2005

Hot Topics in Virginia Taxation: The Present and the Future?

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HOT TOPICS IN VIRGINIA TAXATION

The Present and the Future?

A discussion of 2005 tax legislation, recent court decisions, tax department rulings, and opinions of the Attorney General from January 1, 2005 through September 30, 2005
I. CORPORATE INCOME TAX

A. 2005 Legislation

1. Fixed Date Conformity. H.B. 2411 (Chapter 5) and S.B. 856 (Chapter 26) amends Virginia Code § 58.1-301(B) to conform the State Tax Code with the federal Internal Revenue Code as it existed on January 7, 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 provisions of Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, which liberalizes the rules for claiming dependency exemptions, extends the enhanced deduction for certain computer contributions, and continues certain deductions for teacher classroom expenses and clean fuel vehicles; (2) the American Jobs Creation Act of 2004, Pub. L. No. 108-357, which creates I.R.C. §199 (deduction for domestic manufacturing and production), increases I.R.C. §179 expensing, and allows taxpayers to deduct state and local sales taxes in lieu of state income tax in 2004 and 2005; and (3) allows taxpayers to deduct in 2004 charitable contributions made in January 2005 for the relief of victims in areas affected by the December 26, 2004, Indian Ocean tsunami (Pub. L. No. 109-001). The conformity law is retroactive to January 1, 2005. For additional guidance See Virginia Tax Bulletin 05-1 (March 7, 2005).

2. Tax Credit for Conservation Tillage Equipment. H.B. 1655 (Chapter 58) amended Virginia Code §§ 58.1-334 and 58.1-432 to expand the definition of "conservation tillage equipment" and increase the maximum amount of the credit from $2,500 to $4,000. Under this legislation, individuals and corporations can claim an income tax credit equal to 25% of all expenditures for the purchase and installation of certain conservation tillage equipment up to a maximum of $4,000 or the taxpayer's liability, whichever is less. Conservation tillage equipment is now defined to mean a planter, drill or any other equipment used to reduce soil compaction including guidance systems to control traffic patterns that are designed to minimize disturbance of the soil in planting crops. Effective January 1, 2005.

3. Enterprise Zone Grant Program. H.B. 2570 (Chapter 884) and S.B. 983 (Chapter 863) amend a number of provisions of the Enterprise Zone program and creates the Enterprise Zone Grant Act (Va. Code §§ 59.1-530, et. seq.). The legislation establishes new processes and procedures for providing grants relative to enterprise zones. The legislation becomes effective July 1, 2005, while the current enterprise zone act expires on July 1, 2005.

B. Recent Court Decisions

No recent court decisions.
C. Recent Virginia Tax Commissioner Rulings

1. Intangible Holding Company ("IHC") Lacked Economic Substance. P.D. 05-28 (March 7, 2005). Tax Commissioner held that an out-of-state intangible holding company that made loans to its Virginia parent corporation and charged the parent interest on the loans, lacked economic substance for Virginia corporate income tax purposes. Tax Department, relying upon Va. Code § 58.1-446, combined the incomes of the IHC and the parent corporation for purposes of determining the parent company's taxable income.

The taxpayer contested the Department's adjustment, asserting that (1) the IHC had no nexus with Virginia, (2) the transactions between the taxpayer and the IHC were at arm's length rates, and (3) Virginia lacked authority to adjust the taxpayer's federal taxable income. The Tax Commissioner ruled the Department is authorized to equitably adjust a corporation's tax due if it finds that any arrangements exist in such a manner as to improperly reflect the business done or the Virginia taxable income earned from business done in Virginia. Generally, the Department will exercise its authority to equitably adjust tax if it finds that a transaction, or a party to a transaction, lacks economic substance or transactions between the parties are not at arm's length. Under this general equitable authority, the Department may determine that an affiliate's income be deemed Virginia income even if the affiliate does not have nexus with Virginia.

IHC Lacked Economic Substance

The IHC was not a separate and distinct business entity with its own economic substance. The IHC had no office expenses, office assets, or payroll for staff. Further, all the directors of the IHC were officers of the taxpayer and employed primarily in Virginia. Although the IHC reported other deductions on its federal income tax return for the taxable years at issue, it failed to provide documentation as to the nature of these deductions. Also, the IHC made a substantial charitable contribution to a nonprofit foundation established by the taxpayer and located in Virginia.

Loan Not Conducted at Arm's Length

The taxpayer also failed to demonstrate that the loans made by the IHC to the parent corporation were made in an arm's length transaction. Rather, the evidence indicated that the taxpayer made several large contributions to the IHC's capital in prior tax years by transferring assets to the IHC in a tax-free transaction. If the taxpayer had been dealing with an unrelated third party, it would not transfer assets without consideration, and then agree to pay interest for the use of funds generated by these same assets. Had the assets been transferred to an unrelated third party for their fair market value, the gain realized by the taxpayer would have been subject to tax by Virginia. In addition, because the IHC was a wholly-owned subsidiary, the taxpayer never lost the ability to control the subject assets, the rate or terms of the loan agreements, or the unrestricted use of the assets.
Start-Up Corporation Had Nexus with Virginia

In an unrelated transaction, the taxpayer was allowed to deduct the expenses associated with starting up a new corporation to undertake a business venture that was terminated before it began any business activities. A Department auditor denied the deduction on the basis that the new corporation lacked nexus with Virginia because it lacked a positive apportionment factor. However, the corporation had nexus with Virginia because it was incorporated and domiciled in Virginia and never conducted business outside the state. Therefore the issue of apportionment was irrelevant.

2. **Royalties Paid to IHC Disallowed.** P.D. 05-29 (March 2, 2005). Royalties paid and interest paid on late royalty payments to an affiliated intangible property holding company (IHC) were disallowed for Virginia corporate income tax purposes. The Virginia Department of Taxation determined that the licensing agreement between the IHC and the taxpayer constituted an arrangement that improperly reflected business done in Virginia.

**Department's Authority to Equitably Adjust Tax**

Under Virginia law, the Department has the authority to equitably adjust a corporation’s tax if two or more commonly owned corporations’ structure an arrangement in such a manner as to reflect improperly, inaccurately, or incorrectly the business done in Virginia or the Virginia taxable income. Generally, the Department will exercise its authority if it finds that a transaction, or a party to a transaction, lacks economic substance or transactions between the parties are not at arm’s length. The taxpayer contended that the Department’s authority to equitably adjust tax (1) only applied to tangible goods and not to intercompany trademark and loan transactions, (2) was not proper in the instant case because the IHC had sufficient economic substance and a business purpose, and that (3) consolidation of income rather than expense reattribution was the only proper statutory remedy.

The Department’s authority extended to transactions involving intangible property. Although the first part of the statute governing the Department’s equitable adjustment authority relates to products, goods, and commodities, the second part of the statute grants the authority to the Department if any arrangements exist in such a manner as improperly to reflect business done in Virginia or the Virginia taxable income earned from business done in Virginia. Furthermore, in *Commonwealth v. General Electric Company*, 236 Va. 54 (1988), the Virginia Supreme Court upheld the Department’s authority to equitably adjust tax in a case that involved neither goods nor services.
No Economic Substance

The IHC did not have sufficient economic substance even though the taxpayer demonstrated that the IHC had its own employees, office space, and books and records. The Virginia Tax Commissioner held that the IHC did not operate as a discrete, separate business enterprise. This conclusion was based on the fact that:

- all of the IHC’s officers and directors were employees of either the taxpayer or the taxpayer’s affiliates, and none of the officers or directors were compensated for their services;
- all of the IHC’s activities related to protecting its trademarks occurred outside the taxable years at issue;
- the IHC failed to produce any evidence that it conducted any activities related to maintaining the trademarks’ quality;
- the IHC failed to prove that it was capable of conducting inspections of the taxpayer’s operations and use of the trademarks or that it had ever attempted to do so; and
- the IHC failed to provide legends or guidelines to the taxpayer concerning the use of the trademarks.

The fact that the license agreement provided the authority for the IHC to perform these duties was insufficient to establish that it was indeed a separate and distinct business entity.

Failure to Establish Arm’s Length Transaction

Finally, the taxpayer failed to demonstrate that the terms of the licensing agreement were established in an arm’s-length transaction. The amount of the royalty fees paid exceeded the amount of the reasonable royalty fees determined in the taxpayer’s own study. Further, the taxpayer accrued and paid interest on the royalties payable to the IHC even though the license agreement did not provide for any interest to be charged for unpaid royalties.

3. Consolidated Return Filing Denied. P.D. 05-30 (March 10, 2005). A group of affiliated corporations that initially filed on a separate company basis for Virginia corporate income tax purposes was not allowed to file consolidated returns for the tax years at issue. In addition, the Virginia Department of Taxation correctly denied the taxpayers’ requests to have their accounts consolidated with their common parent corporation and affiliated corporations and to have interest expense incurred by the parent corporation allocated among the taxpayers.
Consolidated Returns

Under Virginia law, taxpayers must make an election in their first taxable year to file on a single company, combined, or consolidated basis. Once the election is made, the filing method may only be changed upon request to the Department. The taxpayers failed to request the Department’s permission for a change in filing methods. To allow the taxpayers to file on a consolidated basis would effectively grant retroactive permission to change filing methods.

The Department does not generally grant permission to change to or from the consolidated filing method, because such a change would affect the allocation and apportionment factors and possibly distort the reporting of the business done in Virginia. In the instant case, when the taxpayers switched to a consolidated return basis they included out-of-state affiliates in the return that did not have nexus with Virginia, which impacted the allocation and apportionment factors.

The taxpayers contended that reporting on a separate company basis distorted Virginia income because it did not allow for the allocation of expenses associated with the parent corporation’s performance of services on behalf of the taxpayers. However, this was not due to the taxpayer’s election to file separate returns but was because of the inability of the controlled group to allocate those expenses in the manner permitted under the Internal Revenue Code. In addition, difficulty allocating expenses among related corporations did not constitute an extraordinary circumstance sufficient to warrant granting permission to change to filing on a consolidated basis.

Consolidation of Accounts

The taxpayers’ request to have the Department consolidate the taxpayers’ accounts with the parent corporation’s and other members of the federal consolidated group’s accounts was also denied. Consolidation of accounts is available only to businesses that are subject to Virginia income tax. However, several members of the taxpayers’ federal consolidated group had insufficient business activity to be subject to Virginia income taxation. Further, the taxpayers failed to provide any evidence to show that consolidation was necessary to reflect Virginia taxable income accurately, other than to state their unitary relationship to entities that were not subject to Virginia income tax. To grant the request under such circumstances would circumvent the Department’s long-standing policy regarding the corporate filing status election and the circumstances in which permission to change status is allowed.

The taxpayers also failed to follow the regulatory procedures that require taxpayers requesting a consolidation of accounts to (1) file returns using their elected method and amended returns using the proposed consolidation and (2) attach an explanation how and why the Virginia income is distorted and why consolidation of accounts is necessary.
Interest Expense Allocation

Finally, the taxpayers’ request that interest incurred by their common parent corporation be allocated to the taxpayers was also denied. As part of its operations, the parent corporation provided administration, oversight, and almost all of the financing for its subsidiaries. As a result of this arrangement, the parent corporation had a large interest deduction, but little income to offset the deduction. The Department has the equitable authority to adjust tax if it is demonstrated that an arrangement between two or more commonly controlled corporations results in the distortion of Virginia taxable income. However, the allocation process used by the parent corporation to allocate interest expense to its various affiliates did not accurately reflect interest being charged to the affiliates as the result of debt directly benefiting the taxpayers.

4. **Sales Factor: Sales Less Customer Rebates.** P.D. 05-54 (April 11, 2005). Tax Commissioner upheld audit adjustment that excluded customer rebates taxpayer provided customers when computing the denominator of the Virginia sales factor. See 23 VAC 10-120-20 (returns and allowances excluded to the extent they are included in federal taxable income). Taxpayer used total sales in both numerator and denominator of the sales factor.

