

1997

## BPOL Reform in Virginia: Putting the Income Tax Genie Back in the Bottle

William L.S. Rowe

---

### Repository Citation

Rowe, William L.S., "BPOL Reform in Virginia: Putting the Income Tax Genie Back in the Bottle" (1997). *William & Mary Annual Tax Conference*. 344.  
<https://scholarship.law.wm.edu/tax/344>

## ***BPOL Reform In Virginia***

### ***Putting The Income Tax Genie Back In The Bottle<sup>1</sup>***

**William L.S. Rowe  
Hunton & Williams  
951 E. Byrd Street  
Richmond, VA 23219-4074  
Telephone 804-788-8410**

#### **I. Privilege Tax, Not An Income Tax**

As traditionally administered, Virginia's business, professional and occupation license ("BPOL") tax, measured by gross receipts, was, relatively speaking, a narrowly defined "privilege tax." The major thrust of Virginia's recent reform legislation was to return administration of the tax to its limited historical roots and eliminate efforts by localities to find authority in the statutes for a local income tax on businesses.

##### **A. Historical Precedents**

1. Privilege Tax. Through the 1970's, the BPOL tax was administered and interpreted as a privilege tax. Case law restricted scope of tax to specific privileges that were taxed and to income directly related to those privileges. E.g., City of Richmond v. Boshier, 197 Va. 182, 89 S.E.2d 36 (1955) (head of surgery at Medical College of Virginia was held not to be taxable with respect to compensation for teaching and supervising residents at McGuire Hospital; City apparently had no tax on privilege of teaching versus practicing medicine). See also, Estes Express Lines v. City of Richmond, 193 Va. 181, 68 S.E.2d 109 (1951) (common carriers of freight held not subject to BPOL tax under ordinance taxing the privilege of hauling and moving goods for others); Tidewater-Raymond-Kiewit v. City of Hampton, 216 Va. 262, 217 S.E.2d 862 (1975) (where

---

<sup>1</sup>This outline reflects the views and opinions of the author gained from his representation of the Virginia Chamber of Commerce and Virginia Manufacturers Association in the legislative and administrative process that produced the 1996 "reform" legislation and associated "Guidelines" (herein, "Regs.") published by the Virginia Department of Taxation on January 1, 1997. As with any "new" tax, which must evolve over time, much will be learned from the application of these new laws to the facts of specific cases. No prediction of the result in any such case is intended, especially since administrative determinations by the Department of Taxation can be appealed to the courts by a locality which disagrees with any such determinations.

local ordinance defined the privilege of "contracting" to mean "accepting or offering to accept contracts", joint venture was taxable only in year that contract was accepted and not in each year that contract was performed); Williams v. City of Richmond, 177 Va. 477, 14 S.E.2d 287 (1941) (City's attempt to tax all businesses under a "dragnet clause" held unconstitutional).

2. No Income Tax Authority. The distinction between an income tax and a privilege tax is important because Virginia localities are generally denied the ability to impose an income tax. See Va. Code § 58.1-300 (local income tax prohibited) and Va. Code § 58.1-3009 (occupations and professions taxable only as a privilege tax).

## **B. Erosion of Historical Precedents**

Notwithstanding clear historical precedents, localities began administering their BPOL taxes using income tax principles and "catch all" clauses seemingly invalidated in Williams v. City of Richmond, *supra*. With rising costs of litigation, practical administrative precedents generally came from Attorney General's office which seemed to support an income tax metamorphosis.

1. Opinion of the Attorney General to the Honorable Ray A. Conner, 1990 Att'y Gen. Rep. 220 (Dec. 14, 1990). Local customer relations office of computer manufacturer held subject to BPOL tax as a merchant, on sales related to that office, even though it had no inventory of goods on hand for sale and all sales made at factory. Interpretation undermined statute, Virginia Code § 58.1-3703B(4), which prohibits localities from taxing the privilege of manufacturing and selling at the place of manufacture.
2. Opinion of the Attorney General to Ross A. Mugler, Commissioner of the Revenue for City of Hampton, 1994 Att'y Gen. Rep. 106 (November 17, 1994). In analyzing BPOL taxability of mail order catalog business, Attorney General follows classic income tax analysis: company has nexus through local office and sole remaining question is fair apportionment.
3. Short Brothers (USA) v. Arlington County, 244 Va. 520, 423 S.E.2d 172 (1992). Total gross receipts of U.S. subsidiary of Irish aircraft manufacturer held taxable in Virginia as a merchant even though aircraft that were sold or leased never came into Virginia. Court's analysis follows income tax rationale that apportionment necessary only to prevent double taxation; ignores lack of exercise of taxable privilege in locality.

4. Income tax analysis hits its nadir in *City of Winchester v. American Woodmark Corporation*, 252 Va. 98, 471 S.E.2d 495 (1996). Locality assessed corporate headquarters of a manufacturer with tax on its worldwide gross receipts. Apparently based on a Short Brothers double tax analysis, locality allows a deduction only for receipts actually taxed elsewhere (there were none) and taxed balance. Applying income tax apportionment theory, Supreme Court of Virginia holds that assessments are unconstitutional under external consistency test. Court's opinion does not reach the fundamental issue of whether a locality can tax the privilege of managing one's own affairs.

