2006

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Repository Citation
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HOT TOPICS IN VIRGINIA TAXATION

The Present and the Future?

A discussion of 2006 tax legislation, recent court decisions, tax department rulings, and opinions of the Attorney General from January 1, 2006 through October 20, 2006

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Date of Outline: October 23, 2006
RECENT AND FUTURE DEVELOPMENTS IN VIRGINIA TAXATION

A discussion of 2006 tax legislation, recent court decisions, tax department rulings, opinions of the Virginia Attorney General (from January 1, 2006 through October 20, 2006), plus commentary on the movement to improve Virginia's tax dispute resolution system.

NEWS: Virginia Tax Commissioner Kenneth W. Thorson announced his retirement effective May 1, 2006. Governor Tim Kaine appointed Janie E. Bowen, former Deputy Secretary of Finance, to succeed Mr. Thorson. Ms. Bowen is the fifth Tax Commissioner in the 79-year history of the Department of Taxation, and its first woman Commissioner. Prior to her appointment as Deputy Secretary of Finance, Ms. Bowen worked at the Department of Taxation for 28 years. Throughout her 28 years at the Department of Taxation, Ms. Bowen held a number of positions including Executive Tax Commissioner for Policy and Administration and Assistant Tax Commissioner for the former Office of Tax Policy.

I. CORPORATE INCOME TAX

A. 2006 Legislation

1. Land Preservation Credit. The Virginia General Assembly adopted a substitute version of two identical bills, House Bill 5019 (2006 Special Session I Chapter 4) and Senate Bill 5019 (2006 Special Session I Chapter 5), submitted by Governor Tim Kaine that makes substantial changes to the Land Preservation Tax Credit program effective on January 1, 2007.

   Chief among the many changes is a new annual aggregate limitation of $100 million in credits that may be granted each year along with a lowering of the credit percentage to 40% of the fair market value of the qualified donation from 50%. The $100 million cap will be applied on a first come-first served basis instead of pro-rating the available credit among those that apply.

   In conjunction with the $100 million cap, a new application process will take effect on January 1, 2007, for taxpayers wishing to earn a credit. Any taxpayer that has made a qualified donation must apply to the Virginia Department of Taxation to receive credit. For credits in the amount of $1 million or more, the taxpayer's application must also be filed with the Virginia Department of Conservation and Recreation. The Department of Conservation and Recreation is then required to verify the value of the donation before the credit may be granted.

   In another change to the credit, charitable organizations that may hold conservation easements and that actually hold at least one such easement are not allowed to earn a Land Preservation Tax Credit. Prior to this bill, there were no statutory limitations in place that limited a nonprofit organization's ability to earn credits.
Finally, among the other changes made to the Land Preservation Tax Credit, a fee of 2% of the value of the credit or $10,000, whichever is less, will be applied to each transfer of the credit. No fee is currently imposed on the transfer of Land Preservation Tax Credits. The carryover period for any unused credits is extended from five years to ten years by this legislation. Also, a new five year limitation is placed on property that may be eligible for a Land Preservation Tax Credit as well as a Historic Rehabilitation Tax Credit. Taxpayers earning a Land Preservation Tax Credit will have to wait five years before earning a Historic Rehabilitation Tax Credit for a building that is present on land that is the basis for a Land Preservation Tax Credit. The converse is also allowable in that the taxpayer may choose to earn the Historic Rehabilitation Tax Credit and wait five years to earn a Land Preservation Tax Credit.

2. **Fixed Date Conformity.** HB 531 (Chapter 63) and SB 69 (Chapter 162) amend Virginia Code § 58.1-301(B) to conform the State Tax Code with the federal Internal Revenue Code as it existed on December 31, 2005, for individual and corporate income tax purposes. Virginia continues, however, to disallow the federal bonus depreciation deduction and the five year net operating loss carryback period for state tax purposes. The new conforming date enables the state to adopt (1) the Energy Tax Incentives Act of 2005 which modifies the depreciation rules for certain properties, and provides a temporary 50% expensing for certain equipment; (2) the Katrina Emergency Tax Relief Act of 2005 which provides a temporary suspension of limitations for qualified corporate and individual charitable contributions and allows enhanced deductions for contributions of food and books; and (3) the Gulf Opportunity Zone Act of 2005 which temporarily waives limits regarding charitable cash contributions for Rita and Wilma relief and extends the provision allowing combat pay to count as income for purposes of calculating the earned income tax credit. This legislation contained an emergency clause and was effective upon the Governor’s approval on March 7, 2006.

3. **Coal Tax Credits.** HB 1043 (Chapter 788) and SB 365 (Chapter 803) allow the Virginia Coal Employment and Production Incentive credit to be allocated between the electricity generator and such person with an economic interest in coal. This allows the benefit of the credit to be shifted from an electricity generator that is subject to the minimum tax on certain electric suppliers to the person with an economic interest in the coal. The allocation of the credit may be provided in the contract between the parties for the sale of the coal. The parties may amend any such allocation with a written instrument prior to December 31 of the year that the coal is purchased.

Virginia Coal Employment and Production Incentive credits earned on or after January 1, 2006, which are allocated to persons with an economic interest in coal may be used against any tax imposed by the Commonwealth. If the credits earned on or after January 1, 2006, and prior to July 1, 2011, exceed the tax liability of such person, the excess may be redeemed in a manner similar to the Coalfield Employment Enhancement Tax Credit.

The carryover period for the Virginia Coal Employment and Production Incentive credit is increased from five years to ten years. This change is effective for coal purchased and consumed on or after January 1, 2001.
These bills also extend the sunset date of when the Coalfield Employment Enhancement Tax Credit can be earned and claimed to the 2014 and 2017 years, respectively.

4. **Clean Fuel Job Creation Credit.** SB 690 (Chapter 238) amends the clean fuel job creation income tax credit by adding the manufacture of components designed to produce, store, and dispense hydrogen as a vehicle fuel, and extends the sunset provisions applicable to this tax credit from December 31, 2006, to December 31, 2011.

B. **Recent Court Decisions**

No recent court decisions.

C. **Recent Virginia Tax Commissioner Rulings**

1. **S Corporation Nexus & Individual Residency.** P.D. 06-4 (January 6, 2006). The Tax Commissioner held that an S Corporation had nexus with Virginia and was not protected under P.L. 86-272 as the corporation provided financial and consulting services in Virginia. These services were found to exceed solicitation and could not be considered de minimis. As a result, the S Corporation was required to file returns for the years in question and apportion its income between Virginia and its home state. In addition, nonresident shareholders of the S corporation were required to file nonresident income tax returns reporting their share of the S Corporation income. Finally, the individual taxpayer/shareholder of the corporation was an actual resident of Virginia during 2003 as he spent 250 days in Virginia. Note: Virginia is the only state that extends the protections of P.L. 86-272 to services.

2. **Alternate Method of Apportionment.** P.D. 06-13 (February 7, 2006). The Tax Commissioner denied the taxpayer’s request for alternative method of apportionment as the taxpayer did not follow the procedure for making such a request as provided in 23 VAC 10-120-280. The taxpayer also did not demonstrate that Virginia’s method of allocation produces an unconstitutional result or is inequitable. The taxpayer’s sole claim was that the property factor resulted in an excess tax liability. However, the Tax Commissioner noted that the taxpayer’s state of domicile uses the same apportionment method as Virginia. Therefore, any increase in the property factor in Virginia would be matched by a decrease in the other state.

3. **Foreign Source Income Subtraction.** P.D. 06-19 (February 7, 2006). The Tax Commissioner overruled an auditor’s adjustment to disallow a foreign source income subtraction. The taxpayer provided the Tax Commissioner with documentation that showed the income in question were technical fees incidental to licensing contracts for services, which are covered in the definition of foreign source income under Virginia Code § 58.1-302.

4. **Deductibility of Intercompany Management Fees.** P.D. 06-27 (March 20, 2006). The taxpayer appealed the denial of a refund claim made by filing amended returns on which the taxpayer added a deduction of management fees paid to a related corporation. The fees were determined by the actual cost incurred by the related corporation plus a 7.5% markup. Based on the authority of Virginia Code § 58.1-446, the Tax Commissioner allowed a refund based on the actual cost of the services provided by the related corporation. However, the Tax
Commissioner did not allow any refund attributable to the 7.5% markup of the fees as the taxpayer did not provide any evidence that this markup fee was based on fair market value.

5. **Nexus Based on Related Company Activities.** P.D. 06-32 (March 22, 2006). The taxpayer requesting the ruling in this case are three related corporations only one of which is subject to the Virginia income tax. The taxpayer requested a ruling on whether the taxpayer would have nexus with Virginia based on a distribution center operated by a related single member LLC. The LLC would purchase products from the taxpayer on arms' length terms and sell the products to third parties. The Tax Commissioner ruled that the facts above would not be sufficient to acquire nexus with the taxpayer as the taxpayer would not have title to any of the property (inventory) in Virginia. Additionally, the taxpayer requested an alternate form of apportionment for its sales factor. The taxpayer requested that the sales made to the LLC should be excluded from the numerator of its sales factor as the sales were not made to the ultimate consumer. The Tax Commissioner denied this request as subsequent sales have no bearing on the determination of the sales factor.

6. **Intangible Holding Company & Foreign Source Income Subtraction.** P.D. 06-33 (March 22, 2006). The Tax Commissioner upheld an assessment based on a disallowance of interest expense on intercompany loans. The taxpayer incurred interest expense on a loan from a wholly owned subsidiary formed as a related intangible holding company. The holding company loaned funds to related companies in exchange for demand notes, most of which had an interest rate tied to the prime rate. The interest payments on the notes are due either monthly, quarterly, or on demand. There is also no collateral on the loans and no penalty for the failure to pay. In addition, the holding company had one part time employee and minimal rent expense. The Tax Commissioner held that the holding company lacked substance.

The assessment was also based on the disallowance of a foreign source income subtraction based on technical fees. Based on contracts provided to the Tax Commissioner, the technical fees were royalty payments for the use of the taxpayer's intangible property. This portion of the assessment was abated.

7. **Statute of Limitations for Federal Adjustment.** P.D. 06-37 (April 5, 2006). The Tax Commissioner denied an appeal from a taxpayer who filed a claim for a refund after the expiration of the statute of limitations. The claim was based on a change in the taxpayer's return due to a federal audit that required the filing of over 400 returns. Despite this volume, the Tax Commissioner would not grant the request.

8. **Nexus Through Rental Equipment Located in Virginia.** P.D. 06-38 (April 5, 2006). The taxpayer was assessed with corporate income tax based on the presence of rental equipment owned by the taxpayer in the Commonwealth. The taxpayer was renting the equipment directly to customers in Virginia. The Tax Commissioner denied the appeal as this activity exceeded the protection provided by P.L. 86-272. In addition, upon examining the various contracts, the Tax Commissioner found that the transactions were indeed rentals instead of installment sales as argued by the taxpayer.
9. **Consolidation of Corporations Due to Lack of Economic Substance.** P.D. 06-52 (April 28, 2006). The taxpayer appealed an assessment of corporate income taxes where three related out-of-state corporations were consolidated with the parent due to lack of economic substance. The three holding companies lacked economic substance as each had minimal operating expenses, the taxpayer monitors the trademarks, not the holding company, intercompany loans were not at arms’ length, and the taxpayer never lost control of the trademarks.

10. **Alternate Method of Apportionment.** P.D. 06-66 (August 16, 2006). The taxpayer requested an alternate method of apportionment. The taxpayer is a Virginia corporation that provides information technology services. As the majority of the cost of the services provided by the taxpayer is incurred in Virginia, all of its sales are sourced to Virginia for purposes of the sales factor under the cost of performance standard under Virginia Code § 58.1-416. The taxpayer argues that this leads to double taxation. The Tax Commissioner denied the taxpayer’s request saying that the circumstances in the taxpayer’s case did not rise to the “extraordinary” level which would warrant an alternate method and because Virginia’s method of apportionment is reasonable even though other states may proscribe a different method of apportionment.


*Intangible Holding Company*

The taxpayer appealed the denial of a deduction for royalty expenses paid to a wholly owned subsidiary for the use of intangible property. The Tax Commissioner found no evidence the any cash transactions were made between the taxpayer and the holding company and that any fees deducted were mere paper entries. Further, the appraisal of the rates charged by the holding company was completed several years after the transactions in dispute and a copy of the appraisal was not provided to the Department. The taxpayer also continued to contribute to the value of the intangible property without consideration through its “activities including advertising, investment, business practice and expertise, manufacturing processes, quality merchandise, and dependable service to the consuming public.” Based upon these factors, the Tax Commissioner found that this was an arrangement between related companies designed to improperly reflect Virginia income.

*Misallocated Partnership Income*

The taxpayer formed a partnership with an unrelated third party and designated a separately filing subsidiary to hold the partnership interest. Upon the sale of the partnership, the taxpayer, not the subsidiary, reported the income on its Virginia income tax return and subsequently deducted the income as nonbusiness income. The auditor disallowed the nonbusiness deduction. The Tax Commissioner concluded that the income should not have been included on the taxpayer’s return in the first place as the subsidiary held the partnership interest
and filed separately from the taxpayer. The taxpayer's sales factor was also adjusted to account for this change.

**Foreign Source Income**

The taxpayer deducted certain expenses as nonbusiness deductions which the auditor subsequently disallowed. The taxpayer asserted that these deductions should be classified as foreign source income subtractions instead and provided necessary documentation showing that the deductions were determined in accordance with IRC §§ 861, 862, and 863 as is required for the foreign source income subtraction. Based upon this information, the Tax Commissioner allowed the deductions.

**Net Operating Loss deduction**

Finally, the taxpayer claimed that it should be allowed a net operating loss deduction for 1995 for the changes made pursuant to this appeal. The Tax Commissioner reviewed the allowed changes and determined that the taxpayer has positive income for 1995 after the allowed adjustments. Therefore, a net operating loss was not permitted by the Tax Commissioner.

12. **Nexus, Net Operating Loss Deduction, & Payroll Factor.** P.D. 06-75 (August 23, 2006). The taxpayer originally included a Virginia corporation in a consolidated return, but subsequently filed amended returns removing the corporation. The auditor disallowed this adjustment as the corporation had Virginia source income, the president of the corporation resided in Virginia, and the corporation had sales in Virginia. The Tax Commissioner overruled the auditor and allowed the corporation to be removed from the consolidated return. Despite being a Virginia corporation and required to file an income tax return, the corporation had no property or payroll in Virginia. The sales reported in Virginia were erroneous and actually reflected goodwill from a stock sale. The taxpayer provided documentation supporting this assertion. Finally, the wages earned by the president were paid by a related corporation, not the one in question in this ruling.