5. **Financial Corporation Apportionment and Nexus.** P.D. 05-61 (April 18, 2005). The Department released Tax Bulletin 05-3 to advise that the Tax Department will not change its interpretation of nexus standards until it has fully implemented policy changes attributable to the Virginia Supreme Court decision in *General Motors Corporation v. Commonwealth of Virginia*, 268 Va. 289 (2004). The Department is reviewing its policies relating to financial corporation apportionment. Regulatory amendment and/or legislation is likely.

Until the Department of Taxation can develop and implement policies that fully address the issues raised by the *GM Decision*, the Department will apply the following principles to financial corporations:

- At the election of the Taxpayer, the Department will continue to accept returns prepared in accordance with 23 VAC 10-120-250, i.e., excluding costs of performance of independent contractors. The Department will not seek to retroactively impose any new policies developed in response to the *GM Decision* on returns filed in reliance upon 23 VAC 10-120-250.

- Pending adoption of policies in response to the *GM Decision*, the Department will not use the Court’s interpretation of § 58.1-418 to assert that nexus exists solely because of services performed in Virginia by an independent contractor, or the existence of an office of the independent contractor in Virginia.
Financial corporations that choose to rely on the *GM Decision* to ignore 23 VAC 10-120-250 and include costs attributable to independent contractors in their Virginia apportionment factor must disclose the criteria used to determine the location of such costs. The Department may make audit adjustments to such costs if the final policies adopted in response to the *GM Decision* are retroactive.

6. **Exclusion of Certain Miscellaneous Income from the Sales Factor.** P.D. 05-72 (May 6, 2005). The taxpayer appealed an assessment where the auditor removed miscellaneous income from the denominator of the sales factor but not the numerator. The Tax Commissioner agreed that income removed from the denominator should also be removed from the numerator. The Commissioner sent this case back to the auditor to take a second look at the character of the disputed income and to make the appropriate adjustments.

7. **Changing filing methods without seeking permission.** P.D. 05-80 (June 1, 2005). The taxpayer was assessed additional tax based on the separate filing method. The taxpayer and affiliates originally began filing separately in Virginia before changing their filing method to consolidated without requesting or receiving permission from the Tax Commissioner. The Tax Commissioner upheld the assessments based on the separate reporting and denied the taxpayer’s present request to begin filing on a consolidated basis. In addition, the Tax Commissioner rejected the taxpayer’s requests to consolidate the accounts of the various affiliates as the taxpayer did not take the proper steps for such a consolidation under the regulations and the taxpayer failed to show that such a consolidation would prevent a distortion of income.

8. **Corporation with No Property or Payroll has Nexus with Virginia.** P.D. 05-90 (June 9, 2005). A corporation with no property or payroll and no definite place of business but had officers in Virginia who performed the administrative functions from Virginia is subject to the Virginia corporate income tax. In addition, as the corporation is not subject to any other state’s income tax, all of the corporation’s income would be apportioned 100% to Virginia. Finally, this corporation should have been included in the combined Virginia corporate income tax filing with its affiliates. Therefore, the corporation should at least file amended returns for the three taxable years for which the statute of limitation has not expired.

9. **No Supporting Information on Intangible Holding Company.** P.D. 05-100 (June 28, 2005). The Tax Commissioner upheld an assessment combining the corporation’s income with the income of a wholly owned subsidiary. The subsidiary was an intangible holding company to which the corporation paid royalties for the use of certain intangible property. The subsidiary did not have any employees or a physical place of business. On a request for more information regarding the subsidiary, the corporation did not respond. Due to lack of response, the Tax Commissioner upheld the assessment.
10. **Taxpayer Failed To Provide Information.** P.D. 05-103 (July 1, 2005). The taxpayer originally filed a combined return with numerous affiliates. The auditor removed five of the affiliates due to lack of nexus. The five affiliates had neither any property nor any payroll within Virginia. It was the auditor’s judgment that these five affiliates presence in the return improperly reflected Virginia income by diluting the apportionment factors. The taxpayer protested this adjustment. The taxpayer failed to provide requested additional information in response to the protest. The assessment was therefore upheld.

11. **Land Preservation Tax Credits.** P.D. 05-125 (July 26, 2005). The Tax Commissioner ruled that a non-profit organization could earn land preservation tax credits subsequent to a qualified donation so long as it qualifies as a taxpayer (i.e., pays any tax imposed by the Commonwealth) and is itself not qualified to hold a conservation easement. Further, the organization may sell or transfer the credits to any entity who actually may use the credits.

12. **Website Nexus.** P.D. 05-128 (August 2, 2005). The taxpayer has no connection to Virginia other than it has placed a link on a website that is housed on a server in Virginia. The taxpayer requested from the Tax Commissioner a ruling on whether this would constitute nexus in Virginia. To avoid saying that the presence of intangible property in Virginia does not constitute nexus alone, the Tax Commissioner created a convoluted argument using P.L. 86-272 to find that the link on a website did not create nexus.

13. **Taxing Out-of-State Intangible Holding Companies.** P.D. 05-139 (August 23, 2005). Tax Commissioner held that out-of-state holding companies that held intangible property, held mortgages, and made loans to its Virginia parent corporation lacked economic substance for Virginia corporate income tax purposes. The Tax Department, relying upon Va. Code § 58.1-446, combined the incomes of the holding companies and the parent corporation for purposes of determining the parent company’s taxable income.

The taxpayer established three different holding companies (the HC") for holding intangible property (the “IHC”), holding all mortgages (the “MHC”), and loaning capital to the parent (the “NHC”). For discussion of the Department of Taxation’s authority to equitably adjust tax, see items #1 and #2 above.

The Tax Commissioner held that the holding companies had no economic substance as:

- Each HC had three members of the Board of Directors that were also employees of the parent who were not fairly compensated for their services;
- Each HC incurred minimal expenses for payroll, rent, and communications;
- Each HC incurred legal fees, however no documentation was provided concerning the nature of the fees;
- Anyone wishing to use a trademark contacted the taxpayer rather than the IHC;
• While each HC used fair market rates with the taxpayer, the transactions were not arms length as each HC was 100% owned by the taxpayer and the agreements could be changed by the taxpayer at any time.

Finally, the taxpayer argued that instead of combining income, the Tax Commissioner should adjust the rates in the transactions between the affiliates. The Commissioner noted that there was no statutory authority for such an adjustment.

14. Taxpayer is not a Financial Corporation. P.D. 05-149 (September 8, 2005). The taxpayer requested a redetermination of P.D. 04-167 in which the Tax Commissioner ruled that the taxpayer was not a financial corporation. The Tax Commissioner upheld his prior ruling and noted that the taxpayer does not qualify as a financial corporation as it earns over 70% of its income from nonrecourse factoring and bad debt recovery and not recourse factoring and interest which would be required to attain financial corporation status.

15. Department will no Longer Assess the Large Corporate Underpayment Interest Rate. P.D. 05-154, Tax Bulletin 05-10 (September 23, 2005). Pursuant to the decision of the Circuit Court of Fairfax County in General Motors Corporation v. Commonwealth of Virginia, the Department is no longer applying the large corporate underpayment rate. The large corporate underpayment rate was the interest rate for all other underpayments plus a 2% premium.

II. INDIVIDUAL INCOME TAX

A. 2005 Legislation

1. Personal Exemption Increase. H.B. 1833 (Chapter 67) amended Virginia Code § 58.1-322(D)(2)(a) to change the effective date from January 1, 2006 to January 1, 2005, for the increase in the personal exemption from $800 to $900.

2. Salary Subtraction. S.B. 866 (Chapter 27) amended Virginia Code § 58.1-322(c)(24) to clarify that the individual income tax subtraction for federal and state employees is only available to employees with a total annual salary from all employment of $15,000 or less for the taxable year. The legislation is effective for tax years beginning on or after January 1, 2005.

3. Land Preservation Tax Credit. S.B. 1139 amended the Virginia Land Conservation Incentives Act of 1999 (Va. Code § 58-510, et. seq.) to require the fair market value of qualified donations to be substantiated by a qualified appraisal, which must be signed by a qualified appraiser, and a copy of the appraisal must be submitted to the Department of Taxation. A false or fraudulent appraisal may lead to revocation of the appraiser's license or other disciplinary action, and future appraisals by the same appraiser may be disallowed. The Tax Department may also disregard an appraisal in its entirety if the appraisal is determined to be false or fraudulent.
S.B. 1139 also included a provision, for purposes of the credit, to reduce the fair market value of the qualified donation by the amount of gain that would not be long term gain if the property was instead sold at its fair market value. Basically, for purposes of this credit, this provision reduces the value of an easement on property held less than a year to the value of the basis allocable to the easement.

4. **Neighborhood Assistance Tax Credits.** H.B. 2041 (Chapter 82) amended Virginia Code § 63.2-2006(B) to increase the maximum tax credit that individuals may receive from $750 to $50,000. The Neighborhood Assistance Act grants a tax credit to business and individuals who contribute to approved neighborhood assistance organizations designed to benefit impoverished individuals. The credit can be applied against the income tax on individuals, trusts, estates, and corporations; the bank franchise tax; and the gross receipts tax imposed on insurance and public service corporations. Taxpayers are permitted a tax credit equal to 45% of qualified monetary donations. The legislation raises the amount of a taxpayer's donation that could qualify for the credit from $1,667 to $111,111. However, the practical result of this legislation, on a state fiscal basis, remains the same as only $8 million per year of maximum credits may be authorized.

5. **Rent Reduction Tax Credit Extended.** H.B. 2444 (Chapter 414) amended Virginia Code § 58.1-339.9 to extend the availability of the rent reductions tax credit until December 31, 2010. The legislation also limits the reduced rents that qualify for the credit between January 1, 2006 and January 1, 2011, to those charged by an individual or corporation that validly claimed the credit for a dwelling unit for all or part of December 1999, and that rents the dwelling unit to the same tenant that occupied such unit on December 31, 2005. The tax credit is available to landlords engaged in the business of renting dwelling units and subject to the Virginia Residential Landlord and Tenant Act. If the landlord provides rent reductions to low-income elderly, disabled or previously homeless tenants and the rent charged is at least 15% less than market value, a credit equal to 50% of the rental reductions is allowed to the landlord.

6. **Extension for Filing Income Tax Returns.** H.B. 2325 (Chapter 100) amends Virginia Code §§ 58.1-344, 58.1-393.1, and 58.1-453 to allow taxpayers to request an extension of six months after the original due date for filing income tax returns. The legislation also increases the penalty for failing to pay at least 90% of the tax by the extension date from 0.5% to 2%. The current "failure to pay" penalty for taxpayers who, in the past, did not file an extension form with the Tax Department would be reduced from 6% per month to 2% per month. Under this legislation, if the taxpayer does not file on or before the extended due date, the taxpayer will be subject to the existing penalties as if no extension election were taken. One of the purposes of this legislation is to encourage electronic filing of tax returns by eliminating the paper from requesting the extension and then filing a paper tax return because the taxpayer attaches the paper extension request form to the actual tax return filed with the Department.
B. Recent Court Decisions

No recent court decisions.

C. Recent Virginia Tax Commissioner Rulings

1. **Domicile – Failure to Abandon.** P.D. 05-7 (February 1, 2005). A taxpayer failed to demonstrate that he intended to abandon his Virginia domicile and thus was subject to Virginia personal income tax as a domiciliary resident. Although the taxpayer lived in another state after ending a long-term relationship and worked about half of each month in the other state, purchased and registered two cars in the other state, and obtained a driver’s license from the other state, the evidence was insufficient to establish his intent to abandon his Virginia residency. He still maintained joint ownership of his home with his former girlfriend, returned to work in Virginia two to three days per month, paid the utility bills on the Virginia home, maintained magazine subscriptions in Virginia, and returned to live in his Virginia home when he married two years after he began to live in the other state. In addition (1) he never entered into any formal lease agreement in the other state during the tax years at issue, but rather exchanged household maintenance duties in exchange for rent and (2) the type of work the taxpayer was engaged in often required employees to maintain secondary lodging quarters. Because the taxpayer did not meet his burden of proof establishing he abandoned his Virginia residency, the Virginia Department of Taxation’s determination was upheld.