### **C. Reform Efforts**

Aggressive administration of the BPOL tax along income tax lines led to a groundswell of voter discontent. Governor Allen, with broad support in the business community, proposed repeal of BPOL tax authority on a reformed and phased-out basis. H.B. 1974 (1995) and S.B. 895 (1995). Unable to determine a reliable replacement for lost revenues, the legislature proposed reform based on return to traditional privilege tax concepts. See "Report of the Joint Committee Studying the BPOL Tax," 1995 H. Doc. 59 and House Bill 2351 (1995). As a result of impasse between the Governor and the legislature, nothing passes during 1995 Session of General Assembly, but Study Commission during 1995 leads to passage of reform legislation, supported by both the Governor and the General Assembly, during 1996 Session. Compare HJR 487 (1995) with H.B. 293 (1996) and S.B. 587 (1997). Legislation passed with general effective date of January 1, 1997. 1996 Acts, chs. 715 and 720.

## **II. BPOL Legislation -- Substantive Reforms**

The key to BPOL reform is returning administration of this tax to privilege tax concepts. Although each locality retains significant discretion in drafting its local ordinances (e.g., determining rates at or below state's ceilings, exemptions, and which businesses to tax or not to tax), state law now requires each local ordinance to contain certain provisions. These are the so-called "Uniform Ordinance" provisions found in Virginia Code § 58.1-3703.1.

### **A. Nexus**

With one limited exception, taxable nexus requires a local office where a trade or business is regularly conducted. When a person has no office, it is possible that his home may be treated as a taxable place of business.

1. **"Definite place of business"** means an office or a location at which occurs a regular and continuous course of dealing for thirty consecutive days or more. A definite place of business for a person engaged in business may include a location leased or otherwise obtained from another person on a temporary or seasonal basis and real property leased to another. A person's residence shall be deemed to be a definite place of business if there is no definite place of business maintained elsewhere and the person is not subject to licensure as a peddler or itinerant merchant. Va. Code § 58.1-3700.1.
2. **"Business"** means a course of dealing which requires the time, attention and labor of the person so engaged for the purpose of earning a livelihood or profit. It implies a continuous and regular course of dealing, rather than an irregular or isolated transaction. A person may be engaged in more than one business. The following acts shall create a rebuttable presumption that a person is engaged in a business: (i) advertising or otherwise holding oneself out to the public as being engaged in a particular business or (ii) filing tax returns, schedules and documents that are required only of persons engaged in a trade or business. Va. Code §§ 58.13700.1.
3. As a result of this very clear nexus requirement, transient presence in Virginia of employees assigned to offices outside Virginia generally will not result in liability for local BPOL tax.
4. Clear "engaged in business" requirements also serve to eliminate from taxation investment and other miscellaneous income not attributable to the exercise of a licensed privilege.

**B. Taxable Privilege**

Assuming there is taxable nexus, local office is taxable only if it is engaged in the exercise of a specific privilege taxed by the local ordinance.

1. Certain privileges may not be taxed locally. For example:
  - (a) Manufacturing and selling at wholesale at the place of manufacture. Va. Code § 58.1-3703(A)(4). "Regulations"<sup>2</sup>

---

<sup>2</sup>References to "Reg. § \_\_" are to Guidelines for Business, Professional and Occupational License Tax Imposed by City, County and Town Ordinances issued by the Virginia Department of Taxation January 1, 1997. These "Guidelines" will have force of regulations after June 30, 2001.

make clear that statute provides a broad exemption for all a manufacturer's wholesale sales unless an independent sales location, with inventory, is established away from the factory. Reg. § 7.3.

- (b) Public service corporations -- except as specifically provided in Virginia Code § 58.1-3731. Va. Code § 58.1-3703(C)(1).
- (c) Farmers selling outside city markets. Va. Code § 58.1-3703(C)(2).
- (d) Newspapers, publications, radio and television stations, and broadcasting services. Va. Code § 58.1-3703(C)(3).
- (e) Insurance companies and agents. Va. Code § 58.1-3703(C)(11).
- (f) Banks. Va. Code § 58.1-3703(C)(12). But see Reg. § 6.3 noting that banks may be subject to a retail merchants license tax depending upon how checks and other such items are sold to customers.
- (g) Charities. Va. Code § 58.1-3703(C)(18).
  - (i) Trade associations and other such businesses are taxable on their business income but not dues and contributions.
  - (ii) Hospitals, schools, museums and other such "public charities" generally taxable on only their unrelated business taxable income as determined under federal Internal Revenue Code. Va. Code § 58.1-3703(C)(18)(a).
- (h) Venture capital funds. Under Virginia Code § 58.1-3703(C)(19), venture capital funds are recognized as an example of monies handled in a fiduciary capacity by the fund managers. Receipts of the fund are not taxable, but the fund manager is taxable on his compensation for management services. See Opinion of the Attorney General to the Honorable Vincent F. Callahan, Jr., 1995 Va. AG LEXIS 49 (June 20, 1995).