The auditor also disallowed a carryforward of net operating loss deductions generated by two subsidiaries. The Tax Commissioner examined the NOLs and determined that they were allowable under federal law and thus allowable for Virginia purposes.

Finally, the auditor adjusted the taxpayer's payroll factor to match the payroll as reported by the Virginia Employment Commission. The taxpayer argued that the VEC numbers overstate the taxpayer's payroll. The Tax Commissioner determined that the overstatement is due to the taxpayer serving as a common paymaster for a number of subsidiaries. Based upon this determination, the Tax Commissioner ruled that the taxpayer will need to demonstrate that either the amounts reported to the VEC were incorrect or that the compensation is otherwise included in the consolidated payroll factor.
13. **Inclusion of Corporations in Consolidated Return.** P.D. 06-76 (August 23, 2006). The auditor removed four corporations from the taxpayer's consolidated return as he found that each lacked nexus. The taxpayer appealed and the Tax Commissioner upheld the removal of two of the corporations. The Tax Commissioner found that the first corporation had no property or payroll in Virginia. This corporation did not report any wages to the Virginia Employment Commission. The CFO who lived and worked in Virginia received wages from the taxpayer, not the first corporation. The taxpayer provided amended returns filed with the VEC indicating that the CFO's wages were paid by the corporation, not the taxpayer, but offered no evidence that the returns were accepted by the VEC. The corporation reported a positive sales factor, but the Tax Commissioner determined this report to be in error as the factor was based on interest earned. As the corporation was based outside of Virginia and had no operations in Virginia, the cost of performance in earning this interest would be sourced outside of Virginia. Therefore, without a positive apportionment factor, this corporation was removed from the consolidated return.

The second corporation holds investments in foreign subsidiaries. While it does not have a positive apportionment factor, the corporation's commercial domicile is Virginia as its affairs are conducted by employees of the taxpayer. As corporations with a Virginia commercial domicile are subject to the income tax, this corporation was permitted to remain in the consolidated return.

The third corporation did not report a positive apportionment factor, but had substantial property, payroll, and sales outside of Virginia. The taxpayer charged this corporation a management fee for certain services provided, but the Tax Commissioner ruled that this was not sufficient to establish nexus with Virginia. Therefore, without a positive apportionment factor, this corporation was removed from the consolidated return.

Finally, the taxpayer argued that the fourth corporation should be considered a financial corporation as 100% of its income was interest income. Further, all of its activities were conducted by employees of the taxpayer. The Tax Commissioner agreed that this corporation is a financial corporation and has nexus with Virginia. Therefore, it was permitted to remain included in the consolidated return.

14. **Sales Factor: Location of Sales.** P.D. 06-86 (August 30, 2006). The taxpayer requested a ruling as to whether sales of food it manufactures in Virginia should be included in the numerator of the sales factor. The taxpayer sells its products to wholesalers who transport the food to hubs both inside and outside Virginia. The food is loaded onto the wholesalers' trucks at loading docks the wholesaler rents from the taxpayer. Prior to being loaded on the trucks, all of the food has a known destination. The taxpayer maintains that because of the known destination, the food destined for places outside of Virginia should not be included in the numerator of the sales factor. The Tax Commissioner disagreed. Because the wholesaler rents the loading docks from the taxpayer, the Tax Commissioner determined that all of the food is a Virginia sale as it is delivered to the wholesaler in Virginia.
15. **Inclusion of Intercompany Receipts in Apportionment Factor.** P.D. 06-88 (September 19, 2006). The taxpayer appealed an assessment of income taxes made after the auditor removed intercompany rent expense from the denominator of the property factor and intercompany receipts from the sales factor. The Tax Commissioner upheld the assessment with little analysis other than citing 23 VAC 10-120-322 which requires the elimination of intercompany items in determining Virginia taxable income.

16. **Improper Reflection of Income.** P.D. 06-107 (October 5, 2006). The Tax Commissioner abated an assessment of income taxes for 1993. The auditor combined the income of related corporations citing an improper reflection of income. The Tax Commissioner found that the affiliates had no connections to Virginia aside from minimal fees charged by the taxpayer for administrative services. Such fees were not sufficient to create an improper reflection of income.

17. **Combined Return and Limited Partnership Interest.** P.D. 06-111 (October 10, 2006). In 2001, the taxpayer acquired a subsidiary. The subsidiary held no real or tangible property or payroll. All of the subsidiary's functions were performed by the taxpayer's employees in Virginia. The taxpayer did not include the subsidiary in its 2001 and 2002 original combined returns, but included it in its 2003 return when it showed a loss. The taxpayer amended its 2001 and 2002 returns to include the subsidiary. The auditor disallowed the addition of the subsidiary to the 2003 return. The Tax Commissioner disagreed and found that the subsidiary's commercial domicile was Virginia and should be included in all three returns. In addition, the Tax Commissioner found that only one of the limited partnership interests held by the subsidiary should be included in the return as it exceeded a 10% ownership.

18. **Nexus of Out-of-State Collection Agency.** P.D. 06-114 (October 11, 2006). The taxpayer requested a ruling as to whether it had nexus with Virginia. The taxpayer is an out-of-state collection agency with no property or payroll in Virginia. The taxpayer has Virginia clients and will hire a Virginia attorney or hire a Virginia collection agency if it has an uncollectible receivable. The Tax Commissioner ruled that the taxpayer will not have nexus so long as the attorneys or collection agencies are independent contractors. Further, if the taxpayer does have nexus, it is unlikely that it would have any Virginia source income as the cost of its performance in conducting its services would be sourced outside of Virginia.

**D. Opinions of the Attorney General**

No recent opinions of the Attorney General have been released.

**II. INDIVIDUAL INCOME TAX**

**A. 2006 Legislation**

1. **Amending Returns Pursuant to a Change in Another State.** SB 583 (Chapter 234) allows taxpayers one year from the final determination of a change made by any other state to file an amended return to request a refund resulting from credits for taxes paid to other states. In keeping with the practice of coordinating a taxpayers right to claim a refund with the Department's right to assess additional tax, taxpayers are required to file amended returns in
order to report a reduction to the credit for taxes paid to other states resulting from changes made by any other state. The Department will be allowed to make assessments at any time if the taxpayer fails to file the required returns. This legislation is effective on July 1, 2006.

2. **Long-Term Insurance Credit.** HB 786 (Chapter 599) and SB 287 (Chapter 570) create an individual income tax credit for certain long-term care insurance premiums. The credit will be granted to an individual taxpayer who enters into such an insurance policy on or after January 1, 2006. The amount of the credit would be fifteen percent of the amount paid by an individual during the taxable year for premiums for long-term care coverage for himself. The total credits over the life of any policy, however, would not be allowed to exceed fifteen percent of the amount of premiums paid for the first twelve months of coverage. Unused amounts of the credit could be carried over for the next five taxable years. Individuals who claim this credit would not also be allowed to utilize the long-term care insurance deduction that is currently available. Individuals claiming the deduction for long-term health care insurance premiums on their federal income tax return will not also be allowed to take this proposed credit for the same insurance premiums. This legislation is effective for taxable years beginning on or after January 1, 2006.

3. **Agricultural Best Management Practices Credit.** HB 963 (Chapter 440) expands those individuals qualifying for the credit to include any individual who has equines that create needs for agricultural best management practices to reduce non-point source pollutants and has in place a soil conservation plan approved by the local Soil and Water Conservation District. This legislation is effective for taxable years beginning on or after January 1, 2007.

4. **Death Benefits Subtraction.** HB 1535 (Chapter 617) creates a subtraction for death benefit payments received from an annuity contract to the extent that any portion of the payments is treated as taxable income on the investment in the annuity contract and subject to federal income taxation. This would effectively exempt all annuity payments received by beneficiaries from Virginia income tax. This subtraction is effective for taxable years beginning on or after January 1, 2007.

5. **Tobacco Quota Holder Subtraction.** SB 70 (Chapter 214) creates an individual and corporate income tax deduction for contract payments to producers of quota tobacco and tobacco quota holders pursuant to the American Jobs Creation Act of 2004. The deduction can be claimed in the year following the year in which a payment is received, or in which an assigned payment would have been received. If producers and quota holders assign future payments in exchange for a lump sum payment, regardless of when the lump sum payment is received, they receive the deduction over the ten-year period of the program. This legislation is effective for taxable years beginning on or after January 1, 2006.

6. **Penalty for False Claims of Employment Status.** HB 168 (Chapter 393) makes it unlawful for a person to knowingly coerce or threaten an individual to falsely declare his employment status for the purpose of evading the withholding or payment of taxes. This bill also makes it unlawful to knowingly and falsely claim an individual employment status in order to evade the withholding or payment of taxes. A violation would be a Class 1 misdemeanor. This legislation is effective on July 1, 2006.
7. **Deduction for Sales Tax Paid on Purchase of Energy Efficient Items.** SB 262 (Chapter 939) creates a deduction equal to 20 percent of the sales tax paid on certain energy efficient items. The deduction is limited to $500 per taxable year and is only available for items purchased for personal use by the purchaser. Among the various items that are eligible for this deduction when purchased are clothes washers, room air conditioners, dishwashers, and standard size refrigerators, electric heat pumps, central air conditioners, advanced gas or oil water heaters, oil-fired boilers, oil-fired furnaces, and programmable thermostats. Each item must meet certain efficiency standards as set out in the Code of Virginia. This deduction would be effective for taxable years beginning on and after January 1, 2007.

**B. Recent Court Decisions**

No recent court decisions.

**C. Recent Virginia Tax Commissioner Rulings**

1. **Credit for Taxes Paid to Other States.** P.D. 06-15 (February 6, 2006). The Tax Commissioner denied the taxpayer's appeal of an assessment for the credit for taxes paid to other states based on the DC corporate franchise tax. The assessment was upheld based on a previous Virginia Supreme Court decision in which it was held that the DC corporate franchise tax is a tax on the privilege of doing business, not a tax on income.

2. **Credit for Taxes Paid to Other States.** P.D. 06-17 (February 6, 2006). The Tax Commissioner denied the taxpayer's appeal of an assessment for the credit for taxes paid to other states based on the DC corporate franchise tax. The assessment was upheld based on a previous Virginia Supreme Court decision in which it was held that the DC corporate franchise tax is a tax on the privilege of doing business, not a tax on income.

3. **Change of Domicile & Nonresident Shareholder.** P.D. 06-28 (March 20, 2006). The taxpayers appealed an assessment based on their contention that they had acquired a new domicile and abandoned their Virginia domicile for the period in which taxes were assessed. In 2000, the taxpayers acquired an apartment in another country. The husband obtained a foreign driver's license in 2001, and the taxpayers relinquished their Virginia driver's licenses in 2002. The taxpayer's Virginia business was sold in late 2001, and the taxpayers' Virginia home was sold in January 2002. The taxpayers established residency in the foreign country during 2001 and were assigned primary physicians under that country's nationalized healthcare system. The taxpayers maintained motor vehicles in both Virginia and Country A. The taxpayers also owned a sailboat located at a marina in another state in which the taxpayers also used an address for filing federal and state income tax returns. Based on the facts and circumstances, the Tax Commissioner agreed that the taxpayers had abandoned their domicile in 2002.

The taxpayer also held a 20% ownership stake in an LLC operating in Virginia that had elected to be taxed as a partnership. The LLC was involved in patent infringement litigation and received a substantial settlement in 2002. The taxpayers contended that as nonresidents, Virginia should not tax their portion of the settlement. However, the Tax Commissioner ruled that the proceeds of the lawsuit were functionally related to the business and therefore characterized as
ordinary income. Therefore, these proceeds were characterized as Virginia source income and subject to Virginia income taxation.

4. **Land Preservation Credit.** P.D. 06-36 (April 3, 2006). The taxpayer requested a ruling as to whether a bargain sale of a fee simple interest in property to the Department of Conservation and Recreation ("DCR") would qualify for a land preservation credit. The Tax Commissioner ruled that if the bargain sale qualified for a federal charitable contribution, then it would qualify for a land preservation credit as well. In addition, the Tax Commissioner ruled that the conveyance of the land must be for conservation purposes in perpetuity. The deed conveying the land in this instance did not contain a provision providing that the land would be held for conservation purposes in perpetuity despite the fact that a state park would be established on the land. However, based on the fact that one of the purposes of DCR is to conserve land and that DCR cannot convey land without approval from the General Assembly and the Governor, the Tax Commissioner ruled that the intent of the credit is satisfied by this conveyance and that this transfer would qualify to generate credits.

5. **Domicile – Military.** P.D. 06-40 (April 6, 2006). The taxpayer was a resident of another state but was stationed in Virginia pursuant to active duty military orders. The taxpayer did not abandon his domicile in the other state. While in Virginia, the taxpayer started a business and purchased land in Virginia for hunting purposes. In each year the taxpayer earned Virginia source income from his business, he filed nonresident returns with Virginia and paid income tax on the income. He requested a ruling on whether he had established domicile during those years that may subject him to future tax liability. The Tax Commissioner ruled that the taxpayer did not acquire a domicile in Virginia based on protection afforded to military personnel by federal law. In addition, the Tax Commissioner ruled that the taxpayer had properly reported all of his past Virginia source income.

6. **Set-Off Collection.** P.D. 06-42 (April 10, 2006). The taxpayer filed an individual income tax return showing an overpayment of taxes. A portion of the refund was claimed by a locality pursuant to the set-off collection act. The taxpayer later filed an amended return for this same year that showed the overpayment of taxes was in error. The Department issued an assessment to the taxpayer for the amount of the overpayment in error. The taxpayer argued that he should not be liable for the portion of the overpayment sent to the locality. The Tax Commissioner denied this argument as the Virginia Administrative Code states that a refund claimed by a claimant agency (the locality in this case) is deemed a refund paid to the taxpayer. Further the taxpayer claimed he was denied due process in this claim. The Tax Commissioner rejected this claim citing the numerous methods of appeal that were, and maybe still are, within taxpayer’s right to exercise.

