members would not be subject to Virginia income tax if the LLC moved to Virginia. The LLC was a joint venture used by purchasers to acquire products from manufacturers and invest the proceeds of rebates received from those manufacturers. The executive director and secretary of the LLC were leased from an unrelated third party, and all the real and personal property used by the LLC was owned by the executive director.

Commissioner held that the LLC would have positive apportionment factors if the executive director's real and personal property used by the LLC was located in Virginia. If the LLC is taxed as a partnership for federal income tax purposes, each member receiving income from the LLC would be considered to have property in Virginia and would be required to file the appropriate income tax return and pay income tax on their Virginia source income.

3. Probate Tax. Op. No. 04-025, 2004 Va. AG LEXIS 24 (May 19, 2004). Attorney General held that benefits under the Virginia Retirement System retirement plan and insurance policy, which were payable to a third party but are claimed by the surviving spouse when claiming an elective share of the augmented estate under Virginia Code § 64.1-16.1, are not part of the probate estate and are not subject to the probate tax. Property that does not pass by will or intestacy are not subject to the probate tax. Virginia Retirement System retirement plan and insurance policy benefits do not pass by will or intestacy. Those benefits do not comprise a part of the amount of the probate estate itself, but are added to that amount for purposes of calculating the augmented estate.

4. Cigarette Tax. Op. No. 04-053, 2004 Va. AG LEXIS 38 (July 22, 2004). Attorney General held that the legislation increasing the state cigarette tax did not amend Virginia Code § 58.1-3831, which addresses the imposition of local cigarette tax by Fairfax and Arlington Counties. Accordingly, the governing bodies of Fairfax and Arlington Counties may raise their respective local cigarette taxes to an amount not to exceed the greater of 5¢ per pack of cigarettes or the amount of the state tax levied on cigarettes. Because the state cigarette tax will be increased to 20¢ as of September 1, 2004, 20¢ per pack will become the maximum local cigarette tax rate that Fairfax and Arlington may impose. Similarly, when the state cigarette tax increases to 30¢ per pack on July 1, 2005, 30¢ will become the maximum local tax rate for Fairfax and Arlington counties.

Dated: 9/30/2004