2. **Domicile – Change Established.** P.D. 05-8 (February 1, 2005). A taxpayer who signed two six-year employment contracts to work in another country established that he abandoned his Virginia residency for two of the tax years at issue and thus was entitled to a refund of Virginia personal income taxes. While residing in the other country, the taxpayer rented an apartment, registered an automobile, obtained a driver’s license, and established a local bank account. Although he kept his Virginia home, he kept it for his mother to reside in and turned it into rental property upon her death. He only returned to Virginia two weeks out of the year to visit his mother. This evidence was sufficient to establish an intent to change residency for two of the tax years at issue. However, an intent to abandon residency was not established for one of the tax years at issue because the taxpayer filed a resident Virginia income tax return and renewed his Virginia driver’s license during that tax year.

3. **Empowerment Zone Employment Credit – Denied.** P.D. 05-14 (February 14, 2005). A shareholder of an S corporation that claimed the federal empowerment zone employment credit on its federal return was denied a Virginia personal income tax subtraction adjustment for the wages for which the credit was claimed. Although Virginia allows a subtraction for wages for which a federal work opportunity credit was claimed and therefore could not be deducted under federal law, the statute authorizing the subtraction does not extend to wages for which the empowerment zone employment credit was claimed.
4. **Non-Resident’s Income From LLC – Not Subject to Tax.** P.D. 05-15 (February 7, 2005). Wages and distributions received by a non-resident partner from a limited liability company with no nexus with Virginia was not subject to Virginia personal income tax. Although the LLC was organized in Virginia its only activities in Virginia during the tax year at issue was the purchase of administrative services from an unrelated third party and the use of the unrelated third party’s address for financial records. Under P.L. 86-272, this was insufficient to establish nexus with Virginia. Because the taxpayer was not a resident of Virginia and the income from the LLC could not be considered Virginia-source income, the taxpayer was not liable for personal income tax on his wages and distributions from the LLC.

5. **Credit Denied for Tax Paid to Other State.** P.D. 05-18 (February 18, 2005). The Virginia personal income tax credit for taxes paid by residents to other states was denied because the income on which the tax was paid to the other state was not business or earned income. Under the governing statute in effect during the tax year at issue, the credit could be claimed only for taxes paid on earned or business income. Under federal and Virginia law, income distributed through rental real estate partnerships to its limited partners is generally considered to be passive income. Because the income received did not constitute business income, the taxpayers were prohibited from claiming the credit for taxes paid by residents to other states.

6. **Employee Stock Options – Withholding Requirements.** P.D. 05-32 (March 15, 2005). The Virginia Department of Taxation ruled that no income tax withholding is required for Virginia purposes from the grant, the exercise, or the disposition of stock acquired from the exercise of statutory or incentive stock options (ISOs). The Department further ruled that when the fair market value of a nonstatutory stock option (NSO) is readily ascertainable at the time of grant, employers must withhold Virginia income tax if the employee resided in Virginia or was employed in Virginia at the time of the grant. If the NSO did not have a readily ascertainable fair market value at the time of the grant or if the option was sold prior to exercise, employers must withhold income tax on Virginia source income of nonresidents, which is the appreciation of the value of the stock from the date of grant to the date of exercise or sale.

**Statutory or incentive stock options (ISO’s)**

In Virginia Public Document Ruling 99-79, (April 20, 1999), the Commissioner ruled that the appreciation in the value of stock from the date of grant to the date of exercise is compensation from Virginia sources for services performed in Virginia by an employee who is granted ISOs. If the taxpayer moves out-of-state after the ISOs were granted, the nonresident recipient is taxable on the appreciation of the value of the stock. The amount taxable is determined at the time the stock is sold and income or gain is recognized for federal income tax purposes. The Department acknowledges that there could be a significant administrative burden for both a nonresident taxpayer and the Department in determining whether ISOs held by
nonresidents are subject to Virginia income taxation. So, in the interest of fairness, the compensation earned from the appreciation of stock acquired through ISOs is not Virginia source income for nonresidents provided they were not residents of Virginia for at least two years prior to the sale of the stock. If, however, the two-year holding requirement is not met, the nonresident is subject to Virginia income tax on the appreciation of the stock granted through ISOs.

**Withholding Requirements on ISOs**

Since wages for purposes of the Virginia income withholding tax follows the federal definition of wages, and currently the IRS does not treat the proceeds from the disposition of stock acquired from the exerciser of ISOs as income subject to withholding, no income tax withholding is required for Virginia purposes from the grant, the exercise or the disposition of stock acquired from the exercise of ISOs.

**Nonstatutory Stock Options (NSOs)**

For Virginia income tax purposes, a nonresident individual’s income from an NSO is recognized at the same time compensation is recognized for federal income tax purposes, which is at the earliest point at which a fair market value is readily ascertainable. If an NSO has a readily ascertainable fair market value at the time of grant, compensation for federal purposes is the fair market value of the option at the time of grant less any amount paid for the option. For Virginia purposes, salaries and wages of nonresident employees are generally sourced to their state of employment. If the fair market value of an NSO is not readily ascertainable until the time the NSO is exercised or sold, compensation for Virginia sources is equal to the appreciation of the value of the stock from the date of grant to the date of exercise or sale. If an individual moves out-of-state after the date the NSOs are granted, Virginia source income is an amount equal to the amount that the fair market value of the stock exceeded the option price at the date the NSO was exercised, multiplied by the number of days of the taxable year the individual resided in Virginia during the period from the date the NSO was granted to the date of exercise or sale, and divided by the number of days from the date the NSO was granted and the date of exercise or sale.

**Withholding Requirements for NSOs**

For Virginia withholding tax purposes, an employer may be required to withhold Virginia income taxes for an employee who is not a resident of Virginia when that employee earns income from Virginia sources. Consequently, when the fair market value of the NSO is readily ascertainable at the time of grant, employers must withhold Virginia income tax if the employee resided in Virginia or was employed in Virginia at the time of the grant. If fair market value of the NSO is not readily ascertainable at the time of the grant, or if the options were sold prior to the exercise, employers must withhold income tax on Virginia source income of nonresidents, which is the appreciation of the value of the stock from the date of grant to the date of exercise or sale.
7. **Armed Forces – Combat Zone – Extensions.** P.D. 05-67 (April 26, 2005). Tax Bulletin 05-3 provides information regarding tax benefits for members of the Armed Forces, extensions to file tax returns, and related information while serving in a combat zone.

8. **Credit for Taxes Paid to Other States.** P.D. 05-60 (April 14, 2005). A new tax on Maryland nonresidents will be allowed in the computation for the credit for taxes paid to other states. Note: Maryland and Virginia currently have a reciprocal agreement which provides that neither state will tax the other’s residents for compensation earned in the nonresident state under certain conditions. When this agreement does not apply, then the individual is eligible for the credit for income taxes paid to the other state.

9. **Land Preservation Tax Credit.** P.D. 05-66 (April 26, 2005). A non-profit organization pursuant to I.R.C. § 501(c)(3) that is not a private foundation by virtue of I.R.C. § 509(a)(2), that provides facilities for youth activities (i.e., baseball, softball, football and soccer) to support the population growth in its community will qualify as a “Private Conservation Agency” within the meaning of the Va. Code § 58.1-511 provided the organization has the power to acquire, hold, and maintain land or interest in land for conservation. The Commissioner opined that real estate devoted to open-space use may include recreational and park areas, provided no more than 10% of the site is attributable to buildings. Furthermore, fences, bleachers and temporary structures would not prevent the real property from qualifying as real estate devoted to open-space use.

10. **Domicile – Lump-Sum Severance Payment.** P.D. 05-36 (March 16, 2005). Taxpayer was formally a domiciliary resident of Virginia whose employment form a Virginia employer was terminated. Taxpayer signed a separation agreement that provided for a severance allowance to be paid as a lump-sum severance payment. Furthermore, periodic severance payments would be paid provided taxpayer complied with all of the terms and conditions set forth in the separation agreement, which included compliance with a non-competition and non-solicitation agreement. Upon termination, taxpayer moved to another state to begin a new job. The Tax Commissioner held that the periodic payments received by the taxpayer after he moved out of Virginia, despite their label as “severance” payments, were not payments provided because of termination of employment. Rather, this income was received by a non-resident from a former Virginia employer for a promise not to compete and will not be considered income from Virginia sources and is not taxable by Virginia. See P.D. 02-151 (December 10, 2002) for additional discussion. The lump-sum severance payment paid at termination of his employment, however, was deemed to be a remuneration for past services. Therefore the lump-sum payment was considered Virginia source income to a non-resident when paid by the Virginia employer.
11. **Domicile – Subchapter S Corporation – Combination of Returns.**
P.D. 05-33 (March 15, 2005). Taxpayer moved from Virginia and established domicile in another state in 1999. Taxpayer continued to maintain a residence in Virginia and was also the majority owner of a Virginia S corporation which operated an automobile dealership located in Virginia. Upon relocation to another state, taxpayer formed a new Subchapter S Corporation to provide consulting services to the Virginia automobile dealership. The payments for consulting services received by the non-Virginia S corporation all came from the Virginia S corporation that owned the automobile dealership. The taxpayer did not claim the consulting service fees as Virginia source income. At audit, the Department of Taxation relying upon Va. Code § 58.1-445 combined the incomes of the two S corporations. On appeal, the Tax Commissioner held that the consulting arrangement lacked economic substance. Specifically, the management agreement provided that the taxpayer would provide consulting to include preparing forecasts and operating goals, hiring management, controlling inventory management and financial reports, recruiting, training and managing a sales force that resides in Virginia. Yet, the taxpayer asserts that he only performed consulting activities on behalf of the Virginia based automobile dealership entity 3.44% of the time while actually being present in Virginia. The Commissioner noted that the taxable income of the automobile dealership entity was significantly reduced from prior years as a result of the consulting fees that were paid to the non-Virginia Subchapter S consulting company. The Tax Commissioner held that it had the authority to combine the Virginia and Florida company’s income under its authority pursuant to Va. Code § 58.1-446 and that no violation of public law 86-272 occurs as a result of this action. Note: Virginia extends P.L. 86-272 treatment to services.

12. **Domicile – Residence in Another Country.** P.D. 05-46 (April 5, 2005). Taxpayer resided in Virginia until this transfer to another country in 1992. Upon this transfer, taxpayer obtained a “temporary work permit” to work in this country until March 1995. Taxpayer returned to Virginia in March 1995 and remained until March 1996. Taxpayer returned to this other country in late March 1996 where he resided continuously ever since. In 1993, taxpayer acquired a drivers license in the foreign country, owned and registered a vehicle in this country and rents a residence under a long-term rental agreement. In 2001, taxpayer received a “permanent residence permit” to reside in the foreign country. The taxpayer has also voted in the foreign country’s national local election since receiving the permanent resident permit. The Tax Commissioner held that the taxpayer did not establish domicile in the foreign country until 1999. Prior to that date, the Tax Department concluded that the taxpayer failed to establish a permanent residence in that country because he had a temporary work permit. The temporary work permit needed to be renewed each year and the taxpayer was required to show proof that he was still employed in the foreign country in order to renew the temporary work permit. The taxpayer also owned a residence in Virginia, which was rented to unrelated third parties since 1993 until 2000 when it was sold. The Virginia property could not be sold before this time due to a property settlement agreement incident to his divorce. Furthermore, the taxpayer’s Virginia drivers license was not renewed when it expired. The Tax Commissioner concluded that the taxpayer successfully established domicile in a foreign country in 1999.
13. **Domicile – Change for One Spouse.** P.D. 05-41 (March 24, 2005). Husband was required under his employment contract to reside in another state. Husband resided in temporary quarters until he purchased a condominium in this other state. Husband also obtained a drivers license in the new state and registered two vehicles in this state. He also registered to vote in the new state. Husband filed resident tax returns in the new state and maintained a college savings plan available exclusively to residents of the new state. Husband’s wife and their children continue to reside in Virginia for all of the years at issue. Husband did come to Virginia for 79 days in 1998, 58 days in 1999, and 88 days in 2001. Husband and wife jointly own a Virginia residence. The taxpayers filed Virginia income tax returns under the status “married, filing separately on this combined return” for the 1998-1999 tax years and then filed jointly for the 2000-2001 tax years. Taxpayers claimed a subtraction for the salary earned by the husband from his employer in the other state. Upon audit, the subtraction of the husband’s employment was disallowed. The Tax Commissioner held that the taxpayers met the burden of proving the husband intended to acquire a new domicile with the intention to remain their permanently or definitely. The Commissioner held that the husband performed a significant number of acts that were consistent with changing domicile such as acquiring full-time employment requiring that he reside there, purchasing a condominium, registering cars, obtaining a drivers license and registering to vote in the new state. The Tax Commissioner held that continuing to own a joint domicile in Virginia did not overcome the steps taken by the husband to reestablish his domicile in the new state.