7. **Nonresident Beneficiary of a Virginia Estate.** P.D. 06-43 (April 11, 2006). The Tax Commissioner abated an assessment against the beneficiary of a Virginia estate. The estate was a Virginia estate solely because the fiduciary was a Virginia resident. None of the assets in the estate or any beneficiary was located in or a resident of Virginia, respectively. Nonresident are only taxed on their income based on the ratio of their Virginia source income to all of their income. Therefore, as none of the income distributed by the estate was Virginia source income, the taxpayer did not owe income taxes to Virginia.
8. **Virginia Prepaid Tuition Contract.** P.D. 06-44 (April 11, 2006). The Tax Commissioner made the following rulings concerning Virginia Prepaid Tuition Contracts: (1) the grantor of a grantor's trust is entitled to take the Virginia individual income tax deduction for the amounts paid by the trust for a tuition contract or contributed to an education savings trust account; (2) if a plan is transferred, the transferee of a plan may use the full amount of deductions for the transferor's payments or contributions when the transferor was not able to use the deductions; and (3) once a purchaser of a plan reaches the age of 70, he may deduct all payments that were not deducted in a prior year due to being previously limited to $2,000.

9. **Credit for Taxes Paid to Other States.** P.D. 06-45 (April 11, 2006). The taxpayer was assessed income taxes based on his computation of the credit for taxes paid to other states. The taxpayer argued that he should be able to take a credit for the full amount of taxes paid to another state. Further, the taxpayer proposed an allocation method that deviates from the Code of Virginia and corresponding regulations. The Tax Commissioner disagreed and cited the limitations imposed by the Code of Virginia on the computation of the credit.

10. **Domicile – Failure To Abandon.** P.D. 06-54 (May 31, 2006). The Tax Commissioner ruled that the taxpayer had failed to abandon his Virginia domicile and upheld the assessment of individual income taxes. The taxpayer and his spouse purchased a house in another state in 2000 and also obtained driver's licenses, registered automobiles, and registered to vote in that state. However, the taxpayer retained the Virginia home and purchased two other homes in Virginia. The taxpayer also continued to receive financial documents at his Virginia address and did not spend enough time in any state outside of Virginia to be considered an actual resident in any other state. Based upon these facts, the Tax Commissioner ruled that the taxpayer did not carry the burden of abandoning his Virginia domicile.

11. **Joint Filing Status: Divorce Decrees.** P.D. 06-58 (June 19, 2006). The taxpayer requested a ruling on how separate maintenance decrees in a divorce affect individual income tax filing status in Virginia. The Tax Commissioner noted that Virginia conforms to federal law with regard to filing statuses. In order for a divorcing couple to each file as a single individual, they must have a court decree legally separating the couple. The ruling states that there is no exception to this rule. However, there is one exception under Internal Revenue Code § 7703(b). If an individual who is married but is not legally separated from their spouse lives separate from their spouse for at least the last six months of the calendar year, has a child living with them for whom they are entitled to receive a dependant exemption, and provide over one-half of the cost of maintaining the household, they may file as a single individual.

12. **Disability Income Subtraction.** P.D. 06-63 (August 8, 2006). A permanently disabled taxpayer requested a ruling as to whether third party sick pay reported on a W-2 would qualify for the Virginia disability income subtraction. The Tax Commissioner ruled that this income would not qualify for the subtraction. To be eligible for this subtraction, the income must be paid through an employer’s accident, health, or pension plan. The income that is the subject of this ruling is given by a third party, such as an insurance company, not the employer. It is therefore ineligible for the subtraction.
13. **Nonresident Virginia Source Income.** P.D. 06-71 (August 16, 2006). The taxpayers appealed an assessment of income taxes based upon a misinterpretation by the auditor in determining the number of days worked by the taxpayer. The taxpayer is a nonresident of Virginia, but works in Virginia for a portion of the year. The auditor interpreted certain information provided by the taxpayer to mean that the taxpayer worked a total of 60 days a year, all of which was in Virginia and subsequently assessed income tax on 100% of the taxpayer’s wages. Upon appeal, the taxpayer provided more information that showed he worked a full time job only 60 days of which he worked in Virginia. The Tax Commissioner accepted the information provided by the taxpayer and adjusted the assessment to apportion the taxpayer’s wages by 60 days out of a full year of 260 days.

14. **Domicile: Insufficient Information.** P.D. 06-82 (August 24, 2006). The taxpayer appealed an assessment of income taxes for taxable years 2000 through 2003. The taxpayer claimed he was not a domiciliary resident of Virginia for 2000 and 2001 and the returns filed for 2002 and 2003 were correct as filed. He also claimed that he maintained homes outside of Virginia and paid taxes on his wages to another state. However, an examination of real estate records did not show that the taxpayer owned homes in the other state and the other state’s taxing authority stated that it had no record of the taxpayer filing taxes in that state. The Department requested additional information from the taxpayer twice, but did not receive a response. The Tax Commissioner upheld the assessment and gave the taxpayer 30 days to provide additional documentation supporting his claims.

15. **Taxation of Nonresident on LLC Income.** P.D. 06-85 (August 25, 2006). The taxpayer appealed an assessment of income taxes on income earned by a Virginia LLC of which the taxpayer held a membership interest. The taxpayer claimed the income was exempt under a tax treaty with a foreign nation and was not Virginia source income and was a violation of Due Process to tax such income. However, no information was provided to show that the income was exempt under the foreign tax treaty and further as the LLC did not have nexus with any state other than Virginia, all of its income was Virginia source income. Therefore, the Tax Commissioner held that Virginia was within its jurisdictional rights to tax the income. The taxpayer further argued that he is a passive investor in the LLC and his income should be considered investment income not subject to taxation by Virginia. The Tax Commissioner disagreed and stated that the taxpayer, as an owner of the LLC that has elected pass-through treatment, has all of the attributes of the LLC and is therefore taxable by Virginia.

16. **Amended Return Pursuant to a Federal Change.** P.D. 06-95 (September 28, 2006). The taxpayers filed an amended income tax return after the conclusion of a federal audit. The audit resulted in an increase in their adjusted gross income. The amended return filed with Virginia also changed the taxpayer’s filing status. The return was filed beyond three years from the date of the filing of the original return. The Tax Department assessed the taxpayers with additional tax and denied the claim for refund based on the change in filing status. The Tax Commissioner upheld the assessment and denial of the refund as the change in filing status was unrelated to the federal audit and should have been filed within three years from the date of the filing of the original return.
17. **Domicile: Establishing and Abandoning Domicile in Virginia.** P.D. 06-99 (September 29, 2006). The taxpayers moved to Virginia in 2000 from State A. Upon arrival in Virginia, they purchased a Virginia residence, obtained Virginia drivers licenses, registered automobiles in Virginia and registered to vote in Virginia. They maintained their prior residence in State A by renting it to tenants. They also continued seeing physicians in the State A. In August 2003, the taxpayers abandoned their Virginia domicile and moved back to State A. At this time, they obtained State A drivers licenses, registered vehicles in State A, and registered to vote in State A. They also executed an affidavit at the time of the move stating their intention to abandon their Virginia domicile and reestablish their domicile in State A. The auditor assessed income taxes on the basis that the taxpayers did not abandon their Virginia domicile. The taxpayers appealed and claimed they never established a Virginia domicile dating back to 2000. The Tax Commissioner disagreed with both the taxpayer and the auditors. The Tax Commissioner determined that the taxpayers did establish a Virginia domicile in 2000. However, the Tax Commissioner also determined that their Virginia domicile was properly abandoned in 2003. Regarding the affidavit, the Tax Commissioner held that this was merely a statement of their intentions which was afforded little weight, but was helpful in determining the date of abandonment. In addition, the Tax Commissioner noted several errors in the taxpayers' part-year resident return filed for 2003. Specifically, a loss incurred by a Virginia farm owned by the taxpayers was attributed 100% to Virginia. This should have been divided between Virginia and State A. Also, the Tax Commissioner determined that various items of income earned outside of Virginia must also be attributed to Virginia based on the ratio of days the taxpayer had a Virginia domicile. Finally, as the taxpayers had Virginia source income after abandoning their domicile, they are required to file a nonresident Virginia income tax return for this portion of the 2003 taxable year.

18. **Amended Return Statute of Limitations.** P.D. 06-108 (October 5, 2006). In August 2004, the taxpayer filed amended returns for 1995 through 2003. The taxpayer was assessed additional tax for 1995 through 1997 and 1999. A refund due for 1998 was applied to the assessments. The taxpayer argued that the 1995 through 1997 returns were filed for informational purposes only and tax could not be assessed as the statute of limitations had expired. The Tax Commissioner agreed and found that the statute of limitations had expired and abated the assessment.

19. **Domicile.** P.D. 06-109 (October 5, 2006). The taxpayer appealed an assessment claiming that he abandoned his Virginia domicile in 2002. The Tax Commissioner upheld the assessment after the taxpayer did not provide sufficient information supporting the change in domicile. Also, the Tax Commissioner found that the taxpayer maintained vehicles in Virginia, renewed his drivers license in 2004, and received bank statements and tax records at a Virginia address. Further, the taxpayer claimed he was exempt from the tax as a merchant seaman. The Tax Commissioner held that federal law does no prevent a state from taxing its domiciliary residents.

20. **Domicile.** P.D. 06-118 (October 16, 2006). The taxpayer appealed an assessment of taxes for 1998 through 2001 claiming he was not a domiciliary resident of Virginia. After being discharged from the military in 1992, the taxpayer obtained a Virginia domicile. Beginning in 1994, the taxpayer obtained employment in states other than Virginia.
However, he did not spend a preponderance of his time in those states. Plus, his connections to those states were only short term. The taxpayer purchased a Virginia home in 1997 and registered vehicles in Virginia. The taxpayer also obtained driver's licenses in the other states of employment. Despite this, the Tax Commissioner found that the taxpayer's actions were not sufficient to change or abandon his Virginia domicile.

D. Opinions of the Attorney General

No recent opinions of the Attorney General have been released.

III. RETAIL SALES AND USE TAXES

A. 2006 Legislation

1. True Object Test for Government Contracts. The Virginia General Assembly approved the 2006 Appropriations Act (House Bill 5002, Chapter 3, 2006 Acts of Assembly, Special Session I) which contains language altering the Virginia Department of Taxation's interpretation of the true object test in relation to government contracts for sales and use tax purposes. Effective July 1, 2006, the true object test will be applied to each separate work order, task order, or statement of work entered into after July 1, 2006. It is important to note that this language will not be codified in the Virginia tax code.

This change in policy brings some clarity to this issue that has not existed in Virginia. Under the new rule, the overall contract will not be used to determine the taxability of each transaction under the contract. Rather, the true object test will be applied to each separate task order, work order, or statement of work to determine the taxability of the property purchased under each task or work order. Applying the true object test in this fashion will provide sales tax relief for task orders for the purchase of tangible personal property under what was previously considered a service contract by the Tax Department. However, the opposite will also be true. A contractor will now pay sales tax on tangible personal property purchased under a task order for the provision of a service even though the overall contract could be considered a contract for tangible personal property. For purposes of that task order, the contractor will be considered the taxable user of all tangible personal property purchased to perform the task.

2. Communications Tax Reform. HB 568 (Chapter 780) imposes a new Virginia Communications Sales and Use Tax ("Communications Tax"). The Communications Tax will be a state tax administered and enforced by the Virginia Department of Taxation. The Communications Tax will be imposed on customers of communications services at the rate of 5% of the sales price of the services. The new tax will appear as a line item on customers' bills.

Communications services subject to the tax would include:

- Landline and wireless telephone services (including Voice Over Internet Protocol);
- Paging;
- Cable television;
- Satellite television;
The Communications Tax will be collected by all communications services providers ("Providers") with sufficient contact, or nexus, with the Commonwealth. The providers will be subject to the tax using the same rules that apply to the retail sales and use tax act. Providers will register with the Department of Taxation in the same manner as sales tax dealers. Each Provider will separately state the amount of the tax and add that tax to the sales price of the service.

Further, this legislation repeals the following state and local taxes and fees:

- Local Consumer Utility Tax on landline and wireless telephone service;
- Local E-911 tax on landline telephone service;
- Virginia Relay Center Assessment on landline telephone service for the costs of a telephone relay service for the hearing impaired;
- The portion of the local Business, Professional, and Occupational License (BPOL) tax on public service companies exceeding .5% currently billed to customers in some grandfathered localities;
- Local Video Programming Excise Tax on cable television services; and
- Local Consumer Utility Tax on cable television.

The bill also imposes a new E-911 tax on landline telephone service. The E-911 tax will be state tax administered and enforced by the Virginia Department of Taxation. The E-911 tax will be imposed on the end user of each access line at the rate of $0.75 per access line. The new tax will appear as a line item on customers' bills. Providers will be allowed a dealer discount of three percent of the amount of the E-911 tax revenues. The state wireless E-911 fee is unaffected by this bill.

Finally, this legislation prohibits any cable franchise agreement entered into or renegotiated after January 1, 2007 from including a franchise fee. Cable franchise agreements in effect as of January 1, 2007 will remain in effect until their expiration. This legislation is effective on January 1, 2007.

3. **Semiconductor Production Exemption.** HB 530 (Chapter 541) and SB 475 (Chapter 519) exempt equipment, fuel, power, energy and supplies used primarily in the integrated process or sub-process of designing, developing, manufacturing or testing of semiconductors, without regard to whether the item is used in a clean room environment, touches the product, is used prior to or after production, or is affixed to real property.

For purposes of this new semiconductor manufacturing exemption:

- "Integrated process" as it applies to semiconductor manufacturers means a process that begins with the research and development of semiconductor products, equipment, or process, that includes the handling and storage of raw materials at a plant site, and continues to the point that the product is packaged for final sale and either shipped or conveyed to a warehouse. Semiconductor equipment, fuel, power, energy, supplies, or any other tangible personal property used before, during, or after actual production that contributes to high product quality, production yields, and process deficiencies.
• “Semiconductor clean rooms” includes, among other things, fixtures, piping, flooring, lighting, and all other property used to provide a controlled environment.

• “Semiconductor equipment” includes supports, bases, foundations, and other equipment, wafers, equipment used in quality control and testing, regardless of where or when the equipment is used or whether it comes in contact with the item being manufactured.

Items used in pre-production and in post-production testing and quality control, as well as, supports and foundations currently taxable to other manufacturers are exempt to semiconductor manufacturers under this legislation. This legislation is effective on July 1, 2006.

4. **Exemption for Semiconductor Wafers.** SB 601 (Chapter 524) provides an exemption from the retail sales and use tax for semiconductor wafers for use or consumption by a semiconductor manufacturer. Currently, only semiconductor wafers that are used directly in the manufacturing process are exempt. Therefore, certain wafers used outside of the manufacturing process are not exempt from sales tax. This legislation provides an exemption for all wafers regardless of whether they are used in the manufacturing process. This legislation is effective on July 1, 2006.