- (i) Employees are generally engaged in the business of their employer. Derrick v. Commonwealth, 122 Va. 906, 95 S.E. 392 (1918). Thus, the employer may be subject to tax, but its employees are not. Reg. § 3.7.1.
- 2. Except for those privileges that state law prohibits localities from taxing (such as those listed above), each local ordinance must be analyzed to determine which privileges are taxed. Localities have broad general authority to create subclassifications, to exempt certain classifications of businesses or to tax them at different rates subject to the state's ceilings. Reg. § 3.1.1. If within state ceilings, these issues of classification and rate generally are not subject to state review. Reg. § 4.12. Classifications based on state law concepts, however, are reviewable. For example, local application of the terms "manufacturer" and "wholesaler" are subject to state review. Reg. § 4.12.
- 3. State law establishes certain thresholds (an exemption in Henrico County) that provide a small business exception. Size of threshold generally depends on local population. Va. Code §§ 58.1-3703; Reg. § 3.4.

<u>Population</u>	<u>Threshold</u>
More than 50,000	\$100,000
25,000 - 50,000	\$ 50,000
Less than 25,000	0

- (a) To replace revenue from thresholds, localities are authorized to impose a fee, also dependent on population. Va. Code § 58.1-3706A; Reg. § 3.4. Statutory change in 1997 makes clear that locality cannot impose fee on top of tax. Id.

<u>Population</u>	<u>Fee</u>
More than 50,000	\$100
25,000 - 50,000	\$ 50
Less than 25,000	\$ 30

### **C. Taxable Receipts**

Assuming there is a taxable business which has an office and receipts in excess of the thresholds, a BPOL tax may be imposed only on those gross receipts that are directly attributable to the exercise of a specifically licensed privilege at that particular business location and that derive from the ordinary course of business.

Va. Code § 58.1-3732; Reg. § 3.3.2. Remember, this is a privilege tax, not an income tax.

1. Several different businesses may be conducted at the same location, in which case each business may be separately licensed. Reg. § 3.5. The taxpayer has the option of paying all taxes under one license (at the highest rate). Reg. § 3.5B. The locality may also tax receipts from ancillary activities separately, at the lower rates, even though they are ancillary to one business. Reg. § 3.5B(3).
2. Receipts that are ancillary to one business must be taxed with that business. Reg. § 3.5A. Receipts that are not ancillary to any license privilege are not subject to BPOL taxation. Id. ("Gross receipts which are not ancillary to a licensable business must rise to the level of a separate business to be taxable").
  - (a) A merchant (retail or wholesale) offers an extended warranty with the merchandise it sells. The warranty covers parts and labor, and may include replacement of defective merchandise. Although a separate charge is made for the warranty, at the time of sale it is impossible to determine how much of the charge will be used (if any) for labor, parts, or replacement merchandise. The charge for an extended warranty is ancillary to the sale of the merchandise. Reg. § 3.5A(1).
  - (b) A retail merchant offers to deliver the merchandise it sells for a fee. The merchant has its own delivery trucks, but also contracts with third parties to make some of the deliveries. The fee charged to the customer varies with distance, but does not depend on whether the merchandise is delivered by the merchant or a third party. Because the delivery service is only offered with respect to merchandise sold by the merchant, the delivery charge is ancillary to the merchandising business. Reg. § 3.5A(2).

#### **D. Classifications**

The primary purpose of classifications is to determine the taxable rate. The most controversial classification (and the one with the highest rate) is that applicable to professionals. Under the BPOL legislation, a business is taxable at the professional rate only if it is one of the specifically listed professions in the state's



regulations. Reg. § 8.4.2. The maximum rates under Virginia Code §§ 58.1-370 are <sup>3</sup>

<u>1. Classification</u>	<u>Maximum Rate</u>
Professional, real estate and financial services	.0058 gross receipts
Repair, personal and business services	.0036 gross receipts
Retailer	.0020 gross receipts
Building contractor	.0016 gross receipts
Wholesaler	.0005 purchases

2. As a general rule, most Virginia localities are required to tax wholesale merchants based on "purchases" and not "gross receipts." Reg. § 7.1. One known exception is Arlington County.

(a) (i) **"Gross Receipts"** means the whole, entire, total receipts, without deduction. Va. Code § 58.1-3700.1.

(ii) The Guidelines incorporate other statutory limitations as follows:

**"Gross receipts"** means the whole, entire, total receipts, or money or other consideration received by the taxpayer as a result of transactions with others beside himself and which are derived from the exercise of the licensed privilege to engage in a business or profession in the ordinary course of business, without deduction or exclusion except as provided by law. See § 3.3 for examples of items excluded from the definition of gross receipts.

(b) **"Purchases"** means all goods, wares and merchandise received for sale at each definite place of business of a

---

<sup>3</sup>Only the City of Richmond has rates in excess of these ceilings and grandfathered by statute.

wholesale merchant. The term shall also include the cost of manufacture of all goods, wares and merchandise manufactured by any wholesale merchant and sold or offered for sale. A wholesale merchant may elect to report the gross receipts from the sale of manufactured goods, wares and merchandise if it cannot determine the cost of manufacture or chooses not to disclose the cost of manufacture. Va. Code § 58.1-3700.1.