14. **Credit for Taxes Paid Other State.** P.D. 05-42 (March 24, 2005). Taxpayers were domiciliary residents of another state. Husband lived in Virginia for employment purposes during 2002. Husband was subject to Virginia income taxation as a resident because he resided in Virginia more than 183 days during the taxable year. The taxpayers filed a joint resident Virginia income tax return and claimed a credit for income taxes paid to the other state. The Tax Department disallowed the credit on the taxpayer’s return. The Tax Commissioner found that the husband was a domiciliary of another state and also an actual resident of Virginia. Accordingly, the Commissioner found that the husband was a resident of both Virginia and the other state. The Commissioner held that the husband would be entitled to a credit for individual income tax paid to the other state provided he provides evidence showing that the income in question was earned in another state.

15. **Guaranteed Payments to Non-Resident not Subject to Virginia Tax.** P.D. 05-38 (March 16, 2005). Virginia based multi-state entity made guaranteed payments to non-resident members who performed work on behalf of the company from home offices located in their state of residence (not Virginia). The Tax Commissioner held that these payments made to the non-Virginia residents were for services without regard to the income of the Company. The Commissioner stated that the payments are ordinary income to the taxpayers and are attributed to the place where the services are performed. The Commissioner concluded that the guaranteed payments made to the taxpayers were not considered to be Virginia source income.
16. **Stock Options.** P.D. 05-40 (March 18, 2005). Taxpayer was granted incentive stock options (ISOs) while a Virginia resident. In January 2001 taxpayer abandoned Virginia domicile and permanently resided outside of the United States. From late January 2001 through January 2003 taxpayer exercised her stock options. Her former Virginia employer withheld Virginia income tax upon the exercise of her options. Taxpayer filed a Virginia non-resident individual income tax attributing all of the income from exercising the ISOs to the foreign country. Taxpayer filed a protective claim for refund seeking the excess withholdings that exceeded the tax liability reported on her non-resident Virginia income tax return. The Tax Commissioner rejected the protective claim stating that the income from the ISOs is Virginia source income and is subject to Virginia income tax.

17. **S Corporation Income – Erroneous Telephone Advice.** P.D. 05-49 (April 7, 2005). Non-resident taxpayer owned shares of stock in a Virginia S Corporation. Taxpayer did not file a Virginia income tax return for the tax year. Virginia asserts tax liability on earnings from the Virginia S corporation as Virginia source income. Taxpayer contends he was resident of another state and was only a passive investor in the Virginia S corporation. Furthermore, taxpayer states that he was advised on the telephone by an employee of the Virginia Department of Taxation that no Virginia income tax return was required in his case. The Tax Commissioner held that when non-resident individuals are shareholders of an S Corporation that conducts business in Virginia, such income will remain Virginia source income in the hands of the shareholders whether they are residents of Virginia or not. The Virginia S Corporation conducted all of its business activities in Virginia. The fact that the taxpayer was not involved in running the business has no bearing on the character of the income from the Virginia S Corporation. Taxpayer was held to be required to file a non-resident individual income tax return and pay tax on his income. The erroneous advice provided over the telephone was not binding against the Tax Commissioner because it was not provided in writing as required by Va. Code § 58.1-1835.

18. **Virginia Partnership – Unified Non-Resident Income Tax Returns.** P.D. 05-65 (April 26, 2005). The Tax Commissioner held that a partnership that requested and received permission from Virginia to file unified non-resident individual income tax returns on behalf of the non-resident partners would remain valid despite former partners refusal to inform the partnership whether they have other income from Virginia sources. The Tax Commissioner acknowledged the difficulty in complying with the requirement to include departed partners in a unified return when they are not responsible for providing information to the partnership on their other income from Virginia sources. The Commissioner stated that the departed partners may be excluded from the unified return in this case.

19. **Maintenance Fee/Bundled Charges Subject to Tax.** P.D. 05-64 (April 26, 2005). Taxpayer, a parent corporation that manufactures, sells and leases equipment and related supplies works closely with its wholly-owned single member subsidiary. Taxpayer invoices its customers a bundled amount composed of charges for the lease of the equipment, furnished supplies, maintenance services and the applicable
sales tax. The Tax Commissioner permitted the parent corporation to utilize its registration and dealer status for the entire bundled transaction with respect to the collection and remittance of sales tax as an agent filer for the single member subsidiary. The subsidiary would not be required to register in Virginia for the collection of the sales and used tax on the lease of equipment to customers. The Tax Commissioner did opine that the bundled charge for the lease payment, maintenance fee and supply charges would all be subject to the 5% sales and used tax. While maintenance contracts that provide for both repair or replacement of parts and repair labor are generally subject to the 5% sales and used tax based on one-half of the total charge, this rule would not apply in this case because the maintenance fee was not identified as such on the invoice and is bundled in a single charge with the equipment lease. The entire charge is fully taxable as gross proceeds derived from the lease in accordance with Va. Code § 58.1-603 (2).

20. **Filing Requirements for Pass-Through Entities.** P.D. 05-69 (May 6, 2005) The Department issued Tax Bulletin 05-6 pursuant to 2004 Special Session HB 5018 which imposed new filing requirements on all pass-through entities. Effective for taxable years beginning on or after January 1, 2004, pass-through entities doing business in Virginia or having income from Virginia sources are required to make a return to the Department on or before the fifteenth day of the fourth month following the close of its taxable year. Except for estates and trusts, all pass-through entities (including S corporations) will file Form 502.

21. **Domicile – Determining the Date for Acquisition of New Domicile.** P.D. 05-74 (May 9, 2005). The Tax Commissioner upheld the auditor’s finding that the taxpayers abandoned their Virginia domicile and acquired a new domicile on October 31, 2001. The taxpayers claimed they changed their domicile in September 2001, but could not produce enough evidence to substantiate their date and invalidate the auditor’s findings.

22. **Land Preservation Tax Credit.** P.D. 05-76 (May 19, 2005). The tax Commissioner ruled that a donation of a conservation easement that does not qualify for a charitable contribution deduction under IRC § 170(h) due to the lacking of certain necessary technical language as required under the Treasury Regulations would similarly not qualify for a land preservation tax credit as qualifying for a IRC § 170(h) is a prequalification for a land preservation tax credit. This P.D. was revoked and replaced by P.D. 05-122 (July 22, 2005), infra, at item #31.

23. **Credit for Income Taxes Paid to Another State Disallowed.** P.D. 05-88 (June 9, 2005). The Tax Commissioner disallowed a credit claimed by the taxpayers in the 2001 taxable year for income taxes paid to another state. The credit was disallowed because the taxes were actually paid for the 2000 taxable year. Virginia law requires that the taxpayers claim the credit for the same taxable year for which they paid the taxes to the other state. The taxpayers argued in the alternative that since the credit was disallowed after the statute of limitation had expired for filing an amended return for the 2000 taxable year for the credit that they should still be allowed to take the credit on their 2001 return. The Tax Commissioner rejected this argument as well.
24. **Domicile Change Established.** P.D. 05-91 (June 9, 2005). The Tax Commissioner ruled that the taxpayer changed his domicile in December 2001, despite the fact that he did not complete the sale of his former Virginia residence until 2003 and that he was active in managing a Virginia based corporation subsequent to his domicile change. The taxpayer did not sell the former residence immediately upon abandoning the domicile as the residence was undergoing renovations. Also, the taxpayer was able to manage the corporation from a remote location.

25. **No Virginia Domicile for Couple.** P.D. 05-92 (June 9, 2005). The Tax Commissioner abated assessments against a married couple where the husband was stationed on active duty in Virginia, but retained his original domicile outside of Virginia. The husband maintained his declaration as a resident of State A for purposes of his military compensation and also maintained a State A driver’s license and registered his car in State A. In addition, the husband did not have any Virginia source income through a number of business and investments that Virginia could tax as a nonresident. The wife was also held not to be a domiciliary resident of Virginia. The PD failed to give much detail on the wife except that she was rarely present in Virginia.

26. **Domicile Properly Acquired Outside of Virginia.** P.D. 05-96 (June 10, 2005). The Tax Commissioner ruled that a couple established domicile elsewhere after they had acquired a new residence, transferred employment (which was not for a limited duration), and later registered to vote, obtained driver’s licenses and registered cars in the other state.

27. **False Deductions & Fraud Penalty.** P.D. 05-104 (July 5, 2005). The Tax Commissioner adjusted an assessment of additional tax and the 100% fraud penalty. Upon an audit review, the auditor discovered false deductions for charitable contributions and unreimbursed employee expenses and also made an adjustment to the mortgage interest deduction. The taxpayer admitted to making the false deductions, but protested the adjustment to the mortgage interest deduction. Upon receiving additional information, the Tax Commissioner agreed to further adjust the mortgage interest deduction, but denied the request for the waiver of the fraud penalty. The Tax Commissioner reasoned that as the taxpayer knew she was signing a tax return that contained false deductions, the fraud penalty was proper.

28. **Family Acquired Domicile in Virginia.** P.D. 05-107 (July 8, 2005). The Tax Commissioner upheld an assessment where a husband and wife were determined to have changed their residence to Virginia. The husband argued that he maintained his domicile in a previous state, but conceded his wife’s change. The husband has performed several actions supporting a change in domicile to Virginia. He also performed actions that are consistent with maintaining the previous domicile such as maintaining a State A driver’s license, voting in State A elections, and having his tax information returns sent to a State A address. He however did not maintain a residence in the previous state.
29. **Credit for Taxes Paid to Other States.** P.D. 05-108 (July 8, 2005). The credit for taxes paid to another state was disallowed as the other state did not provide for a reciprocal credit. Based on the disallowance of the credit, the taxpayer’s returns were adjusted over three years as overpayments were changed that were based on the allowance of the credit. The taxpayer was a non-resident of Virginia.

30. **Family Abandoned Virginia Domicile and Later Reacquired Domicile in Virginia.** P.D. 05-120 (July 19, 2005). The Tax Commissioner agreed with the taxpayer that they performed enough actions to abandon their Virginia domicile in 2000 and established a domicile in another country. They later reacquired their domicile in Virginia on 12/15/02. The auditor had ruled that they had never abandoned their Virginia domicile.

31. **Land Preservation Tax Credit.** P.D. 05-122 (July 22, 2005). This P.D. revokes and supersedes P.D. 05-76. The Tax Commissioner expanded on his previous ruling that any conservation easement that does not qualify for IRC § 170(h) treatment will not be eligible for the land preservation tax credit. However, such a determination must be made on a case by case basis. The Commissioner said that it may be possible to reform an easement that doesn’t fully comply with § 170(h). In such a case, the easement would be eligible for the credit after such reform. However, it is also possible that the opposite could hold true.

32. **Prepaid Tuition Contracts.** P.D. 05-123 (July 25, 2005). The Tax Commissioner upheld an assessment where the auditor disallowed the taxpayer’s deduction for contributions to his granddaughter’s prepaid tuition contract. The deduction was disallowed because the wording of the law limits the deduction only to people who may receive a deduction for contributions to a contract to the listed owners of such contract. In this case, the taxpayer’s daughter-in-law was the only listed owner. Therefore, only the daughter-in-law could receive a deduction for contributions to the contract. The daughter-in-law could even receive a deduction for the contributions that the taxpayer, the grandparent, made.

33. **Income from an IRA Conversion.** P.D. 05-124 (July 25, 2005). The Tax Commissioner upheld an assessment where the taxpayers subtracted income that was earned from an IRA conversion prior to the taxpayer becoming a Virginia resident. The taxpayer argued that since the income earning event occurred before he was a Virginia resident that Virginia should not be allowed to tax the income when spread ratably over a four year period as per the IRC. The Commissioner held that the only modification that a taxpayer is allowed to make to his FAGI are those listed under Va Code § 58.1-322. As there is no subtraction that would allow the taxpayer to subtract this income, the assessment was upheld.