5. **Sales Tax Holiday.** HB 532 (Chapter 593) creates a “sales tax holiday” by providing a temporary exemption from the sales and use tax for certain items of tangible personal property. The exemption will occur on an annual basis, beginning in 2006, and would be in effect for a three-day period starting the first Friday in August and ending at midnight on the first Sunday in August. The exemption would apply on a per item basis to school supplies with a selling price of $20 or less, including but not limited to, dictionaries, notebooks, pens, pencils, notebook paper, and calculators; and Clothing or footwear with a selling price of $100 or less. In addition to an exemption for school related supplies, dealers may absorb the sales tax on the sale of any item during the exemption period.

6. **Exemption for Medicine and Drugs for Farm Animals.** HB 69 (Chapter 331) and SB 73 (Chapter 361) creates an exemption from the sales and use tax for medicines and drugs when sold to a veterinarian, provided that those items are to be used or consumed directly in the care and treatment of agricultural production animals. This legislation is effective on July 1, 2006.

7. **Exclusion of Gratuities.** HB 896 (Chapter 602) and SB 85 (Chapter 568) amend the retail sales and use tax definition of “sales price” to exclude any gratuity or service charge added to the price of a meal at the discretion of the purchaser and any mandatory gratuity or service charge added by a restaurant to the sales price of a meal, to the extent that such gratuity does not exceed 20% of the sales price. The new legislation also exempts from the local meals tax any mandatory gratuity or service charge added to the price of a meal by the establishment provided that the charge does not exceed 20% of the cost of the meal. This legislation is effective on July 1, 2006.
8. **Exemption for Medicine Purchased by Nursing Homes.** SB 110 (Chapter 217) expands the current retail sales and use tax exemption for medicine and drugs to include medicines and drugs purchased by for-profit nursing homes, clinics, and similar corporations. Currently, medicines and drugs are exempt when purchased by a licensed hospital. Controlled drugs are exempt when purchased by a licensed physician, optometrist, licensed nurse practitioner, or licensed physician assistants for use in a professional practice. This legislation is effective on July 1, 2006.

9. **Extension of Gas and Oil Exemption Sunset Date.** HB 1539 (Chapter 618) and SB 714 (Chapter 385) extend the sunset date for the natural gas and oil exploration exemption from July 1, 2006 to July 1, 2011. This legislation also moves natural gas and oil “refining” from the exemption for gas and oil extraction and includes it within the general industrial manufacturing and processing exemption.

10. **Church Property Exemption.** HB 576 (Chapter 338) expands the current exemption for items used in worship services to include video recording equipment, microphones, cassette players, and similar items purchased by a nonprofit church to be used for recording and reproducing services. However, this same equipment could be purchased under the existing exemption process for nonprofit organizations. This legislation is effective on July 1, 2006.

**B. Recent Court Decisions**

1. **Calcium Chloride v. Virginia Department of Taxation,** City of Richmond Circuit Court, Case No. LT-2270 (June 29, 2006). The Circuit Court for the City of Richmond held, as a matter of law, that real property contractors are not liable for use tax on tangible personal property transferred in connection with services performed on real property in any and all contexts and, as a matter of fact, that the contractor at issue was not subject to use tax on calcium chloride applied to roadways.

   The taxpayer at issue, Calcium Chloride Sales, Inc. (“CCSI”), applied calcium chloride to the roadways with the use of one of its trucks. In one scenario, CCSI sold calcium chloride to the Virginia Department of Transportation (“VDOT”) and applied it directly to roadways. In the other scenario, an unrelated third-party had contracted with VDOT for the sale and application of calcium chloride. CCSI was retained by this third party as a subcontractor to simply apply the third party’s calcium chloride to the roadways. The Virginia Department of Taxation (the “Department”) assessed CCSI with use tax on the value of the calcium chloride applied under both scenarios.

   In the first scenario, the Department asserted that applying calcium chloride to the roadways was “any other service with respect to real estate” and, as a result, CCSI was deemed to be the taxable user of the calcium chloride by operation of Virginia Code § 58.1-610(A). The Court rejected this statutory interpretation. In finding that the phrase “any other service with respect to real estate” did not include the application of calcium chloride to roadways, the Court applied the doctrine of ejusdem generis in construing Virginia Code § 58.1-610(a). That doctrine holds that when general words follow words of specific meaning, the general words are not given their broadest interpretation, but rather are construed to be in the same class as the specific words they follow.
In the second scenario, the Department again relied on Virginia Code § 58.1-610, but this time pointed to subsection (B) which provides that any person performing a service is deemed the user of property furnished by the customer unless tax has already been paid on the item and irrespective of whether any right, title, or interest passes to the service provider. The Court rejected this interpretation and viewed CCSI as selling calcium chloride and merely effecting delivery by applying it to the roadways.

C. Current Virginia Tax Commissioner Rulings

1. **Bundling of Car Rental Charges with Hotel Room Charges.** P.D. 06-1 (January 4, 2006). In a classic example of sales tax form over substance, the Tax Commissioner ruled that when a hotel bundles charges for the rental of a car with its hotel room charges and does not separately state the charges for the car rental, the car rental charges are subject to the retail sales and use tax. Normally, car rental charges are subject to the motor vehicle sales and use tax which has a lower rate than the retail sales and use tax. The taxpayer in this ruling did not show that either sales and use tax had been collected on the car rental charges.

   This is a case where a sales and use tax undoubtedly should have been collected. By not separately stating the car rental charges, the taxpayer here has subjected himself to a higher sales tax rate.

2. **Catering Services Provided to a Nonprofit University.** P.D. 06-6 (January 19, 2006). The Tax Commissioner ruled that sales of meals and catering services to a “public institution of learning” are exempt under Virginia Code § 58.1-609(4)(2)(i). The taxpayer also appealed the application of the compliance penalty on a different issue, but offered no mitigating circumstances to explain the penalty as it was calculated correctly. The application of the penalty was upheld.

3. **Agricultural Exemption.** P.D. 06-7 (January 19, 2006). The Taxpayer, a distributor of industrial gases, welding equipment, and supplies to farmers in Virginia, requested a ruling on whether the agricultural exemption applied to his sales to farmers. The Tax Commissioner ruled that these sales would not qualify for the exemption as the equipment described is not used directly in agricultural production.

4. **Credit for Taxes Paid to Other States.** P.D. 06-12 (February 7, 2006). The Tax Commissioner denied the taxpayer’s request for a protective claim as it was filed beyond the three-year statute of limitations. The protective claim was requested for an audit of sales taxes being conducted by Pennsylvania. The Tax Commissioner further ruled that as the taxpayer was subject to PA sales tax, the taxpayer would be eligible for a credit for sales tax paid to Pennsylvania for the materials used by the taxpayer in its contracting business in Virginia, provided that sufficient documentation is provided.

5. **Failure to Maintain Adequate Records.** P.D. 06-20 (February 7, 2006). The Tax Commissioner denied an appeal from the taxpayer due to the taxpayer’s inadequate records. The Taxpayer made a number of exempt sales during the audit period but did not keep
the necessary documentation to justify the exemptions. The taxpayer had register receipts that showed taxable and exempt sales. However, the sales could not be matched with the exemption certificates that the taxpayer had collected. Moreover, many of the certificates were not valid. In addition, a sample period for the audit could not be selected as the taxpayer did not have sufficient records for any period. The auditor instead used information based on a comparative data method.

6. **Effective Date of Exemption.** P.D. 06-21 (February 14, 2006). The taxpayer sold equipment to a nonprofit entity without charging sales tax. The taxpayer did not collect an exemption certificate from the entity and was assessed with the sales tax upon an audit. The taxpayer argued that the nonprofit entity was in the process of applying for an exemption. The Tax Commissioner upheld the assessment as the certificate would not apply retroactively.

7. **Federal Instrumentality.** P.D. 06-22 (February 14, 2006). The taxpayer was assessed sales and use tax upon an audit performed by the Department. The taxpayer appealed the assessment and argued that it was exempt from the tax and the audit as a federal instrumentality and a nonprofit entity. The Tax Commissioner disagreed based upon the United States Code section creating the entity provided that it was not an agency of the U.S. government and that Virginia law does not preclude the Department from auditing nonprofit entities.

8. **Subsequent Use Tax Payments.** P.D. 06-23 (February 28, 2006). The taxpayer appealed an assessment based upon a number of issues. First, the Tax Commissioner upheld taxes assessed for exempt sales where the taxpayer did not obtain an exemption certificate. Also, the taxpayer argued that the sample used in the audit was inaccurate as a number of the taxpayer’s customers paid use tax on items purchased from the taxpayer without paying sales tax. The taxpayer said that the sample should not include sales where a subsequent use tax payment was made. The Tax Commissioner ruled that the inclusion of the sales in the sample was correct as the taxpayer had a duty to collect sales tax in those instances. However, without any apparent authority, the Tax Commissioner allowed the taxpayer to have a one-time credit based upon the use tax payments. Finally, the Tax Commissioner corrected the audit where the Virginia auditor assessed sales tax at the DC tax rate instead of the Virginia tax rate.

9. **Coffee Service Providers.** P.D. 06-24 (March 8, 2006). The Tax Commissioner ruled that coffee service providers that collect sales tax on coffee products such as coffee, cream, and sugar, should collect sales tax on these items based on the 2.5% reduced sales tax rate for food.

10. **Silicon Wafers Used in Manufacturing.** P.D. 06-34 (March 23, 2006). The taxpayer, a semiconductor manufacturer, requested a ruling concerning the applicability of the manufacturing exemption to various types of wafers used by the taxpayer. The types of wafers addressed in this ruling are: (1) filler or dummy wafers; (2) process control wafers; (3) cleaning wafers; (4) conditioning or warm-up wafers; (5) engineering wafers; and (6) characterization wafers.
**Filler or Dummy Wafers:** The Tax Commissioner ruled that these wafers may be purchased exempt of tax using the manufacturing exemption. These wafers facilitate the uniform distribution of heat during the baking process to ensure the integrity of the semiconductors. These wafers are integral to the production process.

**Process Control Wafers:** The Tax Commissioner ruled that these wafers may be purchased exempt of tax using the manufacturing exemption. These wafers are used to collect real time data concerning the production process as well as facilitating post-production analysis. The purpose of these wafers is to ensure quality control standards. These wafers are integral to the production process.

**Cleaning Wafers:** The Tax Commissioner ruled that these wafers may be purchased exempt of tax using the manufacturing exemption. These wafers are used to clean and decontaminate production tools from within. This cleaning is a required function of the production process and must occur at regular intervals.

**Conditioning Wafers:** The Tax Commissioner ruled that these wafers may not be purchased exempt of tax. These wafers are used to warm up production tools prior to the beginning of the manufacturing process. While this may be integral to the quality of the semiconductors, the Tax Commissioner ruled that the manufacturing exemption was not applicable as this process occurred prior to the beginning of the manufacturing process.

**Engineering Wafers:** The Tax Commissioner ruled that these wafers may not be purchased exempt of tax. These wafers are used to properly calibrate the tools and maintain quality whenever production tools are restarted after a shutdown. The Tax Commissioner ruled that to qualify as quality control these wafers must be used during the actual production process.

**Characterization Wafers:** The Tax Commissioner ruled that these wafers may not be purchased exempt of tax. These wafers are used during the characterization process to provide testing of the production tools. This process is strictly a pre-production process. The Tax Commissioner reiterated his interpretation that these wafers must be used during the actual production process to qualify for the exemption.

11. **Software License Agreements.** P.D. 06-35 (April 4, 2006). The taxpayer appealed the assessment of sales and use taxes on the eight different software license fees which the taxpayer claimed to be exempt under the research and development exemption. The Tax Commissioner found that seven of the licenses are exempt under the R&D exemption based on the intent to develop a new software product. This intent was determined from the language in the contract granting each license to solely use the software for development purposes. The eighth license was found by the Tax Commissioner to be subject to the sales and use tax based on the fact that the taxpayer was allowed to use the software for other purposes in addition to development.
12. **Management Fees and Exempt Sales.** P.D. 06-46 (April 11, 2006). The taxpayer appealed an assessment of sales taxes on sales which it claimed were exempt and on management fees collected by the taxpayer. The Tax Commissioner ruled that the taxpayer failed to meet its burden to prove that certain sales were exempt as the purchaser of certain goods was not the holder of a direct pay permit and that certain transactions were for exempt services. The taxpayer did show however, that the fees upon which taxes were assessed were for the management of cafeteria services and that no tangible personal property passed to the taxpayer’s customer. As a result, the assessment on the management fees was abated.

13. **Research and Development Exemption and Use Tax.** P.D. 06-49 (April 13, 2006). The taxpayer appealed an assessment of sales and use taxes on royalty fees paid for software and use taxes on a display booth stored in Virginia. The software was delivered through tangible media. The taxpayer claimed that the fees were exclusively for research and development purposes. The Tax Commissioner disagreed citing the facts that the customers are using the software rather than producing new software products by integrating the software. In addition, the Tax Commissioner held the exemption for audiovisual works does not apply to online content as it exceeds the scope of the exemption as originally enacted by the General Assembly. Finally in the case of the software, the Tax Commissioner ruled that the service exemption would not apply as the software was delivered in a tangible medium which the taxpayer retained. In regards to the display booth, the use tax applies to the mere storage of TPP in Virginia. Therefore, the assessment on the display booth was proper.

14. **Store Fixtures.** P.D. 06-50 (April 18, 2006). The taxpayer appealed an assessment of sales tax on store fixtures purchased from and installed by an out-of-state contractor in Virginia. The fixtures were purchased in Pennsylvania by the contractor where sales tax was paid on the fixtures. The Tax Commissioner upheld the assessment. The taxpayer argued that since the fixtures were being affixed to real property that the contractor should be liable for use tax. The Tax Commissioner applied the three prong test used by the Virginia Supreme Court to determine whether fixtures are affixed to real property. The fixtures were deemed to not be affixed to real property because they were not permanently annexed, they were easily removed, and the taxpayer would retain the fixtures upon the termination of its lease. Therefore, the contractor did not owe use tax on the fixtures, and the taxpayer did owe sales tax. Further, the purchase was not eligible for the credit for taxes paid to other states as the Tax Commissioner determined that Pennsylvania sales tax was incorrectly collected on this purchase.

15. **Government Contract.** P.D. 06-53 (May 25, 2006). The taxpayer requested a ruling on the taxability of TPP purchased for the performance of a government contract. The Tax Commissioner reviewed the statement of work and concluded that it is a contract for services and the contractor must pay tax on the purchase of any TPP for the performance of the contract.