3. Because of the significant rate differential in most localities, the distinction between wholesale and retail merchants is an important one.

- (a) Wholesale merchant is defined in § 7 of the Regulations as:

**§ 7.2. What is the Licensable Privilege of Wholesale Selling.** Whether or not a sale of tangible personal property is properly classified as wholesale selling depends on the facts and circumstances of the particular transaction under consideration. Wholesale trade is generally recognized as the selling at such prices and in such quantities to others who will then resell such goods either to ultimate consumers or further down the normal distribution chain. Wholesale trade may also include sales to industrial, commercial or governmental users where goods sold will be used by the buyer in its productive processes. Although no single factor such as price, purpose, or place of sale may always distinguish between wholesale and other types of sales, the following inquiries may be helpful:

Is the sale to an individual consumer for the consumer's own personal use? This type of transaction is never considered a wholesale sale for BPOL purposes regardless of whether the taxpayer sells the item at a purported "wholesale price" or sells the item from a business facility that appears to be a wholesale establishment.

Is the sale to another merchant for resale? Transactions in which the taxpayer is selling new "in the box" items to a merchant for retail or distribution to other retailers or wholesalers are wholesale sales for BPOL purposes. Sales of used

goods for resale may be wholesale depending upon the facts and circumstances of the transaction.

Taxpayers engaged in the business of selling goods to a government, institutional, business or industrial entity for consumption, used or incorporation in an assembly, manufacturing or processing operation are typically subject to the BPOL tax on wholesalers. Examples of these wholesale activities include: bulk quantity sales of goods for maintenance of facilities or equipment; sales of materials or components for incorporation into a product; or the supplying of machinery, fixtures or furnishings. "Wholesale price" can be an important factor in classifying this type of sales activity, especially when the transaction in question involves goods which are simultaneously offered to individual consumers at a higher price.

**FACTORS THAT HELP DISTINGUISH BETWEEN WHOLESALE AND RETAIL SELLING**

<b><u>RETAIL</u></b>	<b><u>WHOLESALE</u></b>
<ul style="list-style-type: none"><li>◦ Personal Use by Individual Consumer</li><li>◦ Retail price offered to consumers</li></ul>	<ul style="list-style-type: none"><li>◦ Sale for Resale</li><li>◦ Volume</li><li>◦ Sale to government, institutional or industrial entity for input into productive process</li><li>◦ Sales by the original manufacturer</li></ul>

- (b) (i) Manufacturing -- because manufacturers earn gross receipts (or have taxable purchases) by selling goods, they are usually licensed as a form of merchant, usually wholesale. Reg. § 7.3. When manufacturing and selling at the place of manufacture, the wholesale merchant cannot be subjected to a local license tax. Va. Code § 58.1-3703.1(B)(4). Similarly, sales activities ancillary to

manufacturing are not taxable. Thus, no tax on a manufacturer when:

- (A) All activities occur at place of manufacture. Reg. § 7.3.
- (B) Sale function occurs away from place of manufacture but goods shipped from place of manufacture Id.
- (C) Sales of function at place of manufacture but goods warehoused elsewhere. Id.

As a general rule, manufacturer will not be BPOL taxable on its wholesale sales unless made at a store apart from the place of manufacture.

- (i) Manufacturing is defined as subjecting "new material" to a process that produces a product that is substantially different. County of Chesterfield v. BBC Brown Boveri, 238 Va. 64, 380 S.E.2d 890 (1989). Guidelines, Manufacturing Appendix B. "Manufacturing" is contrasted with "processing" in that a processor merely makes something more valuable or marketable, not substantially different. See Solite Corp. v. County of King George, 220 Va. 661, 261 S.E.2d 535 (1980) (crushing and blending stone to produce different grades of gravel is processing not manufacturing).
- (ii) A manufacturer which sells directly to governments, industrial and commercial businesses is generally selling at wholesale, not retail. A manufacturer, however, which establishes a retail store from which it makes sales may be taxable at either wholesale, retail or both depending upon the facts and circumstances surrounding those sales. Reg. § 7.3, example 1.

#### **E. Situs Rules**

One of the most important aspects of the new law is the establishment, for the first time, of specific rules under which taxable receipts (or purchases) are attributed to particular places of business. See Virginia Code § 58.1-3703.1(A)(3)(a). Thus,

even if the requirements of nexus (*i.e.*, an office) and exercising a taxable privilege are met, taxable receipts (or purchases) must be attributed to that place of business under the situs rules if the business is to be subject to a tax (as opposed to a fee) there. Under the general rule, gross receipts are attributed to the place of business from which the activities that give rise to the receipts are directed or controlled. Reg. § 2.1.3. Specific rules are provided as follows:

1. Services -- "Hindquarters Rule". Services are generally deemed to be performed at the service provider's office. See Reg. § 3.8.5. For example, a lawyer's services are taxable at his office, not at the various courthouses where he may try cases. *Id.*, example 1.
2. Retailer -- "Store Rule". Merchants taxable based on gross receipts (*i.e.*, retailers and wholesalers in at least one jurisdiction) are taxable where sales solicitation activities occur. Reg. § 3.8.2. Sales solicitation is defined as activities relating to the "sale of a particular item to a particular person." Reg. § 1 (definition "Sales solicitation"). As a result, marketing, customer relations and follow-up activities generally are not deemed to be part of "sales solicitation." *Id.*
3. Wholesalers -- "Warehouse Rule". Wholesalers taxable on purchases are generally taxable where goods are delivered to customers or at the shipping point to customers. Reg. § 3.8.3. Thus, a manufacturer may have a sales office in a locality, but it will have no purchases attributable to that sales office unless there is also a warehouse of goods there. *Id.*, example 4.
4. Contractors -- "Job Site Rule". A contractor is generally taxable both at the place where he has his office and where he has a job site if receipts attributable to that job site exceed \$25,000. The locality where the office is located is generally required to reduce its base by receipts taxable under the job site rule. Reg. § 3.8.1.
5. Lessors -- "Rental Office Rule". Lessors of tangible personal property are taxable at the office from which the property is leased to customers. Reg. § 3.8.3. The place where that property is actually used is generally not able to tax. *Id.*, example 2.
6. Real Estate -- "Property Rule". In the few Virginia localities allowed to impose a tax on rental receipts (e.g., Arlington and Fairfax Counties), rental receipts are taxable at the situs of the rental property. Va. Code § 58.1-3700.1; Reg. § 1 (definition of "definite place of business").

7. Other Apportionment Rules. The statutes contain a number of other rules that are used in conjunction with the general situs rules.
  - (a) Multiple Sales Offices. When more than one location contributes to making a sale, receipts must be apportioned based on payroll. Reg. § 3.9. The narrow definition of "sales solicitation" for retailers helps minimize the number of instances where this is necessary. The statute does not specify how apportionment factor is to be derived; i.e., who to include in numerator and denominator of payroll factor.
  - (b) If a business is subject to tax by more than one locality (e.g., a wholesaler based on gross receipts in one locality and in another based on purchases), the localities have the ability to enter into an apportionment agreement. In the absence of such an agreement, the State Tax Commissioner can arbitrate a solution to avoid double taxation. Reg. § 2.1.5.
  - (c) Remember, under the general rule a person is taxable only with respect to receipts attributed to the exercise of the specific privilege at the specific business location. Thus, each business location is taxable only with respect to the receipts generated there. If receipts are attributable to another business location, they are not subject to tax simply because they have not been taxed elsewhere. See Va. Code § 58.1-3703.1(A)(3)(b); Reg. § 2.1.4.

## **F. Exclusions**

Because of the limited privileged tax nature of the new statutes, there are a number of exclusions from the taxing authority of localities. The general statutory rule is that only gross receipts directly attributable to the exercise of a specific licensed privilege at a specific business location, and arising in the ordinary course of business, are subject to tax. Va. Code § 58.1-3732; Reg. § 3.3.3. The statute then lists a number of specific exclusions. The legislative history indicates that these exclusions are illustrative only and are not intended as a finite expression of the scope of the general rule. See Reg. § 3.3.3. Some of the more important exclusions are:

1. Affiliated Receipts. Receipts from members of the same affiliated group generally are not subject to tax. This is based on a specific statutory exclusion. Va. Code § 58.1-3703(C)(10). Generally,

companies entitled to file a consolidated federal income tax return are part of an "affiliated group" for BPOL purposes. See Reg. Appendix B for explanation of "affiliated group."

2. Investment Income. Except for certain financial services business, dividends, interest and other investment income does not arise from sales to other persons. As a result, investment income should be excluded under both the general rule and the specific statutory exclusion. Va. Code § 58.1-3732(A)(8). Note that some interest income (e.g., late fees) is ancillary to a taxable business and taxable. Reg. § 3.5.A (example 5). Nota Bene: some localities have indicated that they will hold that royalties from patents and trademarks are subject to tax on basis that owner is in the business of licensing such assets. This position appears questionable in context of a privilege tax, especially given statutory exclusion for investment income, and begs for use of Delaware investment company to shelter this type of income from BPOL tax.
3. Financing Proceeds. Except for certain financial services businesses, proceeds from borrowing and the issuance of securities do not involve sales of goods or services to third parties and therefore are not taxable under the general rule or the illustrative statute. See Reg. § 1 (definition "gross receipts"). See also Reg. § 3.3.3 (example 4).
4. Principal Repayments. Repayments of principal in loan transactions are specifically excluded from taxation. Va. Code § 58.1-3732(A)(5); Reg. § 3.3.5B.
5. Sale of Capital Asset. Proceeds from the sale of capital assets generally do not arise in the ordinary course of the licensed privilege. Thus, they are excluded under both the general rule and the specific statutory exception. Va. Code § 58.1-3732(A)(5). Reg. § 3.3.3.
6. Factoring. When business sells accounts receivables, it generally is not doing so as part of the taxable privilege which gave rise to the accounts receivable. Thus, proceeds from factoring are not subject to tax under the general rule. They are also specifically excluded. Va. Code § 58.1-3732(A)(2). This is an important example of how the statutory exclusions illustrate the general rule, for the statute refers to "previously taxed receipts". Any amount representing the liquidation of a debt or conversion of another asset to the extent that the amount is attributable to a transaction previously taxed is

excluded by statute (e.g., the factoring of accounts receivable created by sales which have been included in taxable receipts even though the creation of such debt and factoring are a regular part of its business). If the statutory exclusion were read as limiting the general rule, the anomalous situation would arise that receipts attributable to sales and business conducted outside Virginia would become taxable if factored in Virginia.