34. **Converted Assessments.** P.D. 05-132 (August 10, 2005). The taxpayer questioned the authority of the Tax Department to convert corporate income tax assessments of penalty and interest to assessments of individual income tax against a
responsible officer based on the Internal Revenue Code. The Tax Commissioner ruled that § 58.1-1813 allows for such conversions and IRC § 6672 is not applicable.

35. **Land Preservation Credits for Spouses.** P.D. 05-136 (August 10, 2005). The taxpayer requested a ruling on whether two spouses could each claim up to the maximum of $100,000 of Land Preservation Credits. The Tax Commissioner ruled that each spouse could claim up to the maximum so long as the credits are purchased jointly or each individual spouse purchases enough credits to reach the maximum individually. The taxpayer also asked whether nonresidents may use Land Preservation credits. The Tax Commissioner ruled that nonresidents may use the credits as well.

36. **No Income Tax Due from Military Couple.** P.D. 05-150 (September 8, 2005). The Tax Commissioner ruled that assessment against a married couple were incorrect. The couple moved to Virginia as the husband was on active duty in the military and was transferred to Virginia. Despite the transfer, the husband actively maintained his domicile in another state. (The ruling does not list any facts.) Aside from his military pay, the only other income from the husband was interest paid on his bank account. The wife who is not in the military only has income from interest earned from a bank account. For both individuals, the interest earned is below the filing threshold and therefore, the couple does not owe any taxes on this Virginia interest income.

37. **Protective Claim Unnecessary for IRS Audit.** P.D. 05-151 (September 9, 2005). The taxpayer filed a request for a protective claim pursuant to an IRS audit of the taxpayer. The Tax Commissioner denied the request as a protective claim is unnecessary for an IRS audit. Va.Code § 58.1-1823 allows a taxpayer to file an amended return pursuant to changes made to the taxpayer’s return as a result of an IRS audit within one year. Because of this section, a protective claim is unnecessary.

**III. RETAIL SALES AND USE TAXES**

**A. 2005 Legislation**

1. **Sales Tax on Grocery Foods Reduced.** H.B. 1638 (Chapter 521) and S.B. 708 (Chapter 487) amended Virginia Code § 58.1-611.1 to reduce the retail sales and use tax on food purchased for human consumption to a rate of 2.5 percent on and after July 1, 2005 (1.5% state and 1.0% local). The legislation accelerates the rate reduction schedule that would have occurred between July 1, 2005 through July 1, 2007.

2. **Retail Sale and Sale at Retail Definitions Changed.** H.B. 2762 (Chapter 121) amended the definitions of "retail sale" and "sale at retail" to provide that paint and other refinishing materials that are permanently applied to or affixed to a motor vehicle during the vehicle’s repair (i.e., paint, primer, clear coat) are subject to sales tax if they are charged for separately on the bill. This legislation reflects a change in policy from the long-standing rule of the Department of Taxation that automobile painters, repairers, and refinishers are providing a nontaxable service and are deemed to be the users and consumers of all tangible personal property used and consumed by them and
the automobile painters pay the tax on these items they use at the time of purchase. See also P.D. 04-211 (November 19, 2004) (Auto body shops may be reimbursed for tax paid on paint).

3. **Gift Transaction for Sales and Use Tax Purposes.** S.B. 1219 (Chapter 355) enacts Virginia Code § 58.1-604.6 to define a "gift transaction" for sales and use tax purposes and allow a Virginia dealer the option of collecting the tax imposed in the state of the gift recipient or collect the Virginia tax, provided the dealer is registered in the gift recipient's state and the goods are shipped out-of-state and the recipient is someone other than the purchaser. The legislation requires the dealer to obtain approval from the Tax Commissioner prior to collecting the tax of the state in which the gift recipient is located. The new statute establishes "sourcing rules" applicable to these third party "gift transactions". The legislation allows dealers the option of conforming to the destination sourcing rules under the Streamlined Sales and Use Tax Agreement, or continue collecting the tax based on the point of sale rules currently in effect. The legislation restricts the destination sourcing option to apply only in the case of gift transactions.

4. **Bad Debt Credit – Alternative Method.** S.B. 1219 (Chapter 355) amends Virginia Code § 58.1-621 to provide an alternative means for determining the sales tax credit allowed for bad debts when a dealer has a high volume of uncollectible accounts or there is some other impracticable reason a dealer cannot substantiate the credit on an account-by-account basis as required under existing law. Any alternative method must be approved by the Tax Department in advance of the method's use or application.

5. **Public Transportation Exemption.** S.B. 1195 (Chapter 46) and H.B. 2599 (Chapter 116) amend Virginia Code § 58.1-609.17 to restore a sales and use tax exemption for tangible personal property sold or leased to Alexandria Transit Company, Greater Lynchburg Transit Company, GRTC Transit System, or the Greater Roanoke Transit Company that is owned, operated, or controlled by any county, city or town (or any combination thereof), that provides public transportation services. The legislation was approved as emergency legislation and is retroactive back to September 1, 2004.

6. **Manufactured Signs are TPP.** H.B. 2774 (Chapter 122) amends Virginia Code § 58.1-602 to classify manufactured signs as tangible personal property for retail sales and use tax purposes. Prior to this amendment, the Tax Department treated sign manufacturers as contractors based on the provisions of Va. Code § 58.1-610 and regulation 23 VAC § 10-210-4070 (contractors with respect to real estate). Contractors will now be able to be treated as retailers when they sell and install manufactured signs regardless of the fact that the sign may be attached to or become part of real property.
7. **Non-Profit Exemption - Education.** S. B. 1105 (Chapter 42) amends Virginia Code § 58.1-609.11 to provide that any non-profit educational institution doing business in Virginia which provides "face-to-face" educational experience in American government that was exempt from sales and use taxes as of June 30, 2003, will continue to be exempt provided the other requirements of Va. Code § 58.1-609.11 are met.

8. **Non-Profit Exemption - Transition.** H.B. 2100 (Chapter 89) amends Virginia Code § 58.1-609.11 to clarify that any non-profit entities that were exempt from paying sales and use tax on the purchases of services as of June 30, 2003, shall continue to be exempt from such taxes provided the non-profit entity meets the requirements of Va. Code § 58.1-609.11. See P.D. 05-57 (April 13, 2005) for additional clarification.

9. **Declaratory Judgment - Personal Jurisdiction Over Non-Virginia State Officials.** H.B. 2094 (Chapter 800) and S. B. 888 (Chapter 736) amend Virginia Code § 8.01-184.1 to authorize Virginia courts to exercise personal jurisdiction to the extent permitted by the United States Constitution over officials from other states in declaratory judgment actions relating to the collection of sales taxes. The legislation states that this act is declaratory of existing law. NOTE: The 2004 General Assembly created Virginia Code § 8.01-184.1 to grant circuit courts jurisdiction over civil actions in which a Virginia business seeks a declaratory judgment against officials in other states to prevent such other states from forcing the Virginia business to collect and remit retail sales and use taxes to another state. In making the decision whether to grant a declaratory judgment, the circuit court must evaluate whether the demand from the other state constitutes an undue burden on interstate commerce within the meaning to the U.S. Constitution and decisions of the federal courts construing Article 1, Section 8, Clause 3 of the U.S. Constitution (Commerce Clause). See Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

**B. Recent Court Decisions**

1. **LZM, Inc. v. Department of Taxation,** 269 Va. 105 (2005). The Virginia Supreme Court held that pumping services for portable toilets are subject to sales tax under the true object test and that those services are not exempt under the maintenance contract exemption. LZM, Inc. leases portable toilets to customers who may also purchase pumping services. The charges for leasing the toilets and pumping services are listed separately on a single invoice. No lessee is required to use LZM's pumping services and some do not. The Department of Taxation audited LZM for sales tax and found that LSM did not collect and remit sales taxes for amounts collected for its pumping services. The Department issued a deficiency, which LZM paid. LZM then filed suit to recover the sum. The trial court granted summary judgment for the Department.
Before the Virginia Supreme Court, LZM argued that the trial court erred in applying the true object test to resolve the matter and in holding that the statute exemption for maintenance contracts did not apply. The Supreme Court disagreed. First the court rejected LZM's argument that the test was inapplicable because the regulations at issue did not contain the word "lease." Second the Supreme Court held that under the true object test the pumping services were taxable because customers contracted primarily for the portable toilets and the pumping services were needed only as a result of the lease. The Supreme Court wrote, "[c]ustomers do not rent portable toilets for the waste removal services." The Virginia Supreme Court also rejected LZM's contention that listing rental and pumping services separately on the invoice was determinative. Finally, the Court affirmed the trial court's decision that the pumping services did not fall under the maintenance contract sales tax exemption and held that the trial court did not issue findings of fact contrary to the established evidence. The additional sales tax was upheld.

2. Hardaway Construction v. Department of Taxation. (Case No. LR-1165-1, Circuit Court City of Richmond, July 8, 2005). The Circuit Court for the City of Richmond granted summary judgment to the taxpayer holding that the Use Tax does not apply to services. The Court further held that regardless of whether the Sales Tax applies to a service, the tax may not be levied directly by the Department of Taxation against the purchaser of the service.

The taxpayer, Hardaway Construction Corporation of Tennessee ("Hardaway"), entered into a contract with the Federal Bureau of Prisons to perform site preparation work at a parcel of property located in Virginia. In connection with the project, Hardaway engaged an out of state subcontractor ("Mellott") to come onto the site in Virginia and crush shot rock which had previously been severed from the land into gravel. On audit of Hardaway, the Department determined that crushing rock into gravel constituted "fabrication," that "fabrication" as such was subject to the Sales Tax, that Mellott had not collected the Sales Tax from Hardaway and remitted it to the State and, as a result, Hardaway was liable for Use Tax on its purchase of rock crushing services.

Citing the plain language of the statute, the Court concluded that the Use Tax, on its face, does not apply to services of any kind. Instead, it applies only to tangible personal property. Further, while the Court agreed that the Sales Tax and the Use Tax are "complementary" in that only one of the two can apply to a single transaction, it declined to infer that the two are "coextensive." In the case of services, the Court concluded that only the Sales Tax applies. Finally, the Court concluded that the Sales Tax, by its clear unequivocal terms, is imposed on the seller, or "dealer", for the privilege of making taxable "retail sales", and that Mellott – not Hardaway – was the dealer.

3. Cisco Systems, Inc., et al. v. Thorson, Tax Commissioner. (At Law No. 219609, Fairfax County Circuit Court, August 17, 2005). The Circuit Court for the County of Fairfax ruled that the sales and use tax exemption for certain types of Internet equipment applies solely to the type of equipment used and not to the type of Internet Service Provider using the equipment.
Cisco Systems, Inc. (hereinafter “Cisco”) initiated this case by petitioning for a refund of excess taxes paid under Va.Code § 58.1-1825. Cisco is a company that provides Internet access via equipment, software, and services, to other companies that provide Internet access to end user customers. In short, Cisco is a wholesale Internet service provider. Cisco argued that the Internet equipment exemption applied to all equipment regardless of the type of Internet services a company supplied to its customers. Accordingly, Cisco asserted that it had paid sales tax on purchases of certain types of Internet equipment that were exempted from the sales and use tax under Va.Code § 58.1-609.6(2). The Department contended that the equipment was not exempt from sales and use tax based on the services that Cisco provides to its customers. The Department argued that the exemption does not apply to wholesale Internet providers, but rather to retail Internet providers.

The Court held that the exemption is not limited as the Department argued and that Cisco would qualify for the exemption. Furthermore, the Court ruled that the Department of taxation rulings are not given the same judicial deference as regulations. The Court specifically disallowed the Department’s attempt to impose requirements into the exemption statute that the legislation did not enact in the statute.