16. **Virginia Alcoholic Beverage Control Audit.** P.D. 06-59 (June 29, 2006). The Tax Commissioner denied the taxpayer’s appeal of an assessment of sales tax and a fraud penalty on unreported alcoholic beverages that was discovered during an audit by the Virginia Department of Alcoholic Beverage Control. The taxpayer argued that the ABC methodology overestimated his alcohol sales. However, the Tax Commissioner found that the ABC
methodology was more likely to underestimate the sales rather than overestimate. The fraud penalty was upheld as the taxpayer underreported his sales by at least 50%.

17. **New Application of the True Object Test to Government Contracts.** P.D. 06-60 (July 7, 2006); Virginia Tax Bulletin 06-4. The 2006 Appropriations Act (House Bill 5002, Chapter 3, 2006 Acts, Special Session 1) contained language altering the Virginia Department of Taxation’s interpretation of the true object test in relation to government contracts. Effective July 1, 2006, the Department will apply the true object test to each separate work order, task order, or statement of work entered into after that date. Prior to this change, the Department applied the true object test to the overall contract under which the work order, task order, or statement of work was issued. The Department will issue regulations prior to June 30, 2007 on this change.


a) The Tax Commissioner reviewed the statement of work provided by the taxpayer and agreed that the first contract was for the provision of tangible personal property.

b) Additionally, the taxpayer was assessed use taxes on a second contract which was classified. The taxpayer was unable to provide the auditor with the contract due to its classified status. The Tax Commissioner upheld the assessment on this contract citing the Department’s unbending policy of requiring a review of the contract despite its status as a classified document. However, the Tax Commissioner gave the taxpayer an additional 45 days to allow Tax Department personnel to review the contract or to provide the statement of work.

c) The Tax Commissioner agreed that the third contract was for the provision of tangible personal property. However, the Tax Commissioner upheld the assessment of taxes on several items upon which title never passed to the government and were consumed by the taxpayer.

d) In the fourth contract, the taxpayer argued that the contract was an ID/IQ contract and that each task order should be evaluated separately to determine if any tax should be assessed. The Tax Commissioner upon reviewing the contract disagreed and found the contract to be for the provision of services. Specific language from the contract was cited in the ruling as support for the Tax Commissioner’s interpretation.

e) In the fifth contract, the taxpayer argued that it was a “task order” contract and each task order should be reviewed individually. Again, the Tax Commissioner found this contract to be for the provision of services and upheld the assessment.

f) The taxpayer argued that the sixth contract was for maintenance and repair services performed by the taxpayer and that the contract was for the provision of tangible personal property. The Tax Commissioner was unable to make a determination on the
contract based on the information provided and upheld the assessment. It is unclear from the ruling why the taxpayer did not argue that the contract was a maintenance contract and entitled to treatment under Virginia Code § 58.1-609.5(9). This section grants a resale exemption for all tangible personal property purchased under a maintenance contract that provides for both repair and replacement of parts.

g) The Tax Commissioner reviewed the statement of work provided by the taxpayer and agreed that the seventh contract was for the provision of tangible personal property.

In an issue separate from the government contracts, the auditor assessed use tax on certain assets. The taxpayer acquired these assets in 1999 and 2000, but did not report and pay use tax on the assets until filing its November 2001 return. The auditor assessed tax on the assets and advised the taxpayer to amend the November 2001 return to remove the assets and request a refund. Instead, the Tax Commissioner allowed a credit for the tax paid in November 2001 on these assets, but upheld the penalty and interest assessed on the tax assessed on these assets.

Finally, the taxpayer appealed the penalty assessed by the auditor based on the taxpayer’s low compliance ratio (49%) where an 85% compliance ratio is required as this is the taxpayer’s ninth audit. The Tax Commissioner ruled that the penalty will be upheld if the ratio remains below 85% after the adjustments made in this ruling are implemented. In addition, the taxpayer is allowed to exercise the option of computing an alternative compliance ratio which includes sales taxes paid to vendors. However, the computation of the alternative ratio is the taxpayer’s responsibility. The Tax Commissioner directed the auditor to review the computations with the taxpayer.

19. Gift Transactions. P.D. 06-64 (August 11, 2006). The taxpayer requested a redetermination from a prior ruling (P.D. 05-138) in which the Tax Commissioner upheld the assessment of sales taxes the taxpayer should have collected from orders placed by Virginia customers, accepted and processed in Virginia, with the items sent to individuals outside of Virginia. The taxpayer provided additional information which showed the orders were actually accepted and processed outside of Virginia. Based on the new information, the Tax Commissioner adjusted the assessment.

20. Sale of a Business/Occasional Sale Exemption. P.D. 06-67 (August 16, 2006). The taxpayer appealed an assessment of sales taxes on the sale of several divisions of its business. The Tax Commissioner applied the criteria set out in P.D. 91-290 to determine if the sale of a business qualifies for the occasional sale exemption. The Tax Commissioner found that this sale did not meet the criteria. The taxpayer did not maintain separate accounting for the divisions it sold. The taxpayer did not maintain separate bank accounts for the sold divisions. The divisions were not separately housed from other divisions either. The taxpayer did not provide enough information for the remaining two criteria, whether the employees are active in only one division and whether the division has its own fixed assets. On the basis of the three failed criteria, the Tax Commissioner upheld the assessment.

21. Software Royalty Fees. P.D. 06-72 (August 18, 2006). The taxpayer appealed an assessment of use taxes on its usage of software. The taxpayer claimed that the research and development exemption should apply. The Tax Commissioner found that the
taxpayer's use of the software for purposes other than research and development exceeded the de minimis exception provided for in the regulations interpreting the exemption. Specifically, the license granted to the taxpayer permitted the taxpayer to use the software to provide support for the end users of the ultimate product which exceeds the de minimis exception.

22. **Poultry Containers and Catwalks.** P.D. 06-73 (August 18, 2006). The taxpayer appealed assessments of use tax on containers used to transport poultry to the processing plant and on catwalks fabricated for use at the processing plant. The taxpayer contended that the containers should be exempt under the agricultural exemption. This position was based on a ruling from 1985 that held containers similar to the containers used by the taxpayer qualified for the exemption as packaging materials. The Tax Commissioner disagreed and cited a ruling (P.D. 94-330) that overturned the 1985 ruling and stated that containers such as the ones used by the taxpayer in this appeal were not packaging, but instead were used to transport chickens from one location to another. The Tax Commissioner also referenced a letter sent to the taxpayer in 1993 explaining the correct application of tax to the containers. Further, the containers do not qualify for the manufacturing exemption as they are put into use after the chickens have fully grown, i.e. after the manufacturing process has ended. On the second protested issue, the taxpayer contended that the contractor who constructed the catwalks should be liable for the use tax on the catwalks instead of the taxpayer as the catwalks became a part of the realty. The Tax Commissioner denied this portion of the appeal as the taxpayer did not provide sufficient documentation supporting this claim.

23. **Tersa Bale Heads in Tobacco Aging.** P.D. 06-80 (August 23, 2006). The taxpayer requested a redetermination of a prior ruling (P.D. 04-87) which held that tersa bale heads (plywood boards used to form loose tobacco into cubes for storage) were not eligible for the industrial processing/manufacturing exemption. The sole function of the tersa bale heads is to put tobacco in cubes so it can be stored in a storage shed where the tobacco is aged. Aside from the aging, no treatment of any kind is applied to the tobacco. The Tax Commissioner upheld the prior ruling and stated that because no manufacturing process occurs during the time the tersa bale heads are in use, the exemption will not apply.

24. **Carbon Used in Tobacco Aging.** P.D. 06-81 (August 23, 2006). The taxpayer appealed an assessment of use taxes on the purchase of carbon used in the aging process for tobacco. The carbon is solely used to protect tobacco from insects during the process. The Tax Commissioner ruled that the analysis in P.D. 06-80 applies in this case as well. The aging process for tobacco is not manufacturing and therefore the carbon is not eligible for the manufacturing exemption.

25. **Government Contracts.** P.D. 06-83 (August 25, 2006). The taxpayer was assessed use taxes on its purchase of tangible personal property pursuant to three government contracts. The taxpayer claimed contract #1 was an ID/IQ contract and that each task order should be evaluated individually. The Tax Commissioner examined the contract and agreed and directed the auditor to re-examine each task order. The taxpayer claimed contract #2 was actually part of a larger ID/IQ contract and further that this contract was a contract to provide commerce systems and the implementation of the system. The Tax Commissioner again examined the contract and agreed with the taxpayer. Likewise, the taxpayer argued that contract
#3 was for the provision of a computer system. The Tax Commissioner again examined the contract and agreed with the taxpayer. The Tax Commissioner removed all items from contracts #2 and #3 from the audit.

Further, the taxpayer argued that all items purchased for contract #2 should be exempt under the research and development exemption. The taxpayer was tasked with developing a new infrastructure from two systems currently being used. Based on the contract language and 23 VAC 10-210-765, the Tax Commissioner agreed and removed the affected items from the audit.

The taxpayer also challenged the assessment of the amnesty penalty on this audit as the assessment was not made until after the amnesty period had concluded. The Tax Commissioner disagreed stating that the statute clearly contemplates imposing the penalty on taxpayers that underreported or underpaid their liabilities during a period covered by amnesty. However, as the amnesty guidelines make an exception for second and subsequent audits where the compliance ratio exceeds 60 percent for use taxes, the Tax Commissioner directed the application of the penalty to be reviewed after all other adjustments have been made to the assessment. Finally, the Tax Commissioner agreed that the large corporate underpayment rate of interest should not have been applied in this case.

26. Fiber Optic Cable. P.D. 06-84 (August 25, 2006). The taxpayer appealed an assessment of sales taxes on the lease of fiber optic cable to third parties. The taxpayer maintained that the cable is a part of real property and therefore the leases are exempt from sales tax. The Tax Commissioner applied the three tests of Transcontinental Gas Pipe Line Corporation v. Prince William County 210 Va. 550 (1970). The three part test to determine whether an item of personal property placed upon realty becomes itself realty are: (1) annexation of the property to realty, (2) adaptation to the use or purpose to which that part of the realty with which the property is connected is appropriated, and (3) the intention of the parties. The annexation of the property is the chief test. The Tax Commissioner agreed that the cable was part of the real property as the cable is buried and if the third party decides not to renew its lease of the cable, the cable remains underground and is therefore a permanent part of the realty. The Tax Commissioner agreed that the leases of the cable are exempt from sales tax but noted that the taxpayer should pay use tax on its purchase of the cable as it is deemed the user and consumer of the cable.

27. Rental of Inflatable Amusement Games. P.D. 06-87 (September 19, 2006). The taxpayer appealed an assessment of sales taxes on the taxpayer’s rentals of inflatable amusement games. The taxpayer contended that the assessment was barred by the statute of limitations and that some rentals were made to exempt organizations, some rentals were through a booking agent, and that tax was erroneously assessed on the rental of inflatable games with an operator. The Tax Commissioner held that the statute of limitations did not bar the assessment as the taxpayer failed to file a return and the period is extended to six years by statute. The assessment took into consideration all rentals where a valid sales tax exemption certificate was presented, but some certificates were issued after the audit. The Tax Commissioner held that these certificates cannot be accepted in good faith and must be scrutinized. The taxpayer requested that the Tax Commissioner not contact any of its customers to verify the use of the games. Therefore, the Tax Commissioner could not scrutinize the certificates and did not alter
the assessment. On the rentals through the booking agent, the Tax Commissioner held that the tax was correct as assessed as the booking agent (purchaser of the games) did not provide a resale certificate and the law allows the seller to be assessed with the tax. Finally, the Tax Commissioner found that the “operator” of the inflatable game was actually an attendant whose duty was to merely supervise the games while in use. Therefore, the skills of an operator was not the subject of the rental which would exempt the transaction from tax.

28. **Effect of a Valid Exemption Certificate.** P.D. 06-89 (September 18, 2006). The taxpayer appealed an assessment on two items remaining from an audit after proper documentation had been provided for all other items in the audit. The two remaining items were the leases of photocopier machines to customers of the taxpayer. In each instance, the taxpayer accepted in good faith exemption certificates for the leases. The first certificate claimed the manufacturing exemption, research and development exemption, and the exemption for packaging materials. The second certificate claimed the research and development exemption. The Tax Commissioner held that the taxpayer is not liable for the taxes on these leases as he accepted the certificates in good faith. However, the Tax Commissioner noted that office equipment such as a photocopier cannot qualify for any of the exemptions claimed.

29. **Manufacturing Exemption.** P.D. 06-90 (September 19, 2006). The taxpayer appealed an assessment of use taxes and argued that its business should be viewed as having three separate divisions for purposes of the industrial manufacturing exemption. However, the Tax Commissioner noted that 68% of the taxpayer’s business was sales and service which placed it under a classification that prevented the taxpayer from being considered an industrial manufacturer. The Tax Commissioner also pointed out that the process of vulcanization is not considered manufacturing based on a prior ruling. Therefore, as the taxpayer is not a manufacturer and the process employed by the taxpayer is not manufacturing, the Tax Commissioner upheld the assessment.

30. **Contractor & Direct Pay Permits.** P.D. 06-92 (September 19, 2006). The taxpayer, a real property contractor, performed work for a customer who holds a direct pay permit pursuant to a purchase order that stated that the customer assumed all responsibility for remitting sales taxes. Based on this language, the contractor did not remit any use taxes for the materials used in the job. The taxpayer was assessed use taxes on the materials. The taxpayer argued that it was not responsible for the taxes and the customer should be responsible based on the purchase order. The Tax Commissioner cited the regulation that deems a contractor the user of all materials and requires the contractor to pay the use tax on such materials. Further, the customer’s direct pay permit absolves dealers from sales tax duties. The contractor is not considered a dealer charged with collecting sales tax. Based on this, the Tax Commissioner upheld the assessment.