7. Returns and Allowances. No matter how accounted for, amounts that represent returns of goods sold, reductions in purchase price, or other allowances are excluded from taxable gross receipts. In each case, they are essentially reductions in the cost of goods sold and do not produce any "receipt." Accord Va. Code § 58.1-3732(A)(6). Reg. § 3.3.3. See Reg. § 3.3.5 for how to account for such items.
8. Withdrawals from Inventory. Amounts withdrawn from inventory, though subject to sales and use taxation, do not arise as a result of a sale to third parties. Thus, they are not taxable under the general rule or the illustrative exceptions. Va. Code § 58.1-3732(A)(7). Reg. § 3.3.3.
9. Fiduciary Receipts. One important non-taxable "receipt" not included in the specific statutory exclusions is fiduciary receipts. Amounts received as an agent, trustee or other fiduciary are receipts of the principal (or beneficiary) not of the fiduciary. Reg. § 3.3.3, example 1.

## **G. Deductions**

In addition to the exclusions from the taxing authority of localities are a number of deductions from otherwise taxable receipts. The two most important deductions are:

1. Computer Resales. Amounts attributable to the purchase of computer hardware and software when the purchaser is required to obtain such items by contracts with either federal or state governments and the goods in question are in fact resold to the government within two years. By restricting the deduction to cost of goods sold, no deduction is allowed for any mark-up in sales price or for handling charges. Va. Code § 58.1-3732(B)(1). Reg. § 3.3.4.
2. Interstate Commerce.



(a) Although taxable receipts (or purchases) are limited to activities based in Virginia offices, there is an additional deduction allowed whenever receipts are liable for a tax based on income in any state other than Virginia. Va. Code § 3732(B)(2). To qualify for this deduction, the taxpayer must file a return with the other state and the other state must impose a tax based on income. Reg. § 3.3.4.

1. Merchant sells goods to a North Carolina resident and ships the goods to him in that state. Gross receipts from the sale of the goods are attributable to a definite place of business in Virginia. North Carolina imposes an income tax and Merchant files a North Carolina income tax return. Merchant reports sales delivered to customers in North Carolina in the numerator of its sales factor for North Carolina income tax apportionment purposes. Gross receipts from sales delivered in North Carolina are deductible from Merchant's Virginia BPOL taxable gross receipts (or the cost of the purchases are deductible from the tax base if the merchant is taxable on purposes). Reg. § 3.3.4 (example 1).

(b) The final regulations indicate that the taxpayer must file a return in the other state, but does not have to pay a tax to another state. Reg. § 3.3.4. Thus, for example, sales not subject to tax in another state because of public law 86-272 are arguably deductible from the Virginia tax base -- if a "no tax" return is filed with that state. Note that Department declined to write regulations to allow deduction for P.L. 86-272 sales if no return is filed.

## **H. Rules of Construction**

The provisions of Virginia Code § 58.1-3700 et seq. are the sole source of authority for localities to impose the BPOL tax. Va. Code § 58.1-3702. Any restrictions on, and exclusions from, that authority should be strictly construed against imposition of the tax. E.g., Hampton Nissan v. City of Hampton, 251 Va. 100, 466 S.E.2d 95 (1996) (locality must be able to put finger on statute authorizing the tax); Commonwealth Natural Resources v. Commonwealth, 219 Va. 529, 248 S.E.2d 791 (1978) (includability in "gross receipts"); City of Richmond v. Boshier, 197 Va.182, 89 S.E.2d 36 (1955) (determination of gross receipts directly attributable to business); Estes v. City of Richmond, 193 Va. 181, 68 S.E.2d 109 (1951) (whether taxable privilege exercised). Whenever there is doubt in interpreting the provisions of Virginia Code §§ 58.1-3700.1, -3703,

3703.1 and -3732A, as well as others, that doubt should be resolved against imposition of the tax. See City of Winchester v. American Woodmark Corp., 250 Va. 451, 464 S.E.2d 148, 151 (1995) (property tax case preceding BPOL case of same name in 1996).

### **III. Procedural Reforms**

One of the most important aspects of BPOL reform was an attempt to produce certain uniform, state-wide rules in administering the BPOL tax. Regs., Introduction at p. vii. This has been accomplished not only by the provisions of the "Uniform Ordinance" in Virginia Code § 58.1-3703.14, but also by the involvement of the Virginia Department of Taxation in the administration of this tax.