C. Current Virginia Tax Commissioner Rulings

1. Imaging Process Not Exempt. P.D. 05-2 (January 19, 2005). Machinery, tools, supplies and power used by a taxpayer to image paper documents and microfiche into source documents that were coded, indexed, and burned onto compact disks (CDs) or tapes did not qualify for the manufacturing exemption from Virginia sales and use tax because the imaging process did not result in the creation of a product and therefore was not industrial in nature. Although the process did provide customers with new search capabilities regarding the source documents, the imaged documents constituted the final product with only a change in form and not content. This ruling supersedes a 1987 Public Document that held that copying documents or information to microfiche was deemed industrial manufacturing. Because the taxpayer converted data contained in one medium to that of another medium, the taxpayer was a fabricator required to pay tax on its purchases of machinery, tools, supplies, and power used in the imaging process. Purchases of CDs and tapes sold to customers would be exempt as purchases for resale. Note: This ruling supersedes P.D. 87-8.

2. Taxation of Defibrillators. P.D. 05-4 (February 1, 2005). A manufacturer’s sales of automated external defibrillators were exempt from Virginia sales and use tax as sales of prosthetic devices if the defibrillators were purchased by or on behalf of an individual for use by the individual. When sales of the defibrillators were exempt, the manufacturer’s sales of training, support, and management services for defibrillators were also exempt. The exemption applied whether the services were billed with the sale of defibrillators, billed as separate services, or billed as bundled services. When the defibrillators were not purchased by or on behalf of an individual, tax was
imposed on the defibrillators and on charges for the services, even if the charges for the services were separately stated on invoices.

3. **Sale/Installation of Sod Subject to Tax.** P.D. 05-5 (February 1, 2005). A taxpayer who furnished and installed sod for real property construction jobs was subject to Virginia sales tax on charges for the sale and installation of the sod because the landscape contractors who provide sod and similar items under the terms of real property contracts are deemed to be making taxable retail sales rather than providing services with respect to real estate.

4. **Sale of Direct Mail Advertising Packets Taxable.** P.D. 05-10 (February 3, 2005). An out-of-state publisher’s sales of direct mail advertising packets to its Virginia franchisees were subject to Virginia sales and use tax as taxable sales of tangible personal property to advertising businesses. If the publisher did not collect sales tax, the franchisees were required to remit use tax on the advertising packets. Printing services provided to non-Virginia franchisees, for distribution outside Virginia, by a Virginia facility owned by the publisher were not taxable if the printed materials were stored in Virginia for 12 months or less and were distributed for use outside Virginia.

5. **Prepaid Credit Card Fees Not Taxable.** P.D. 05-11 (February 4, 2005). Activation and “reload” fees charged for prepaid credit cards were exempt from sales and use tax as fees for services. The “true object” of the transactions was the purchase of the credit card service.

6. **Software License Conveyed by Tangible Means Taxable.** P.D. 05-12 (February 7, 2005). A software license that was conveyed by tangible means, and not electronically, was subject to sales and use tax. In reaching this decision, the Tax Department looked at the language of the contract, other documents and records created at the time the license took effect.

7. **Aircraft Handling Service Fees Exempt.** P.D. 05-13 (February 7, 2005). Fees paid for aircraft handling services including towing and cleaning aircraft, baggage handling, deicing, and skycap services were not subject to Virginia sales and use tax, even if taxable products were included on the same invoice, because the true object of the transactions was the provision of nontaxable services. The tangible personal property transferred to customers was not critical to the transactions.

8. **Government Contractor Subject to Tax.** P.D. 05-16 (February 9, 2005). Purchases of assets and supplies used to operate and maintain public vessels in connection with a taxpayer’s contracts with the federal government were not eligible for the exemption for property sold to the government because the true object of the contracts was the provision of services. The true object of the contracts was determined by examining the overall contracts, rather than by separating the contracts into different parts on the basis of compensation methods, because the true object of the taxpayer’s work could be determined from the language of the underlying contracts. The
true object of contracts may be determined by examining individual tasks or delivery orders only if the underlying contract does not provide evidence of its true object.

The taxpayer did not qualify as an agent of the federal government because the contracts did not designate the taxpayer as a purchasing agent and because the credit of the taxpayer, rather than the credit of the government, was bound to the purchases.

The exemption for supplies delivered directly to ships or vessels plying the high seas applied to purchases that were marked for delivery to qualifying vessels but that were briefly at a warehouse pending the arrival of the qualifying vessel.

9. **Preproduction Equipment to Test Prototypes Taxable.** P.D. 05-21 (March 2, 2005). A taxpayer's purchase of equipment used to test prototype cellular phones that were sent, after customer approval, to another facility for mass production did not qualify for the industrial manufacturing exemption from Virginia sales and use tax because the equipment was used in taxable preproduction activity rather than in the production process. The taxpayer's acquisition of the testing equipment when it purchased a customer's prototype manufacturing division was not exempt as an occasional sale because the customer used the equipment to manufacture both prototype and production cellular phones for sale, which constituted an activity requiring the customer to hold a certificate of registration.

10. **Packaging, Shipping and Related Materials to Ship Goods by Manufacturer.** P.D. 05-22 (March 4, 2005). Brake part manufacturer uses various types of plastic and paper bags to store and handle raw materials at its plant sites. These raw materials become a component part of the brake products it manufactures and are usually in powder or dust form. The bags must be used to store materials at the plant site and to transport the raw materials during production. These plastic and paper bags used to store and relocate the raw materials are exempt from tax as they are deemed to be used directly in the production process at the plant site and qualify for the exemption as they are used to handle and store raw materials. After production, a different type of trash bag is used to dispose of the original raw material handling bags. These disposable trash bags are subject to tax. Upon completion of the manufacturing process, taxpayer purchases corrugated boxes, shipping trays, and pads to package his products for shipment to the distribution facility or to its customers. These items are exempt packaging materials. Shrink-wrap boxes and trays containing his products to pallets for shipment are also exempt because the shrink-wrap methodology restricts movement of the products in more than one plane of direction thus creating a package for purposes of the packaging materials exemption for manufacturers.

11. **Thermal Labels Not Exempt Package Materials.** P.D. 05-23 (March 4, 2005). Taxpayer operates a network of franchise-owned pizza stores. Thermal labels are affixed to the packaging containing a customer's food order. The label shows the customer's itemized food order, delivery address, phone number, and price. The thermal labels are subject to tax and are not exempt packaging materials. Cleaning kits
are also provided to clean the printer that prints the customer's information on the thermal labels. These items are also subject to tax.

12. **Marketer/Distributor of Animal Health Products Must Collect Tax on Most Sales.** P.D. 05-26 (March 7, 2005). Taxpayer is a major marketer and distributor of animal health products including pharmaceuticals, biologicals, implants, insecticides, and cleaning and sanitizing agents. Tax Commissioner held that its sale of prescription medicine and drugs to veterinarians are subject to tax as Virginia law does not permit a veterinarian to purchase prescription drugs and medicines exempt of tax under any circumstances. A resale exemption certificate for these purchases is never acceptable from a veterinarian purchasing prescription drugs and medicines. Taxpayer's sale of certain items to farmers, however, are exempt under the agricultural production exemption when presented with the appropriate exemption certificate.

13. **Dirt Sales Taxable.** P.D. 05-31 (March 11, 2005). Taxpayer is in the excavation and hauling business. The Company also sells dirt. On audit, the sales of dirt were held to be taxable. On appeal, taxpayer seeks to claim the public service corporation exemption because it functions as if it were holding an ICC license. The Tax Commissioner denied the protest because the truck company did not hold either an SCC or ICC common carrier license. Without holding such license the taxpayer cannot be a public service corporation and is not entitled to claim the exemption.

14. **Occasional Sale.** P.D. 05-35 (March 16, 2005). The taxpayer, a hospital, was entitled to claim the occasional sale exemption on its sale of a metal building that was used as a temporary business office and was not used by the hospital for an activity for which it was required to hold a certificate of registration. However, the hospital’s sale of a fitness facility is taxable. The fitness facility provided preventative medical services to its patrons. The tax was correctly assessed on this transaction.

15. **Out-of-State Fabrication Charges Subject to Tax in Virginia.** P.D. 05-43 (March 28, 2005). Tax Commissioner held fabrication labor performed out-of-state is subject to Virginia sales tax because the resulting product was used in a Virginia real property construction project. See P.D. 04-22 (June 2, 2004). The fact that the taxpayer does not perform the fabrication services itself, but contracts with a third party to fabricate the materials outside of Virginia does not avoid the sales and use tax applicable to the fabrication costs used on materials for a Virginia real property construction project. The Tax Commissioner upheld the auditor's use of a six-year period of limitations on the audit due to the fact that no sales and use tax returns had been filed by the taxpayer. See Va. Code § 58.1-634.

16. **Pre-written Software and Software Maintenance Updates Delivered Electronically to Customers Exempt.** P.D. 05-44 (April 4, 2005). The Tax Commissioner upholds its long-standing policy that the sale of pre-written software delivered electronically to customers does not constitute the sale of tangible personal property and is generally not subject to sales and use taxation. This position is conditioned on the fact that no disk, tape or other tangible medium is subsequently
provided to the customer (by mail or other means) before or after the electronic download of the software. The Tax Commissioner also recommends that for documentation purposes, the company should retain sales invoices, contracts or other sales agreements that expressly certify the electronic delivery of the software and that no tangible medium for that software has been or is to be furnished to the customer.

17. Development of New Packaging and Packaging Equipment

Taxable. P.D. 05-45 (April 5, 2005). Taxpayer, a manufacturer and wholesaler of food products, has undertaken a project to research, design and develop new customized packaging for its product. New packaging is to be made of a different material, create a different shape to the product package and also enhance customer protection. So as to retain proprietary rights to the package and equipment design, the taxpayer purchased all new and additional tooling required for the design and development of the manufacturing equipment by its suppliers. The Tax Commissioner held that the new and additional tool and equipment purchased to develop and design the new packaging material neither qualifies for the research and development exemption nor the manufacturing exemption. As to the R&D exemption, the taxpayer's role in the research and development is more supportive and secondary to that of the primary role taken by its suppliers who are actually developing the new packaging, as well as designing and developing new manufacturing equipment. Furthermore, the product testing and quality control functions do not occur on the production line and thus are not eligible for the manufacturing exemption.

18. Installation and Repair of Electronic Components Taxable.

P.D. 05-56 (April 12, 2005). Taxpayer entered into various contracts to work on the construction of the electrical substation for a public utility. The items of property used in this contract were taxable as they were not used directly in the actual rendition of the public utility service. Furthermore, taxpayer could not claim the government exemption under its contract with the water authority for the construction of an electrical substation because it was the prime contractor for the construction. The contract is for services provided to the water authority and accordingly taxpayer is deemed to be the taxable user and consumer of the tangible personal property purchased for use and performing the real property services contract. The Tax Commissioner also refused to remove several items from the audit sample because the taxpayer could not demonstrate they were isolated in nature and not a normal part of its business activity. The purchase of electrical supplies is an integral part of the taxpayer’s business activity. Although the taxpayer may not have performed services pursuant to contracts with a public water authority or public service corporation during the audit, there are likely similar contracts or transactions outside the sample in which the tax was not paid.

19. Audit Sampling Methodology.

P.D. 05-63 (April 26, 2005). A retailer of electrical products and lighting challenged a sample period of only one month to base a three-year cycle audit. The Tax Commissioner held the one month time period was sufficient as both the auditor and the taxpayer mutually agreed upon the selection of the one-month sample because of the volume of the taxpayer’s records. Furthermore, the auditor found recurring errors within the sample in which the taxpayer charged another
The state’s sales tax in error. These items would not be removed from the audit sample given the consistent and recurring basis of the same errors. In other words, it was not a single item or one unusually large sale included in the sample for which the taxpayer collected another state’s sales tax in error.

20. **Cable Television Equipment Exemption.** P.D. 05-70 (May 6, 2005). Equipment owned by a cable television network used to distribute programming via a satellite uplink to cable affiliates does not qualify for the broadcasting equipment exemption under *Va.Code § 58.1-609.6(2)*. The broadcasting equipment exemption requires that the equipment send the programming directly to either the public consumer or the cable subscriber. Because the equipment inquired about in this ruling only sends the programming to the affiliate who in turn sends the programming to the public consumer or the cable subscriber, this equipment would not qualify for the exemption.