31. **Pollution Control Exemption, Occasional Sale, and the Use of Income Tax Apportionment to Determine the Tax Base.** P.D. 06-96 (September 29, 2006). The taxpayer appealed an assessment of sales taxes based on three issues. The first issue was that certain sales were exempt under the pollution control exemption. The taxpayer accepted a valid exemption certificate from the customer at the time of the sale along with a letter from the Department of Environmental Quality certifying the customer’s facility as a pollution control facility. Based on
this information, the Tax Commissioner removed the items from the assessment. The taxpayer also claimed that the sales of certain assets were exempt under the occasional sale exemption. The Tax Commissioner found that the taxpayer's assets actually increased during the year of the sale rather than decreased as if it had sold a portion of its business. Further, the taxpayer claimed that the sale was a transfer made under IRC § 351. However, the Tax Commissioner noted that a sale of assets in a § 351 transaction requires the assets to be exchanged for stock. The bill of sale provided by the taxpayer did not mention the transfer of any stock. Therefore, the Tax Commissioner denied this portion of the appeal. Finally, the taxpayer noted that the tax base was calculated using apportionment data that includes subsidiaries. The Tax Commissioner returned the audit to the auditor to remove the asset data for the subsidiary and recalculate the tax base measure.

32. Reduced Food Tax Rate and Bottled Water. P.D. 06-98 (September 29, 2006). The taxpayer requested a ruling on the proper sales tax rate that should be charged on its sales of various water products. The Tax Commissioner ruled that the reduced food tax rate of 2.5% is the applicable rate. In order for the taxpayer to obtain a refund on sales of this water where the 5% rate was applied, it must first refund the tax to its customers.

33. Invalid Exemption Certificates. P.D. 06-100 (October 5, 2006). The taxpayer appealed the disallowance of two resale certificates by the auditor. The first certificate was accepted by the taxpayer after the conclusion of the audit and had an invalid exemption number. The second certificate was on a generic form and was made out to an affiliate of the taxpayer instead of the taxpayer. The Tax Commissioner found the disallowance of these certificates was proper.

34. Medical Equipment Exemption. P.D. 06-101 (October 5, 2006). The taxpayer appealed the disallowance of the durable medical equipment exemption for its purchase of CPAP machines. The Tax Commissioner upheld the auditor's findings. The purchase of the CPAP machine met only four of the five requirements to receive the exemption. A CPAP machine is intended for repeated use, serves a medical purpose, is not useful to a person without an illness, and is appropriate for home use. However, the CPAP machine was not by or on behalf of an individual. The taxpayer purchased the machines in bulk and apparently did not resell them. If the machines were resold, they could have qualified for a resale exemption.

35. Audiovisual and Manufacturing Exemptions. P.D. 06-102 (October 5, 2006). The taxpayer requested a ruling on the applicability of the audiovisual and manufacturing exemptions. The Tax Commissioner ruled that the audiovisual exemption is available to the taxpayers in their production of master tapes and CDs produced by the taxpayer. However, the exemption does not apply to the taxpayer's equipment used in the screening and selection process of instructors. The Tax Commissioner ruled that the manufacturing exemption only partially applies to the taxpayer. As the taxpayer produces all of the tapes it markets, the exemption applies to the equipment used in that process. However, as the taxpayer out-sources the production of discs, equipment used in the disc process would not qualify for the manufacturing exemption. The taxpayer also requested a ruling on the use of its packaging equipment and materials. The Tax Commissioner ruled that this property will be exempt so long as the preponderance of use is in the tape manufacturing process. If the preponderance of use is
to package the discs which the taxpayer does not manufacture, the exemption will not apply. Finally, the taxpayer asked for the proper procedure to obtain a refund if it had overpaid any sales and use tax. The Tax Commissioner responded that the proper procedure per Virginia regulations is to obtain a refund from the vendor. However, the Tax Commissioner allowed the taxpayer to submit documentation directly to the Department that demonstrates an overpayment to receive a refund directly from the Department.

36. **Software and Scanning Services.** P.D. 06-103 (October 5, 2006). The taxpayer requested a ruling in respect to the software and scanning services it provides to customers. All software and scanning output are provided through the Internet and not in tangible media. Based on this, the sale of the software and services are not subject to the sales tax. Also, the taxability of any training provided by the taxpayer in using the software will be tied to the taxability of the software sold. Finally, as a service provider, the taxpayer will be considered the user of any property used to provide its services. It should therefore pay use tax on such equipment.

37. **Modular Buildings.** P.D. 06-104 (October 5, 2006). The taxpayer requested a ruling on its sales of non-residential mobile offices. Mobile offices are subject to the motor vehicle sales and use tax. The Tax Commissioner ruled that the determination of whether the sale is subject to the motor vehicle sales and use tax or the retail sales and use tax must be made by the Commissioner of the DMV. If the Commissioner of the DMV finds that the modular buildings sold by the taxpayer qualify as a mobile office, it will be subject to the motor vehicle sales and use tax. Absent such a ruling, the taxpayer's sales will be subject to the retail sales and use tax that will be imposed on 60% of the retail price of the modular building per special treatment afforded by Virginia Code § 58.1-610.1.

38. **True Object Test.** P.D. 06-105 (October 5, 2006). The taxpayer appealed an assessment on leases of tangible personal property. The taxpayer provides IT services to affiliates and argued that the property should not be taxed. The Tax Commissioner found that the true object of the transaction is the provision of services by the taxpayer and that the property was not leased separately. Therefore, the assessment was abated.

39. **Purchase of Drugs.** P.D. 06-110 (October 10, 2006). The taxpayer requested a ruling on the taxability of drugs purchased for a specific patient and delivered to a physician to administer to the patient. The Tax Commissioner ruled that this qualified for the exemption under Virginia Code § 58.1-609.10(9).

40. **Successor Liability.** P.D. 06-112 (October 11, 2006). The taxpayer appealed an assessment of sales taxes on a tavern purchased by the taxpayer. The taxpayer contended that the successor liability provisions did not apply as a majority of the assets were purchased from a third party debtor, the Department failed to timely file a memorandum of lien, the online registration provided by the Department did not inform the taxpayer of successor liability provisions, and the Department did not fully pursue collection action against the original tavern owner and its officers. The Tax Commissioner disagreed. The Tax Commissioner noted that the sales tax liability was noted in the taxpayer's purchase agreement, and the taxpayer failed to withhold sufficient funds for the liability. Also, the purchase of the assets from a third
party does not protect the taxpayer from successor liability. Finally, the other arguments advanced by the taxpayer are without merit.

41. Taxability of Pillcams. P.D. 06-113 (October 10, 2006). The taxpayer requested a ruling on whether pillcams are eligible for the durable medical equipment exemption. A pillcam is a small camera about the size of a pill that takes pictures of a person’s digestive system after being ingested by the person. The Tax Commissioner found that they were not eligible as they could not be used repeatedly and were not appropriate for home use.

42. License Plate Frames and Environmental Fees. P.D. 06-115 (October 16, 2006). The taxpayer appealed an assessment of sales and use taxes on license plate frames purchased by the taxpayer (an automobile dealer) and environmental fees charged by the taxpayer in connection with sales of tangible personal property by the taxpayer. The Tax Commissioner denied the appeal. The Tax Commissioner found the license plate frames were not included in the sale price of the automobiles and were advertising for the taxpayer and treated as such by the taxpayer. Further, the purchases were recurring and not isolated and appropriate for inclusion in the sample. The environmental fees were taxable as part of a sale of tangible personal property.

43. Printed Materials. P.D. 06-117 (October 16, 2006). The taxpayer requested a ruling concerning the taxability of printed advertising materials. The Tax Commissioner ruled that materials printed in Virginia, held in Virginia for less than 12 months, and distributed outside of Virginia by the printer are exempt from the sales tax. All other materials are taxable.

D. Opinions of the Attorney General

No recent opinions of the Attorney General have been released.

IV. PROPERTY (AD VALOREM) TAXES

A. 2006 Legislation

1. Sale of Tax-Delinquent Real Estate. HB 194 (Chapter 333) allows the circuit court to authorize the sale of tax delinquent real estate without a report by a commissioner in chancery upon receipt of (1) proper service of process on all parties, (2) a written real estate title certificate and (3) the written report of a licensed real estate appraiser. This legislation also deletes the deposition requirement as it relates to the report of the real estate appraiser and replaces it with the requirement that the report be in writing. This legislation is effective on July 1, 2006.

2. Nonjudicial Sales of Tax-Delinquent Property. HB 1421 (Chapter 616) provides detailed rules concerning nonjudicial sales of tax delinquent real property of minimal size and value, including requirements that (1) each parcel shall be sold at public auction, (2) the sale shall be free and clear of the tax lien, but shall not affect any easements recorded prior to the date of sale, (3) the treasurer shall convey the parcel by a treasurer’s deed, (4) if the sale
proceeds are insufficient to pay the taxes in full, the remaining delinquent taxes remain the
personal liability of the former owner, (5) the sale proceeds shall be applied first to the costs of
sale, then to the taxes, penalty and interest due on the parcel, and then to any other taxes or other
charges owed by the former owner to the jurisdiction, (6) any excess proceeds remain the
property of the former owner and shall be kept by the treasurer in an interest-bearing escrow
account, (7) if no claim for payment of excess proceeds is made by the former owner within two
years after the date of sale, the treasurer shall deposit the excess proceeds in the jurisdiction's
general fund, and (8) if the sale does not produce a successful bidder, the treasurer shall add the
costs of sale to the delinquent real estate account. This legislation also declares that judicial
sales of real property do not affect easements recorded prior to the sale. This legislation is
effective on July 1, 2006.

3. **Deferral of Real Estate Taxes.** HB 1231 (Chapter 356) eliminates the
requirement that the amount of real estate taxes eligible for deferral should be calculated by
subtracting from the real estate tax for the current tax year the "base amount of nondeferrable
tax." As a result, localities will be allowed to grant deferrals for the full amount by which each
taxpayer’s real estate tax levy exceeds at least 105 percent of the real estate tax on their property
in the previous year. This legislation is effective on July 1, 2006.

4. **Application of Roll-Back Taxes.** SB 186 (Chapter 221) eliminates the
current requirement that, in order to continue to qualify for land use taxation, a landowner who
subdivides land into parcels that meet the minimum acreage requirements for land use taxation
must attest that the land is still devoted solely to agricultural, horticultural, forest or open-space
use. This legislation also authorizes counties and certain enumerated cities and towns not to
impose roll-back taxes when real estate subject to use valuation is subdivided, separated or split-
off pursuant to the locality's subdivision ordinance into parcels that do not meet the minimum
acreage requirements for land use taxation if title to the resulting parcels is held in the name of
an immediate family member for the first 60 months following the division. This legislation is
effective on July 1, 2006.

5. **Notice of Change of Real Estate Reassessment.** HB 491 (Chapter 255)
and SB 731 (Chapter 509) require localities to provide additional information to property owners
on each notice of change of their real estate assessment. Each notice will need to show the
immediately prior appraised value of the land and improvements and the immediately prior
assessed value of each if different from the appraised value. If the tax rate that will apply to the
new assessed value has been established, then the notice would need to set out the rate, the total
amount of the new tax levy, and the percentage change in the new tax levy from the immediately
prior one. If the tax rate that will apply to the new assessed value has not been established, then
the notice would need to set out the time and place of the next meeting of the local governing
body at which public testimony will be accepted on any real estate tax rate changes. If the
meeting will be more than 60 days from the date of the notice, then instead of the date of the
meeting, the notice would need to include information on when the date of the meeting will be
set and where it will be publicized. This legislation is effective on July 1, 2006.
6. **Exemption for Redevelopment or Conservation Areas.** SB 358 (Chapter 572) authorizes local governing bodies to provide, by ordinance, for the partial exemption from taxation of new structures or other improvements to real estate located in redevelopment or conservation areas or rehabilitation districts. The partial exemption is a percentage of the increase in assessed value as a result of the new structure or improvement or an amount not to exceed 50 percent of the construction cost of such structure or improvement. For this bill to become effective, a constitutional amendment must be approved in the November 2006 election.

7. **Increased Exemptions for the Elderly or Disabled.** HB 121 (Chapter 585) adds the cities of Norfolk and Richmond to the list of cities that are permitted to extend their income limitations to $52,000 and their net financial worth cap to $200,000. This legislation also increases the net financial worth cap amount from its current $200,000 cap to a $350,000 cap for this group of cities. In addition, this bill removes the counties of Fauquier and Stafford from the list of counties permitted to make these limitation increases.

In addition to these changes, this statute increases the net financial worth cap for certain localities in Northern Virginia from its current cap of $340,000 to $540,000. It also adds the counties of Clarke, Fauquier, and Stafford to the localities in Northern Virginia that are eligible to make this increase. The localities that can currently increase their net financial worth caps to a maximum of $340,000 include the counties of: Fairfax, Arlington, Loudon, and Prince William; the cities of Fairfax, Falls Church, Manassas, Manassas Park, and Alexandria, and the towns of Dumfries, Herndon, Leesburg, Purcellville, and Vienna. Any incorporated town located in these counties are eligible for the increased financial limits. This legislation is effective on July 1, 2006.

8. **Assessment of Affordable Housing.** HB 1173 (Chapter 688) requires that when determining the fair market value of real property containing more than four residential units operated in whole or part as affordable housing, the locality must consider (a) the rent and the impact of applicable rent restrictions, (b) the operating expenses and expenditures, (c) restrictions on the transfer of title, and (d) evidence presented by the property owner of other restrictions imposed by law that impact these variables. Additionally, this bill prohibits federal or state income tax credits with respect to affordable housing from being considered real property or income attributable to real property. This legislation is effective for the assessment and taxation of qualifying properties beginning January 1, 2007, or the beginning of the next general reassessment cycle of the locality in which the property is located.

9. **Assessments for Golf Courses.** HB 916 (Chapter 817) classifies public and private golf courses as real estate devoted to open-space use for purposes of land use taxation. This legislation is effective on July 1, 2006.

**B. Recent Court Decisions**

1. **Young Life, Inc. v. Rockbridge County,** Rockbridge County Circuit Court, At Law No: CH3000048-00 (April 5, 2006). The Court held Young Life is a religious association as described in Virginia Code §§ 58.1-3609 and 58.1-3617 and is therefore exempt
from property taxation. Young Life operates a “summer camp” in Rockbridge County where young Christian adolescents spend time doing a variety of physical activities that are consistent with other summer camps but also spend time learning about and expanding their Christian faith. Originally, Rockbridge County had argued that Young Life did not qualify as a religious association and not exempt from taxes. However, upon a demonstration by Young Life that the primary focus of the camp was for religious purposes, the Court held Young Life is an exempt religious organization.

Prior to this holding, the Court denied a demurrer by Rockbridge County and held the following: (1) The enactment of an amendment to the Constitution of Virginia effective January 1, 2003, authorizing the exemption of property by classification applied on a prospective basis only and did not repeal previously enacted exemptions; (2) the enactment of Virginia Code § 58.1-3651(D) of the Virginia Code to implement the constitutional amendment extended previously enacted exemptions and did not preclude any properly challenged claims based on these amendments; and (3) Young Life was not precluded from being classified as a religious association due to the fact that it is an incorporated entity.