#### **A. Department of Taxation**

Although this local tax is administered, in the first instance, by the Commissioner of Revenue or local assessing officer, its ultimate interpretation is in the hands of the State Tax Commissioner.

1. Regulations. The State Tax Commissioner has authority to issue "Guidelines" interpreting the BPOL tax. A comprehensive initial set of Guidelines was published effective January 1, 1997.
  - (a) These Guidelines (referred to as "Regs." herein) will have the force of regulations effective January 1, 2001. Va. Code § 58.1-3701.
  - (b) Until that time, it is assumed that they will be accorded significant weight by the Supreme Court of Virginia because they represent the interpretation of state statutes by a state tax official charged with their administration. See, e.g., Golden Skillet Corporation v. Commonwealth, 214 Va. 276, 199 S.E.2d 511 (1973) (state sales and use tax regulations were accorded "great weight" by Supreme Court of Virginia even before that result was mandated by statute).
2. Rulings. The State Tax Commissioner is authorized to issue rulings interpreting the application of the state's BPOL statutes. Reg. § 2.1.7. The State Tax Commissioner, however, will not issue rulings that turn solely on the interpretation of a local ordinance. Reg. § 4.12. Local assessing officers also have the power to issue binding rulings. Reg. § 4.11.

3. Appeals. Taxpayers who are assessed with a local BPOL tax as the result of an audit may appeal that assessment to the State Tax Commissioner who has the authority to reverse the local assessing officer's determination. Va. Code § 58.1-3703.1(A)(5)(c). See below for further discussion.

## **B. Audit Reforms**

One of the business community's greatest complaints about the administration of the BPOL tax was the fact that localities could aggressively assess tax, with interest and penalties, but were not required to refund erroneously assessed tax with interest. Thus, there was an economic incentive for local government to overreach in the assessment of taxes in order to keep taxpayers' money on an interest free basis. For an example of this overreaching practice, compare City of Winchester v. American Woodmark Corp., 250 Va. 451, 464 S.E.2d 148 (1995) (in property tax refund case, no interest allowed on refund, not even from date of judgment for the taxpayer in the trial court) with City of Winchester v. American Woodmark Corp., 252 Va. 98, 471 S.E.2d 495 (1996) (patently unconstitutional BPOL tax assessed). Several procedural changes in the statute are designed to remedy this situation.

1. Interest on Refunds. Interest is now generally allowed on BPOL tax refunds except for limited periods attributable to computational times. Va. Code § 58.1-3703.1(A)(2)(e); Reg. § 3.10.3.
2. Stay of Collections. The local government is not permitted to collect on its assessments during the pendency of any administrative appeal. Va. Code § 58.1-3703.1(A)(5)(b). Taxpayer is required to give both local assessing officer and Virginia State Tax Commissioner "Notice of Intent" of its administrative appeal, thereby providing locality notice that it is required to stop collection efforts. Reg. § 4.4 (definition of "Notice of intent to appeal") and § 4.6.
3. Penalties. Unless there is a history of non-compliance, only one 10% penalty may be imposed when a taxpayer fails to file a return and pay the tax on a timely basis. Va. Code § 58.1-3703.1(A)(2)(d); Reg. § 2.1.1; § 3.10.2. Previously, many localities imposed two 10% penalties, one for each of these failings. Statute contains requirement for waiver of penalties (i) when return is filed in good faith and (ii) when late filing or late payment is due to reasonable cause, generally defined as not the

fault of the taxpayer or due to circumstances beyond the taxpayer's control. Reg. § 2.1.1; § 3.10.2; § 3.10.4.

4. Extensions. Where localities generally did not have authority to grant extensions under prior law, it is now possible to obtain an extension to file the return, Va. Code § 58.1-3703.1(A)(2)(c) and (4) and Reg. § 3.10.2; and to extend the time for assessing the tax, as well as filing any refund claim. Va. Code § 58.1-3903. It is unclear if a taxpayer who, in connection with filing an amended return, obtains an extension from the local assessing officer of the time to assess any omitted tax, also extends the statute of limitations for filing his suit in court if that refund on amended return is not granted. Compare Va. Code § 58.1-3903 (time to assess tax (no reference to omitted tax) may be extended) with Va. Code § 58.1-3984 (time for filing court suit often no longer than one year from date of original assessment or from date of final administrative ruling in appeal from audit assessment). Special care should be taken as to statute of limitations when amended return is used to pursue BPOL tax issue. See discussion below of "audit assessment" for purposes of appeal to State Tax Commissioner.

### C. Administrative Appeals

A special appeal procedure has been established with respect to BPOL taxes and audits only. Taxpayers retain their right to file an administrative refund request under Virginia Code § 58.1-3980. In addition, any taxpayer aggrieved by an *audit assessment* of BPOL taxes may proceed administratively under Virginia Code § 58.1-3703.1(A)(5). This special procedure permits appeal of the local assessing officer's determination to the State Tax Commissioner.