21. **Audit Sampling Methodology.** P.D. 05-73 (May 9, 2005). The taxpayer questioned whether the sampling method used by the auditor was appropriate given the taxpayer’s circumstances. The auditor chose 2002 as the sample period from which to generate an error factor to be applied over the entire audit period, 2001-2003. The taxpayer argues that a new compliance system was placed into service in 2002. Therefore as a result of the increased compliance due to the new system, a different error factor should be used for 2003 and forward. The Tax Commissioner ruled that since 2002 contained periods from both before and after the compliance system was implemented and then applied equally to the months of lower compliance and higher compliance that the need for a second error factor was not necessary.

22. **Food Tax Reduction.** P.D. 05-78 (May 31, 2005). Tax Bulletin 05-7 details the procedures for the lowering of the state sales and use tax rate on food for home consumption from 3% to 1½% effective July 1, 2005.

23. **Certain sales included in sample.** P.D. 05-82 (June 8, 2005). The taxpayer objected to two sales being included in the auditor’s sample. The taxpayer claimed that the two sales were anomalies and should not be included in the sample. To compensate for this, the auditor used a two month sample as opposed to one month. The Tax Commissioner upheld the use of this sample and the associated assessment as the taxpayers failed to demonstrate the anomalous nature of the two sales.

24. **Rounding Error.** P.D. 05-83 (June 8, 2005). As the taxpayer was unable to obtain a local meals tax table from his locality, the taxpayer charged 8% tax (4.5% sales tax & 3.5% meals tax) on all purchases of meals at his restaurant. This caused a rounding error which the taxpayer did not dispute. Instead, the taxpayer pleaded mitigating circumstances that despite his efforts, the locality would not provide him with the necessary tax table. The Tax Commissioner upheld the assessment for sales tax as the taxpayer was provided with all necessary information for collecting this tax.
25. **Video Production Services & Government Contractors.**
P.D. 05-85 (June 8, 2005). The Tax Commissioner ruled that the taxpayer's purchase of custom made training DVDs from a video production company was subject to sales tax. However, if the purchase is made pursuant to a contract with the U.S. Navy for the procurement of the videos, then the purchase of the DVDs will be exempt.

26. **Government Indefinite Delivery/Indefinite Quantity Contracts.**
P.D. 05-93 (June 10, 2005). The Tax Commissioner made a fact specific ruling to the contract in question. The contract provided for the procurement of tangible personal property that qualified for the resale exemption as it was being sold to the federal government. Therefore, no tax was due.

27. **Taxpayer is Not a Manufacturer.** P.D.s 05-94 & 05-95 (June 10, 2005). The taxpayer contended that he was a manufacturer and should therefore receive exemptions on all products. The Tax Commissioner found that the taxpayer was a distributor rather than a manufacturer as the taxpayer received finished goods and did not apply any additional manufacturing or processing. Also, classification as a manufacturer for local tangible personal property taxation purposes only does not constitute a manufacturing classification for Virginia retail sales and use tax purposes.

28. **Public Facilities Act.** P.D. 05-97 (June 8, 2005). This ruling provides a brief overview of the procedure for obtaining the sales tax entitlement for sales tax revenues generated by through the Public Facilities Act.

29. **Taxpayer Failed to Provide Evidence.** P.D. 05-99 (June 8, 2005). Taxpayer claimed to be eligible for Internet provider exemption. The taxpayer made numerous claims to support the exemption, but failed to provide any reliable evidence. Due to lack of evidence, the Tax Commissioner upheld the assessments.


The Tax Commissioner granted a refund of sales taxes that the Taxpayer paid to vendors on purchases that should have been exempt. The Taxpayer requested refunds from the vendors, but was denied.

The auditor assessed tax on products used in a process to test the durability and longevity of the copiers the taxpayer sells. The taxpayer contended that the products should qualify for the research and development exemption. However, the Tax Commissioner found no evidence that the contested items should qualify for the exemption.

The Taxpayer obtained vendor refunds for the overpayment of the tax on other purchases and questioned whether it is entitled to interest on the overpayment of the tax. The Tax Commissioner ruled that the taxpayer is entitled to receive interest upon verification of the overpayments and refunds by an auditor.
31. **Durable Medical Equipment Exemption.** P.D. 05-106 (July 8, 2005). The Tax Commissioner ruled that in order to qualify for the durable medical equipment exemption, the equipment must have been purchased for an individual and must pass a four prong test: the equipment (i) can withstand repeated use, (ii) is primarily and customarily used to serve a medical purpose, (iii) generally is not useful to a person in the absence of illness or injury, and (iv) is appropriate for use in the home. In this case, equipment that passed the four prong test but was purchased for churches, businesses, and other organizations not eligible for the exemption as the equipment was not purchased for a specific individual.

32. **Successor Liability.** P.D. 05-109 (July 18, 2005). The taxpayer contested an assessment based on the purchase of a business. The taxpayer contended that the purchase was a nontaxable stock sale and the sales tax had been paid on the leases assessed in the audit. The Tax Commissioner upheld the assessment after the taxpayer failed to provide additional information.

33. **Audit Sampling.** P.D. 05-110 (July 18, 2005). The assessment was upheld as the taxpayer failed to meet his burden to prove that the audit sample was flawed. The taxpayer had asked that certain transactions be removed from the sample. The taxpayer failed to show that these transactions were isolated and not a normal part of the taxpayer’s business.

34. **Caterer Policy.** P.D. 05-111 (July 18, 2005). The Department upheld its policies regarding caterers that were in effect during the period which held certain equipment rentals taxable. As this policy was changed on 1/1/05, the taxpayer appealed his assessments. The assessments were upheld as the audit period was prior to 1/1/05. Note, under the new Department of Taxation policy (effective 1-1-05), items intended to be transferred to the customer are no longer taxable to the caterer. Such items may be purchased by the caterer as a sale for resale.

35. **Llama Breeding.** P.D. 05-113 (July 18, 2005). The Department ruled that the exemption under Va.Code § 58.1-609.21 is not limited to a specific breed of llama, the breeding of any species of llama by a farmer for sale is considered agricultural production for market, and the sale of fleece is considered agricultural production for market.

36. **Software Shipped to Virginia.** P.D. 05-114 (July 18, 2005). The Department assessed the taxpayer sales tax on software that was allegedly shipped to Virginia. The taxpayer disputed that the software was ever shipped to Virginia despite a contract specifying such delivery. The assessment was upheld as the taxpayer did not provide strong enough evidence to support his assertions.

37. **Nonfiler Statute of Limitations.** P.D. 05-115 (July 18, 2005). The taxpayer claimed that the three year statute of limitations had run and the assessments imposed against him were invalid. However, since the taxpayer was a nonfiler for the
periods in question, the statute of limitations is six years under Va.Code § 58.1-634. The Tax Commissioner upheld the assessments.

38. **Ophthalmic Laboratory Eligible for Manufacturing Exemption.** P.D. 05-116 (July 18, 2005). The Tax Commissioner ruled that a taxpayer’s ophthalmic laboratory was separate from the retail division that sells prescription eyeglasses and therefore eligible for the manufacturing exemption. The Commissioner also ruled that the penalties levied against the taxpayer would be abated if, as a result of the granting of the manufacturing exemption, the taxpayer was within the appropriate compliance ratio.

39. **Home Security Systems.** P.D. 05-121 (July 20, 2005). The taxpayer requested a ruling on the applicability of the sales tax to the sale of non-monitored home security systems. The Tax Commissioner ruled that the sale of these systems is subject to the sales tax except for any installation service charge which must be separately stated.

40. **Exemptions for Healthcare.** P.D. 05-126 (August 2, 2005). The taxpayer, a for-profit hospital, disputed the taxability of a number of items ruled taxable pursuant to an audit. The Tax Commissioner ruled that the precision shaped allograft implants and paste were exempt under § 58.1-609.10 as they are considered prosthetic devices. The Tax Commissioner also ruled that based on the exempt nature of the implants, the compliance ratio would be recomputed to determine if the penalty imposed should still apply.

41. **Specialty Advertising Not Exempt.** P.D. 05-127 (August 2, 2005). The taxpayer sells products for specialty advertising through embroidery, screen printing, and other specialty advertising. The taxpayer failed to charge sales tax and was assessed for sales tax upon audit. The taxpayer argued that the charges were purely for labor. The Tax Commissioner disagreed and upheld the assessment holding that the service was provided in connection with a sale of tangible personal property.

42. **Website Nexus.** P.D. 05-128 (August 2, 2005). The taxpayer has no connection to Virginia other than it has placed a link on a website that is housed on a server in Virginia. The taxpayer requested from the Tax Commissioner a ruling on whether this would constitute nexus in Virginia. The Tax Commissioner ruled that this fact alone would not constitute nexus in Virginia as this would not be considered physical presence in Virginia.

43. **Tax Collected But Not Remitted.** P.D. 05-130 (August 3, 2005). The Tax Commissioner ruled that the taxpayer was liable for sales tax collected but not remitted to Virginia. The taxpayer argued that it was taxable in another state and not Virginia. The Tax Commissioner acknowledged that in certain instances, the taxpayer is allowed to deduct taxes paid to other states in determining its Virginia liability, this did not change the fact that the taxpayer had already collected Virginia tax. Therefore, based on § 58.1-625, the assessment was upheld for the unremitted taxes.

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44. **Taxpayer Relied Upon Erroneous Advice from Tax Department.** P.D. 05-131 (August 3, 2005). The Tax Commissioner ruled that the taxpayer should have been liable for use tax on flooring materials stored in Virginia prior to being used on a non-exempt job outside of Virginia. In addition, the taxpayer should not have been eligible to receive an out of state tax credit for any sales and use taxes paid on the same materials to another state. However, in a prior audit, the Department had erroneously agreed to allow the taxpayer an out of state tax credit. As the taxpayer had relied upon erroneous written advice given by the Tax Department, the assessment was revised. The taxpayer was also advised that on a prospective basis that it should begin paying sales and use taxes on all future purchases and that it will not receive a credit for these purchases.

45. **ATVs Are Not Eligible for an Agricultural Exemption.** P.D. 05-133 (August 10, 2005). The taxpayer, a cattle farmer, purchased an ATV to help in the construction and repair of fencing on his farm. The Tax Commissioner ruled that the purchase of the ATV was subject to sales and use tax. The agricultural exemption specifically does not apply to property that will become affixed to the real property. Likewise, equipment and supplies for maintaining such fencing are also not eligible for an exemption.

46. **Software Packages Taxable.** P.D. 05-134 (August 10, 2005). The Tax Commissioner ruled that two software packages purchased by the taxpayer were subject to the sales tax. The first package was subject as it was pre-written software (not custom) and was delivered in tangible form. The second package was taxable as the taxpayer did not provide the requested information concerning the package.

47. **Metamucil is Taxable.** P.D. 05-135 (August 10, 2005). The taxpayer contended that sales of Metamucil should not be subject to the sales tax. The Tax Commissioner ruled that based on the stated ingredients that Metamucil is a natural substance rather than a medicine or drug. The latter finding is required to be eligible for the exemption.

48. **Gift Transactions.** P.D. 05-136 (August 22, 2005). The taxpayer requested a ruling on the taxability of several scenarios where a gift is purchased and delivered.

- **Scenario 1:** A Virginia customer purchases a gift that is filled out of Virginia and shipped to another state. This is taxable as the sale was completed in a Virginia store.
- **Scenario 2:** Company B is a national retailer with stores in Virginia. Company B has a separate subsidiary in CompanyB.com that accepts orders and payment via the Internet and fulfills and ships the orders all from outside Virginia. If a taxpayer places an order with CompanyB.com via the Internet and the order is accepted, payment is processed, and the order is shipped all from outside Virginia, the sale is not taxable.
- **Scenario 3:** Company C is a national retailer with stores in Virginia. If a taxpayer places an order with Company C via telephone and the order and
payment is received, fulfilled, and shipped all from outside Virginia, the sale is not taxable. However, if the order is placed from a special telephone in a store of Company C in Virginia, the sale is taxable.