2. Rapidan Baptist Camp v. Madison County, Orange County Circuit Court, 2006 Va. Cir. LEXIS 66 (March 22, 2006). In a property tax dispute, Madison County filed a demurrer claiming that the property tax exemptions under Virginia Code § 58.1-3606 claimed by Rapidan Baptist Camp (“Rapidan”) were repealed by the enactment of Article X, Section 6(a)(6) of the Virginia Constitution (the “amendment”) which grants authority to localities to enact property tax exemptions. The court overruled the demurrer. Citing Hughes v. Cole, 251 Va. 3, 1996), the Court noted that absent explicit language to repeal a law, there is a presumption against a legislative intent to repeal. In examining whether Virginia Code § 58.1-3606 was repealed by the enactment of the amendment, the court found that the amendment contained no language that repealed Virginia Code § 58.1-3606, nor did it find any language that remotely suggested that Virginia Code § 58.1-3606 was intended to be repealed. Further, the court found that the amendment vests power with the localities to grant exemptions subject to limits set by the General Assembly while the General Assembly retains its power over the exemptions set forth in Virginia Code § 58.1-3606. This identical issue was previously argued in Young Life, Inc. v. Rockbridge County, supra. In that case as well, the court overruled Rockbridge County’s demurrer on the same issue.

C. Recent Virginia Tax Commissioner Rulings

No rulings in this area were released.

D. Opinions of the Attorney General

1. Electronic Transmission of Property Data to Treasurer. Opinion Number 06-029 (May 31, 2006). The Commissioner of Revenue of Franklin County asked whether it was permissible to electronically transmit data to the treasurer necessary to correct erroneous property tax assessments and data notifying the treasurer to bill and collect land-use roll back taxes. The Attorney General noted that the Code of Virginia requires the Commissioner of the Revenue to certify a copy of any record to the treasurer for the purpose of correcting erroneous property tax assessments. Therefore, under a strict and literal reading of the Code of Virginia,
the Attorney General opined that a copy did not include an electronic transmission. After applying Dillon’s Rule, the locality is not allowed to exercise powers not expressly conferred by the Code of Virginia which included electronic transmission of this data. However, for the purpose of the land-use roll back taxes, the Code of Virginia does not specify how the Commissioner of the Revenue must notify the treasurer to bill and collect the taxes. Therefore, for land-use roll back taxes, electronic transmission of this data is permissible.

V. PROCEDURAL

A. 2006 Legislation

1. Judicial Appeals of Tax Assessments. HB 772 (Chapter 342) precludes circuit courts from correcting an erroneous assessment of state taxes if the error in the assessment resulted from the willful failure or refusal of the taxpayer to furnish the Tax Department with necessary information required by law. This requirement has been applicable to taxpayer appeals of local tax assessments to the circuit court for many years. Before the court can refuse to correct an erroneous assessment, it must be satisfied that the taxpayer willfully failed or refused to provide information that was necessary to compute the tax and was required by law to be furnished to the Tax Department, and that the absence of the information caused the erroneous assessment. This legislation is effective on July 1, 2006.

2. Local Use of Collection Agents. SB 302 (Chapter 372) prohibits a locality from utilizing the local sheriff, an attorney or a private collection agent to assist with collection of a delinquent local tax unless the locality has first attempted to send written notification of the delinquency to the taxpayer at the address contained in the locality’s tax records or, if the locality has reason to believe the taxpayer’s address contained in its tax records is no longer current, at such other address, if any, as the locality may obtain from sources available to it. Under current law, localities are authorized to utilize the local sheriff, an attorney or a private collection agent to assist with the collection of local taxes which remain delinquent for a period of six months or more. This legislation is effective on July 1, 2006.

3. Jeopardized By Delay Technical Correction. HB 1366 (Chapter 611) replaces the term “desires” with “designs” in the definition of the term “jeopardized by delay.” This was a Department of Taxation proposal amending a local tax definition. The Department proposed this legislation as they believed that the use of the term “desires” was unintentional. According to the Department, the original use of the term “jeopardize by delay” in Virginia state income tax law refers to situations where a taxpayer designs to do certain acts. The word “designs” requires a finding that a plan exists to commit one of the defined acts, rather than a mere thought or desire. This legislation is effective on July 1, 2006.

B. Recent Court Decisions

1. Virginia Polytechnic Institute v. Interactive Return Service, 271 Va. 304 (2006). The Circuit Court of the City of Richmond denied a motion to declare a judgment against Virginia Polytechnic Institute (“VPI”) satisfied. VPI satisfied the judgment by reducing a debt owed to VPI by Interactive Return Service (“IRS”) by the amount of the judgment pursuant to provisions in the Setoff Debt Collection Act (the “Act”), Virginia Code § 58.1-520 et
seq. The Act provides procedures for Virginia government agencies to collect on debts that it is owed by seizing other payments, such as tax refunds, made to the debtors. The procedures include steps to establish the validity of the debt and its amount, provide the debtor with due process before any funds are seized, and establish appeal and collection procedures. The circuit court refused to declare the judgment satisfied as it found that the Act applied only to tax refunds. VPI appealed the denial and the Virginia Supreme Court found that based on the plain language of the Act, and in particular Virginia Code § 58.1-535, the scope of the Act extended beyond instances where a debtor is due a tax refund. Further, as the debt owed to VPI by IRS was not in dispute, VPI was permitted to offset the judgment against the debt and the judgment should be declared satisfied.

C. Recent Virginia Tax Commissioner Rulings

1. Deadline for Filing an Administrative Appeal. P.D. 06-16 (February 6, 2006). The Tax Commissioner denied an appeal of a converted assessment as the taxpayer sent in the appeal approximately 4 months after the 90 day limitations period, under § 58.1-1821, had expired.

2. 90 Days to Appeal Assessment. P.D. 06-55 (May 31, 2006). The taxpayer appealed two assessments for additional sales tax. The appeal for the first assessment was denied as it was filed 18 months after the assessment was issued. The appeal of the second assessment was timely filed. The taxpayer also provided all requested documentation. The Tax Commissioner referred the assessment back to the audit staff and allowed the taxpayer 60 days after the audit staff's review to appeal any remaining contested issues.

3. 90 Days to Appeal Assessment. P.D. 06-78 (August 23, 2006). The taxpayer appealed an assessment of sales and use taxes after the ninety day deadline imposed by Virginia Code § 58.1-1821. The taxpayer noted that the appeal was late due to the mishandling of the assessment by the former comptroller. Nonetheless, the Tax Commissioner denied the appeal as she did not have the power to extend the deadline beyond the 90 days.

4. Protective Claim. P.D. 06-91 (September 19, 2006). The taxpayer moved from Virginia to California in 2000 and filed part-year income tax returns with Virginia and California for that year. In 2004, the taxpayer's 2000 income tax return was audited by California. The taxpayer filed a protective claim with Virginia pending the outcome of the audit. The Department requested that the taxpayer sign a waiver of the statute of limitations, but the taxpayer failed to do so. The taxpayer filed an amended return for 2000 in September 2004 requesting a refund. The amended return was not accepted. The taxpayer appealed arguing that it had a valid protective claim. The Tax Commissioner agreed and accepted the amended return.

5. Erroneous Advice by the Tax Department. P.D. 06-116 (October 16, 2006). The taxpayer requested a reconsideration of an appeal where the Tax Commissioner upheld an assessment of sales taxes. The taxpayer claimed that the error was due to erroneous advice given by the Tax Department. The Tax Commissioner denied the reconsideration as the law provides that the taxpayer is only protected when given advice by the Tax Department in writing.
D. Opinions of the Attorney General

No recent opinions of the Attorney General have been released.

VI. BUSINESS LICENSE TAXES

A. 2006 Legislation

1. Separate Rate for Fuel Distributors. SB 597 (Chapter 763) limits the amount of local BPOL taxes paid by persons engaged in the business of selling gasoline, diesel, gasohol, alternative fuels and blended fuels at retail on a daily basis to 110% of its motor fuel sales related BPOL tax liability in the license year of the increase upon meeting certain conditions. This limitation applies in the license year following any year in which the Department of Mines, Minerals and Energy determines that the weekly U.S. Retail Gasoline price (regular grade) for PADD 1C (Petroleum Administration for Defense District - Lower Atlantic Region) has increased by 20% or greater in any one-week period over the immediately preceding one-week period and does not fall below the increased rate for at least 28 consecutive days immediately following the week of such increase. This legislation is effective on July 1, 2006.

B. Recent Court Decisions

1. City of Roanoke v. Moody Graphic Color Service, Inc., City of Roanoke Circuit Court, At Law No. CL-98-279, February 8, 2006. The taxpayer, Moody, was in the business of creating and selling specialized printing services and products. A typical service performed by Moody is to take a photograph from a customer and alter and modify the photograph to the customer’s specifications. The City of Roanoke assessed Moody with BPOL taxes. However, Moody claimed it was a manufacturer and therefore exempt from BPOL taxes. Upon appeal, the Tax Commissioner agreed with Moody. Roanoke filed suit in the circuit court on the question of whether Moody was a manufacturer. The Court did not provide much of an analysis, but instead made reference to a number of the Tax Commissioner’s rulings on this subject. Ultimately, the court found that the Tax Commissioner’s rulings were consistent with Virginia law and agreed that Moody was a manufacturer.

C. Recent Virginia Tax Commissioner Rulings

1. Utility Service Company Classification. P.D. 06-8 (January 26, 2006). The taxpayer was classified as a utility service company by the county for BPOL purposes. The taxpayer is a partnership owned by two corporations licensed by the FCC as a mobile radio services provider. The taxpayer does not hold such a license. The taxpayer disputed the county’s classification and argued that it should be classified as a business services provider. The Tax Commissioner agreed with the taxpayer as it did not have any of the necessary attributes required under Virginia Code § 58.1-2600 to be classified as a utility service company. In addition, the Tax Commissioner ruled that just because the taxpayer is related to another entity that does have necessary attributes for the classification, the attributes would not pass-through as each entity is separate and distinct.
2. **Motor Fuels Tax Exclusion.** P.D. 06-11 (February 7, 2006). The Tax Commissioner issued an advisory opinion on the exclusion provided under Virginia Code § 58.1-3732(A)(1) for federal and state excise taxes on motor fuels. The Tax Commissioner advised that this exclusion is no longer applicable to retailers. In order for this exclusion to be applicable, the retailer must collect and pay the tax to the federal or state government. When this exclusion was enacted, retailers collected and remitted the excise tax. The U.S. Government changed the imposition of this tax in 2001. Beginning in 2001, the tax is collected by suppliers from retailers and the supplier pays the tax to the government. Therefore, the retailer in this case neither collects nor pays the tax to the government.

3. **Agency Relationship & Business Situs.** P.D. 06-14 (February 7, 2006). The Tax Commissioner upheld an assessment of BPOL taxes upon an appeal by the taxpayer on two issues. The first issue presented by the taxpayer was that it was in an agency relationship with another entity. The taxpayer rents trucks to consumers. The trucks are owned by another entity. The taxpayer forwards all rentals fees it receives to the owners of the trucks and the truck carriers return a commission to the taxpayer. The County assessed the taxpayer on all of the receipts, not just the commission receipts. Relying on prior rulings and an AG opinion, the Tax Commissioner ruled that the taxpayer must satisfy three requirements to be afforded an agency treatment and only subject to a tax on its commissions. The three requirements are: (1) there must be a contractual relationship between the taxpayer and both the client and the contracted third party; (2) the taxpayer cannot commingle its funds with all other sources, rather it must have a separate accounting system or a fiduciary account where the pass through receipts are recorded; and (3) the taxpayer does not report these "pass through costs" on its federal income tax return. The taxpayer provided no evidence of either the first two requirements and failed the third requirement as it reports all receipts on its federal income tax return.

The second issue was whether the rentals should be sitused in the County. The Tax Commissioner ruled that the receipts were correctly sitused in the County. The taxpayer has a definite place of business in the County where it rents out the trucks and performs other services.

4. **Department of Taxation's Ability to Limit Scope of Assessment.** P.D. 06-39 (April 6, 2006). The Taxpayer was incorrectly paying BPOL taxes for the preceding five years to the County when it should have in fact been paying them to the City. The Taxpayer obtained a refund of taxes from the County for the prior three years. Upon reporting its mistake to the City, the City assessed the taxpayer with BPOL taxes for the previous five years. The taxpayer asked the Tax Commissioner to limit the scope of the City's assessment to the preceding three years. The Tax Commissioner denied this request citing the Commissioner of Revenue's sole authority to accept offers in compromise.

5. **Pass-Through Costs of Customers.** P.D. 06-94 (September 28, 2006). The taxpayer is a customs broker and pays customs fees on behalf of its customers on their shipments. The fees are reimbursed in full by the customer. The taxpayer's BPOL return was audited and the taxpayer was assessed additional tax based on the receipts from customers for the customs fees. The taxpayer argued that it is merely a pass-through for the fees and he should not have to pay tax on the fees. The pass through of costs is a permitted deduction for BPOL purposes. However, three tests must be met for the deduction to be allowed. First, the pass-
through must be a part of a contractual obligation between the taxpayer, customer, and third party. Second, the funds must not be commingled with other funds. Third, the taxpayer may not deduct the fees on its federal income tax return. After a review, the Tax Commissioner found that the funds were commingled with other funds and the taxpayer deducted the fees on its federal income tax returns. Based on these findings, the taxpayer’s appeal was denied.

6. **Definite Place of Business.** P.D. 06-97 (September 29, 2006). The taxpayer is a fuel supplier who sells fuel through a third-party terminal in Virginia. The taxpayer does not own or lease any property at the terminal. By contract with the taxpayer, the owner is compensated by the taxpayer through a fee based on the number of gallons served and by a fee for additives added by the owner to the fuel. The locality assessed the taxpayer with BPOL tax claiming the taxpayer had a definite place of business at the terminal. The Tax Commissioner examined the facts in light of the definition of “definite place of business” in the Virginia Code and determined that the taxpayer did not have a definite place of business at the terminal. This determination was based on the facts that have an office, a phone number, a mailing address, or employees at the terminal as well as not maintaining any records at the terminal.