1. Audit Assessments. This procedure is limited to assessments of tax resulting from an *audit*. Reg. § 4.1. This term is defined generally as any examination of the taxpayer's books and records by the local assessing official. Reg. § 4.4 (definition of "audit"). As a result, a refusal of a local assessing officer to make a refund based on an amended return is probably not appealable because there is no assessment based on an audit. On the other hand, if the amended return results in an examination of the taxpayer's books and records and the assessing officer makes some adjustment resulting in an increase of tax, all issues arising in that audit may be appealed. Id. It is unclear how narrowly local assessing officers will interpret this provision. Some localities, jealous of their administrative jurisdiction, have promised to read this authority

narrowly. Other jurisdictions, recognizing the importance of an effective administrative appeal procedure, have indicated their willingness to have the State Tax Commissioner review virtually any determination based on a careful review of the taxpayer's books and records.

2. Exhaustion of Remedies. Because this procedure results in an appeal to the State Tax Commissioner, the taxpayer must present to the local assessing officer all factual and legal arguments he intends to make. Any such arguments raised for the first time on appeal to the State Tax Commissioner may be returned to the local assessing officer for his determination. Reg. § 4.8.5.
3. Forms. The form of an administrative appeal, both to the local assessing officer and to the State Tax Commissioner, is informal. It may be made in the form of a letter that sets forth all the relevant facts, circumstances and arguments favoring the taxpayer's position. The taxpayer is also required to attach a copy of the assessment appealed from and, on appeal to the State Tax Commissioner, copies of all materials reviewed by the local assessing officer and the local assessing officer's determination. The specific procedure is detailed in Reg. § 4.8.
4. Time Limits. A taxpayer generally has 90 days from the date of the assessment in which to make his appeal to the local assessing officer, Reg. § 4.7.1, and 90 days after that person's final determination is issued in which to take his appeal to the State Tax Commissioner. Va. Code § 58.1-3703.1(A)(5)(a) and (c); Reg. § 4.8.1.
5. Counsel. Although the administrative procedures are designed to be "user friendly" and not require a taxpayer to be represented by an accountant or lawyer, the exhaustion of remedies requirement noted above strongly suggests that, in cases involving substantial amounts of tax, the initial appeal to the local assessing officer be handled very carefully.
6. Court Appeal.
  - (a) Virginia Code § 58.1-3984 permits a taxpayer aggrieved by any assessment to appeal to the Circuit Court within (i) three years from the last year for which the tax is assessed, (ii) one year of the date of assessment, or (iii) one year from final ruling under Virginia Code § 58.1-3703.1 (whichever is later). The effective

date of the 1997 amendment establishing the one year from date of administrative appeal rule may be unclear. It could be argued to apply only to "audit assessments" made on and after July 1, 1997, as well as to suits filed on or after that date. Be careful as to statute of limitations when proceeding by amended return, which may or may not produce an "audit assessment," or when "audit assessment" was made between January 1 and July 1, 1997.

(b) Locality. The locality which "loses" any administrative appeal may also apply to the circuit court for relief. Reg. § 4.10.

EXHIBIT A

*BPOL -- In Seven Easy Steps*

I. Place of Business



II. Exclusions

Manufacturers -- at factory  
Public Service Corps.  
Farmers  
Newspapers, radio, tv  
Banks  
Insurance companies and agents  
Employees  
Non-profits, except on UTBI  
Venture Capital Funds  
Local ordinance exclusions



III. Taxable Entity

Line of Business (1) Line of Business (2) Line of Business (3)

- RULE 1: Each independent LOB is separately licensed.  
RULE 2: Ancillary activities to LOB taxed with that LOB; e.g., warranty work with selling.  
RULE 3: License based on gross receipts not required if receipts less than \$100,000 (locality over 50,000 population) pay \$100 fee



<u>IV. Classification</u>	<u>Maximum Rate</u>
Professional, real estate & financial services	.0058 gross receipts
Repair, personal & business services	.0036 gross receipts
Retailer	.0020 gross receipts
Building Contractor	.0016 gross receipts
Wholesaler	.0005 purchases

(See local ordinance for actual rate)

- V. Situs Rules**
1. Local Receipts -- only from local office's activity.
  2. Services -- "Hindquarters Rule" -- the office where the worker sits; or his "control center" if no office.
  3. Retailer -- "Solicitation Rule" -- where "sales solicitation occurs:
    - a) Solicitation is sale of particular product to particular person
    - b) Can apportion based on payroll if multiple solicitation situses
  4. Wholesaler -- "Warehouse Rule" -- purchase taxable at place of business where (or from which) goods delivered to customer
  5. Contractor -- "Job Site Rule" -- at site where contract performed (over \$25,000)
  6. Lessor -- "Rental Office Rule" -- at place of business where personal property delivered to lessee.



VI. Exclusions from Taxing Authority

1. Investment income.
2. Receipts from affiliated corporation (80% rule).
3. Loan proceeds and principal repayments.
4. Previously taxed receipts (e.g., factoring).

VII. Deductions

1. Interstate Commerce -- receipts on which person is "liable" for tax based on income. E.g., sales included in another state's sales factor numerator.
2. Computer Resales to Government -- hardware or software purchased for sale to government and delivered within two years of purchase.