D. **Opinions of the Attorney General**

1. **Providing Local Business Licenses to Applicants who are not Legally Present in the United States.** Opinion Number 06-040 (July 24, 2006). The Commissioner of the Revenue of Campbell County asked whether a Commissioner of the Revenue is required to issue a local business license to an applicant who is not legally present in the United States. The Attorney General opined that applicable federal and state laws prohibit the granting of a license to such a person. Further, a commissioner must verify the identity and eligibility of all business license applicants by examining documents specified by federal law, including United States passports, resident alien cards, alien registration cards, or other documents designated by the Attorney General of the United States to determine legal status. However, if a business license applicant holds a permanent resident card, a commissioner may issue a business license to the applicant. Finally, a commissioner is required to determine an applicant’s residency status as part of the business license application process.

VII. **MISCELLANEOUS TAXES**

A. **2006 Legislation**

1. **Estate Tax Repeal.** HB 5019 (Special Session I Chapter 4) and SB 5019 (Special Session I Chapter 5) remove language from the Virginia estate tax that ties the tax to the amount of the federal state death tax credit as it existed on January 1, 1978. As the federal state death tax credit no longer exists in the federal estate tax, this legislation effectively repeals the Virginia estate tax. However, the federal legislation that eliminated the state death tax credit is currently set to expire in 2011. If the federal legislation is not extended or made permanent, the Virginia estate tax will come back into effect in 2011.

2. **Pollution Control Equipment Exemption.** Senate Bill 417 (Chapter 375) provides that certified pollution control equipment and facilities used in collecting, processing, and distributing or generating electricity from landfill gas or synthetic or natural gas recovered
from waste, including equipment used to grind, chip, or mulch trees, tree stumps, underbrush, and other vegetative cover for reuse as landfill gas or synthetic or natural gas recovered from waste would be exempt from state and local tax taxation if placed in service on or after July 1, 2006. This legislation is effective on July 1, 2006.

3. Cap on Penalty for Failure to Pay Local Taxes. HB 1283 (Chapter 459) provides that no local tax penalty for failure to pay a tax may exceed the amount of the tax assessable. Under current law, the only local tax penalty that may exceed the amount of the tax is the minimum ten dollar penalty. This legislation is effective on July 1, 2006.

4. Deduction of Bad Debts from Cigarette Taxes Owed. HB 612 (Chapter 64) and SB 418 (Chapter 229) allow a stamping agent to claim a bad debt deduction against the cigarette tax in situations where a customer has failed to pay for stamped cigarettes. The amount of the deduction is the cost of the stamps affixed to the cigarettes. If the bad debt is subsequently paid, in part or full, the stamping agent is required to repay the amount of taxes deducted in connection with that portion of the debt for which payment is received. This legislation is effective on July 1, 2006.

5. Failure to Properly Affix Cigarette Tax Stamps. HB 569 (Chapter 409) increases from $250 per pack to $500 per pack the penalty for failure to affix tax stamps to cigarettes when the number of packs of cigarettes exceeds 100 packs. This legislation also provides that it is prima facie evidence of intent to defraud the Commonwealth when the number of unstamped cigarettes exceeds either 30 packs or 5 percent of the cigarettes in the place of business, whichever is greater.

This statute also establishes a monetary penalty of $2,500 per pack for selling, purchasing, transporting, receiving or possessing 3,000 or more unstamped packages of cigarettes for the purpose of evading the cigarette tax. Additionally, this legislation creates a safe harbor from the penalty for selling, purchasing, transporting, receiving or possessing unstamped cigarettes for a retail dealer who has lawfully purchased the cigarettes from the holder of a stamping agent permit issued by the Department of Taxation. This legislation is effective on July 1, 2006.

6. Classification of Roll-Your-Own Tobacco. SB 729 (Chapter 768) subjects roll-your-own tobacco to the state cigarette excise tax instead of the tobacco products tax. The cigarette tax on roll-your-own tobacco, however, would be imposed at the rate of 10% of the manufacturer's sale price and the tax would be administered much like the tobacco products tax. This is a transparent change for purposes of taxation. The purpose of this bill is to include roll-your-own tobacco in the calculations of escrow deposits required to be made by nonparticipating manufacturers in the Master Settlement Agreement. This legislation is effective on January 1, 2007.

7. Tobacco Manufacturer Reports to the Attorney General. HB 1277 (Chapter 31) requires that (1) the annual certification required of cigarette manufacturers regarding their status as participating or nonparticipating manufacturers under the Master Settlement Agreement and (2) the quarterly report required of cigarette stamping agents listing
the cigarettes they have stamped are filed with the Office of the Attorney General rather than the Department of Taxation. This legislation is effective on July 1, 2006.

8. **Personal Property Tax Classification of Business Use Watercraft.** HB 327 (Chapter 400) provides for additional separate property tax classifications of boats and watercraft (1) weighing five tons or more and not used solely for business purposes; (2) weighing less than five tons and not used solely for business purposes; and (3) weighing five tons or more and used solely for business purposes. This legislation is effective on July 1, 2006.

9. **Personal Property Tax Classification of Certain Aircraft.** HB 862 (Chapter 200) and Senate Bill 521 (Chapter 231) create a separate classification for local property tax purposes for aircraft having a gross empty weight equal to or greater than 20,000 pounds and that are not owned and operated by a scheduled air carriers recognized under federal law. This legislation contains an emergency clause and is effective from its adoption on March 24, 2006, retroactive to January 1, 2006.

10. **Personal Property Tax Rate for Generating Equipment.** SB 404 (Chapter 517) provides that generating equipment reported to the Commission by electric suppliers utilizing wind turbines may be taxed by the locality at a rate that exceeds the real estate rate, but that does not exceed the general class of personal property tax rate applicable in the respective localities. This legislation is effective on January 1, 2007.

11. **Transient Occupancy Tax Restriction.** SB 86 (Chapter 216) prohibits the imposition of a city or town’s transient occupancy tax on the charge for rooms or space rented for meetings, conferences, and purposes other than sleeping, dwelling or lodging. This restriction already exists for transient occupancy taxes imposed by counties. This legislation is effective on July 1, 2006.

**B. Recent Court Decisions**

There were no recent court decisions.

**C. Recent Virginia Tax Commissioner Rulings**

1. **Recordation Tax Exemption for Refinancing.** P.D. 06-3 (January 6, 2006). The Tax Commissioner held that when a taxpayer refinances an existing home mortgage with a lender other than the lender on the current mortgage, the recordation of the new mortgage is subject to the recordation tax and not eligible for the exemption under Virginia Code § 58.1-803(D). The exemption under Virginia Code § 58.1-803(D) requires that the refinancing must be with same lender of the existing debt. This is consistent with 1992 Attorney General Ann. Rep.181.

2. **M&T Fair Market Value.** P.D. 06-9 (January 27, 2006). The Tax Commissioner denied the taxpayer’s appeal from an assessment of the Machinery and Tools tax. When filing its M&T return with the county, the taxpayer reduced the value of its machinery by 50% based on its contention that the equipment no longer had value despite the fact that it was
still in use. The County assessed the taxpayer based on the reduced value. On its appeal to the Tax Commissioner, the taxpayer did not demonstrate that the equipment was assessed at greater than its fair market value.

3. Telecommunications Tax and Pass-Through Entities. P.D. 06-10 (February 6, 2006). The Tax Commissioner denied an appeal from a taxpayer, an S corporation, in which the taxpayer argued that it was not subject to the telecommunications tax. The basis for this argument is that the telecommunications tax applies as a minimum tax when the telecommunications tax exceeds the corporate income tax of the taxpayer, to which this taxpayer is not subject to. However, the Tax Commissioner correctly noted that the taxpayer is a telecommunications company and its receipts are certified by the SCC. Further, 23 VAC 10-120-89(A) provides authority for pass-through entities to calculate their pro-forma corporate income tax and pay the difference if the telecommunications tax exceeds the pro-forma corporate income tax.

4. Fiduciary Income Tax. P.D. 06-18 (February 7, 2006). The taxpayer requested a ruling as to whether it was subject to the Virginia fiduciary income tax. The taxpayer is a nonresident trust with limited partnership interests in various partnerships and LLCs that invest in commercial real estate and tangible personal property in Virginia. A portion of the trust’s income is reported federally as unrelated business taxable income (“UBTI”). The Tax Commissioner ruled that the trust’s UBTI is subject to the fiduciary income tax.

5. Sale of Whole Leaf Tobacco. P.D. 06-48 (April 11, 2006). The taxpayer requested a ruling on the tax consequences in Virginia of selling whole leaf tobacco and equipment used to process the tobacco into consumable tobacco. The Tax Commissioner ruled that whole leaf tobacco that has not been stemmed, cut or otherwise processed is not a tobacco product subject to the Virginia Tobacco Products Tax nor is it a cigarette subject to the cigarette tax. The sale of equipment to process the tobacco would be subject to the sales and use tax, but not to any tobacco tax.

6. Manufacturers & Business Tangible Personal Property. P.D. 06-51 (April 24, 2006). The taxpayer appealed a local assessment of business tangible personal property taxes to the Tax Commissioner. The taxpayer is a manufacturer of lumber products. The taxpayer sells its products on the wholesale market, but also sells complementary products that it does not manufacture. The locality assessed the taxpayer on the basis that it is both a manufacturer and a wholesaler and assessed the property used in its sales office which is separate from its manufacturing facility. The Tax Commissioner ruled that the assessment was incorrect as 75% of its business is manufacturing and the ancillary wholesale business does not change its character as a manufacturer.

7. Bank Franchise Tax: Deduction for Goodwill. P.D. 06-68 (August 18, 2006). The taxpayer purchased the stock of two banks prior to July 1, 2001. The purchase was made at a value that exceeded the assets of the purchased banks. This excess in value was recorded as goodwill in the method chosen by the taxpayer. The goodwill was subsequently deducted in determining the bank’s bank franchise tax liability. The auditor disallowed these deductions and assessed additional bank franchise tax. The taxpayer appealed the assessment based on the contention that disallowing the deduction led to the over-valuation of Virginia capital upon which the tax is imposed. The General Assembly enacted a deduction for goodwill.
created by mergers that occurred on or after July 1, 2001. The Tax Commissioner upheld the assessment as the Code of Virginia does not permit a deduction for mergers that occurred prior to July 1, 2001 and because the taxpayer knew the implication of the merger when it chose the method to account for the purchase of the assets of the two banks.

8. **Bank Franchise Tax: Deduction for Earnings & Surplus.** P.D. 06-69 (August 18, 2006). The taxpayer appealed the denial of a deduction for an additional pro rata share of its subsidiaries’ surplus to the extent that the surplus was not directly traceable to an increase in the taxpayer’s gross capital. A deduction is allowed for retained earnings and surplus of subsidiaries to the extent included in gross capital, but only to the extent that it represents the undistributed earnings of the subsidiaries from the time when the subsidiaries were owned by the bank. The taxpayer argued that the deduction should be allowed to the extent that the surplus was not directly traceable to the increase in gross capital. However, because the statute permits a deduction for the surplus included in the call report, there was no need for a deduction.

9. **Cotton Tax: Increase in Tax.** P.D. 06-70; Tax Bulletin 06-5 (August 17, 2006). Upon a vote by cotton producers and approval by the Cotton Board, the cotton excise tax is increased from $0.10 to $0.95 per bale effective September 1, 2006.

10. **Recordation Tax: Determination of Fair Market Value.** P.D. 06-77 (August 23, 2006). The taxpayer appealed an assessment of recordation taxes upon the recording of a credit line deed of trust. The taxpayer argued that credit line exceeded the fair market value of the property securing the credit line and the tax should only be imposed on the fair market value. The Tax Commissioner ruled that the tax is imposed on the amount secured by the property. Therefore, if the fair market value of the property is less than the credit line, the tax is only imposed on the fair market value of the property. The Tax Commissioner asked the Clerk to make a factual determination on the fair market value of the property and to inform the Department of such value whereupon a refund will be made, if necessary.

11. **Business Tangible Personal Property: Definition of a Manufacturer.** P.D. 06-79 (August 23, 2006). The taxpayer produces and sells educational audio-visual materials in multiple formats: books, audio cassettes, CDs, VHS tapes, and DVDs. The books, cassettes, and VHS tapes are produced in-house while the manufacturing of everything else is outsourced. The County determined that the taxpayer was not a manufacturer based on a prior ruling of the Tax Commissioner (P.D. 97-362). This ruling was based on the SIC system in place in 1997 for classifying businesses. At the time, replication of video materials was not considered manufacturing. Since then, the SIC has been replaced with the NAICS system which does classify the replication of video materials as manufacturing. In addition, the Tax Commissioner determined that the transformation of blank media into media with content is manufacturing. This was based on the three elements of manufacturing enunciated in **Prentice v. City of Richmond**, 197 Va. 724, 90 S.E.2d 839 (1956) which are (1) original material, referred to as raw material; (2) a process whereby the original material is changed; and (3) a resulting product, which by reason of being subject to such processing is different from the original material. However, because of other non-manufacturing activities the taxpayer conducts, the Tax Commissioner could not make a determination on whether the taxpayer passes the substantiality
test from *BBC Brown Boveri*. Therefore, the Tax Commissioner sent this appeal back to the county to make a determination if the taxpayer is substantially a manufacturer.

12. **Machinery and Tools Tax: Microbrewery Equipment.** P.D. 06-106 (October 5, 2006). The taxpayer appealed an assessment of machinery and tools tax on microbrewery equipment. The taxpayer argued that the equipment was part of the real property and therefore not subject to the tax. The Tax Commissioner found the equipment was not part of the real property and upheld the assessment. The equipment was only attached to the property by wires and duct work, was not essential to the operation of a restaurant and could be removed without damaging the property, and not intended to become a permanent part of the restaurant as demonstrated under the lease.

D. **Opinions of the Attorney General**

1. **Taxation of Car Dealer Inventory.** Opinion Number 06-036 (August 11, 2006). The Commissioner of Revenue for Prince Edward County asked whether a commissioner of the revenue may tax cars at the personal property tax rate rather than the capital merchants' tax rate when a car dealer moves the cars off the dealership site to avoid merchants' tax and relocates the cars titled to the dealership to private property. The Attorney General opined that the vehicles must be taxed at the merchants’ capital rate. This opinion was based on definitions provided by the Code of Virginia. Merchants’ capital is specifically excluded from the definition of tangible personal property in Virginia Code § 58.1-3500. Virginia Code § 58.1-3510 defines merchants’ capital to include inventory of stock on hand. While there is no statutory definition of inventory of stock on hand, the Attorney General found its plain meaning to be goods and materials kept on hand by a commercial establishment for sale. Therefore, as the vehicles are merchandise available for sale no matter where they are located, they must be merchants’ capital and cannot be taxed as tangible personal property.