- Scenario 4: Same as #3 except Company D is a catalog retailer.
- Scenario 5: Company E is a national retailer with stores in Virginia and also has a website that accepts sales. Other than the stores, Company E has no other connection with Virginia. For all Internet sales, when Company E receives an order, it places an order for the product with the manufacturer or distributor who fulfills the order and ships directly to the customer. If a taxpayer places an order with Company E via the Internet and the order is accepted, payment is processed, and the order is shipped all from outside Virginia, the sale is not taxable.

- Scenario 6: If a Virginia customer places an order at a Virginia store but asks for the merchandise to be released from another store in another state and the customer pays sales tax in the other state, then there is probably not a sale constituted in Virginia as the customer is likely required to pay at the other store.
- Scenario 7: If a customer purchases a gift from a VA retailer with instructions for the gift to be shipped outside of VA with the retailer assuming the risk of loss until the recipient receives the gift, the purchase is still taxable at the time of payment. Shipping details do not affect the tax.
- Scenario 8: If a customer purchases a gift from a VA retailer, but the item is not present in the VA store and will be shipped from another store or distribution center outside of Virginia to a location outside of Virginia, then the Virginia sales tax will still apply at the time of purchase.

49. **Gift Transaction.** P.D. 05-138 (August 22, 2005). A ruling was requested on the following: The retailer is a mail order and Internet gift company and has an affiliate that operates retail stores in every state. Because the retail stores support the mail order and Internet business, the Retailer is registered and collects tax in all states where they have affiliated stores. Any gift transaction would be subject to the Virginia sales tax if the sale is completed in a Virginia store location, Virginia mail or telephone order location, or Virginia Internet retail center. When orders are placed via the Internet from a customer's home or place of work, the transaction would not be considered a Virginia sale if the sales order is accepted and the payment is processed by the Retailer at a location outside Virginia.

50. **Mezzanines Are Not Tax Exempt.** P.D. 05-140. (August 25, 2005.) In a redetermination, the Tax Commissioner upheld a previous ruling that held that mezzanines used in manufacturing are subject to sales and use taxation. As used in the context of this ruling, a ‘mezzanine’ is an elevated platform used to aid in construction or manufacturing. The basis for the ruling is VAC § 10-210-920 B 2 that says that platforms are used indirectly in manufacturing and are therefore taxable.
51. **Government Contract for Services.** P.D. 05-141. (August 25, 2005). The Tax Commissioner held that the true object of a contract between the taxpayer and an agency of the federal government was a contract for the taxpayer’s services, and not solely to provide a computer system. As this was a contract for services, any tangible personal property purchased by the taxpayer would be subject to tax as the taxpayer would be the consumer of such property.

52. **Inconsistent Exemption Certificate & Sampling.** P.D. 05-153 (September 22, 2005). The taxpayer is an importer and distributor of various types of stone. Upon an audit, the taxpayer was assessed sales tax for sales of TPP on which the taxpayer did not collect sales tax. The taxpayer contended that such sales were exempt and that the inclusion of these sales in the audit sample was not proper as these sales were of a one time nature. The Tax Commissioner upheld the audit finding that the exemption certificates obtained by the taxpayer after the beginning of the audit could not be accepted in good faith. The reason the certificates could not be accepted was that there were numerous discrepancies in the certificates. In two cases, the certificates were nine to seventeen months prior to the date that business registered with the Department for sales tax. Also, the Tax Commissioner ruled that the inclusion of these sales in the audit sample was proper as sales of this type are an integral part of the taxpayer’s business.

IV. **PROPERTY (AD VALOREM) TAXES**

A. **2005 Legislation**

1. **Recordation Tax Exemption - LLC/Partnership "Drop Kick Transaction" Restricted.** H.B. 2177 (Chapter 93) amends Virginia Code § 58.1-811(10) and (11) to modify the exemption from recordation taxes for deeds conveying real estate to and from partnerships and limited liability companies by excluding transfers that are precursors to a transfer of control of the partnership, LLC, or its assets with the intent to avoid recordation taxes. For example, a typical transaction would be for a seller to convey property to a newly organized LLC whose sole asset would be the real property and then sell the membership interest in the LLC instead of the property directly to the purchaser. The property could then be conveyed from the LLC to the purchaser or retained in the LLC. Both conveyances involving the LLC are currently exempt from the recordation tax. This transaction also deprives the local government tax authority of data on the true consideration for the sale of the underlying real property.

2. **Interest on Deferred Real Estate Tax.** H.B. 2635 (Chapter 561) and S.B. 1087 (Chapter 502) amend Virginia Code § 58.1-3219.1 to limit the interest rate localities charge on deferred real estate taxes to a rate that does not exceed the rate established by IRC § 6621 for underpayments of federal taxes.

3. **Elderly/Disabled Exemption Modified.** S.B. 844 (Chapter 214) and S. B. 851 (Chapter 215) amend Virginia Code § 58.1-3211 to permit a locality to exclude up to $5,000 of permanent or temporary disability benefits of an owner when determining eligibility for the locality's tax deferral programs. Currently, the statute
allows a locality to exclude up to $10,000 of income for a taxpayer who is age 65 or older or who is permanently or totally disabled. Effective July 1, 2005 this limit is increased to $15,000.

4. **Definition of Common Spaces.** S.B. 896 (Chapter 218) amends the definition of an "open or common space" in Virginia Code § 58.1-3284.1 to include common areas that are part of a planned residential development initially recorded before January 1, 1985, that did not include automatic membership in a membership corporation or association in its declaration. Prior to this amendment such property is not considered open or common space property if the development's declaration does not provide property owners with automatic membership in a membership corporation or association. The import of the definition change is to prohibit a locality from assessing real estate taxes against these membership corporations or associations for the common area. Instead, the value of the common area will be taxed through the increased value of the residential property that has an interest in the open or common area. Virginia law today requires residential developments with common areas to include mandatory or automatic membership in the corporation or association charged with its upkeep. Older developments did not necessarily have mandatory membership.

5. **Valuation Changes to M&T - Notice Requirement.** H.B. 2477 (Chapter 108) amends Virginia Code § 58.1-3507(B) to require that any proposed changes in the valuation method used for machinery and tools be published by a notice appearing in a newspaper of general circulation at least 30 days prior to such change and permit comments to be submitted to the Commissioner of the Revenue by the public on the proposal during the 30 day notice period. NOTE: Most localities assess machinery and tools on the basis of original costs, coupled with a sliding scale based on the age of the property.

6. **TPP Classification – Business Boats.** S.B. 1273 (Chapter 27) and H.B. 2686 (Chapter 325) amend Virginia Code § 58.1-3506(A)(33) to create a separate classification of tangible personal property for boats weighing less than 5 tons used for business purposes. Prior to this legislation there were separate classifications for boats weighing 5 tons or more, and for privately owned pleasure boats (18 feet and over). The legislation will provide localities with flexibility to apply a different tax rate to each of the 3 classes of boats.

7. **Machinery and Tools Tax – Heavy Machinery.** S.B. 1279 (Chapter 357) enacts Virginia Code § 58.1-3508.2 to provide a separate classification of tangible personal property for certain heavy construction machinery (i.e., land movers, bulldozers, front-end loaders, graders, packers, power shovels, cranes, pile drivers, forest harvesting and silvicultural activity equipment, etc.) as a separate classification of property. The tax rate may not exceed the rate imposed upon the general class of tangible personal property.
B. Recent Court Decisions

No recent court decisions.

C. Recent Virginia Tax Commissioner Rulings

1. **City's Property Valuation Method Unconstitutional.** P.D. 05-3 (January 21, 2005). A city’s Virginia machinery and tools tax assessment of equipment violated the statutory method of valuation used to ascertain fair market value of machinery and tools and violated the fair market value requirements of the Virginia Constitution. The city’s revised basis of the equipment was based on replacement costs reported on federal income tax returns and not the depreciated cost or a percentage of the original total capitalized costs of the machinery, and far exceeded fair market value. The Virginia Constitution required that property be taxed at a uniform rate upon the same classes, and that taxes and property assessment must be at the fair market value of property.

2. **Quality Assurance Equipment Subject to Tax.** P.D. 05-6 (February 1, 2005). The quality assurance equipment used by a snack food manufacturer would be subject to the local Virginia machinery and tools tax because it is used directly in the manufacturing process. This consisted of equipment used to calibrate thermometers, to inspect ingredients, to use in lab testing, to measure moisture content, to weigh the product, to measure viscosity, to test the pH of the finished product, and to test the sanitation of the processing equipment. Whether the equipment used to purify water is directly used in the manufacturing process would depend on the use of the water. If it is used in the manufacture of snacks, this equipment also would be classified as machinery and equipment for purposes of local taxation. Likewise, equipment used to measure the thickness of the packaging film and material could be considered machinery and equipment if it is used in connection with the operation of machinery that is directly used in the manufacturing process. However, the manufacturer’s routine maintenance equipment, the machines used to sanitize the walls and floors, and the fogging equipment used to kill insects are not subject to the machinery and tools tax because they are not directly used in the manufacture of a product, thereby classified as intangible property pursuant to Va. Code § 58.1-1101(A)(2).

3. **Owner/Lessor of Property on Lease to Own Contract Owes Property Tax.** P.D. 05-55 (April 12, 2005). Taxpayer is lessor of TPP in Virginia to federal government agencies under a “lease to own plan” (LTOP). Title does not pass until last lease payment is made at end of lease term. Prior to this event, taxpayer retains legal title to the leased property. The government, as lessee, is responsible for maintaining the property and can terminate the agreement. Tax Commissioner holds taxpayer-lessor is responsible for the BTPP tax on the equipment as the owner of the property.
V. PROCEDURAL

A. 2005 Legislation

1. Tax Return Preparer – Fraudulent Returns. S.B. 1225 (Chapter 48) amends Virginia Code § 58.1-302 and creates Virginia Code §§ 58.1-348.1 and 58.1-348.2. Together, this legislation creates a Class 6 felony for knowingly and willfully aiding, assisting in, counseling, or advising the preparation or presentation of a fraudulent tax return, affidavit, claim, or other document that the income tax return preparer knows is fraudulent or false as to any material error. A Class 6 felony carries a penalty of imprisonment for not less than one year nor more than five years or confinement in jail for up to 12 months and a fine of not more than $2,500 or both. The legislation also authorizes the Tax Commissioner to initiate injunctive action against a fraudulent income tax return preparer. The new law defines an "income tax return preparer" as a person who prepares for compensation, any portion of an income tax return or a claim for refund. The statute expressly excludes from the definition a person who merely furnished typing, reproducing, or other mechanical assistance, prepared a return or refund claim for his or her employer, or prepared a return or refund claim as a fiduciary.

2. Local Business and BPOL Tax Appeals. H.B. 2679 (Chapter 297) amends Virginia Code §§ 58.1-3703.1 and 58.1-3983.1 as they relate to the appeals process regarding local license and local business taxes.

SUMMARY OF CHANGES

The legislation makes several changes to the administrative appeals process related to the BPOL tax, the machinery and tools tax, the merchants' capital tax and the business tangible personal property tax (the "local business tax") and the tangible personal property tax on airplanes, boats, campers, recreational vehicles and trailers (the "local mobile property tax"). Specifically, this law now provides that when a taxpayer appeals an assessment of BPOL taxes to the commissioner of the revenue or the Tax Commissioner, collection activity is only suspended with respect to the amount of the assessment that is in dispute. With respect to appeals of BPOL, local business and local mobile property tax assessments, this law provides that the locality must suspend collection activity when the taxpayer appeals a determination of the Tax Commissioner to the circuit court. This legislation also expands the local business tax administrative appeals process to include local consumer utility taxes, except for the consumer utility tax on mobile telecommunications, where the amount in dispute exceeds $2,500. Additionally, this legislation shortens from two years to one year the time that must pass before a taxpayer may elect to treat a commissioner of the revenue's failure to issue a final determination on an appeal as a denial of the appeal so that the taxpayer may appeal the assessment to the Tax Commissioner absent a final determination from the commissioner of the revenue.
WHO GETS WHAT?

The local government gets:

1. Collection activity reinstated unless taxpayer notes appeal.
2. Taxpayer must file appeal 30 days after noting it.
3. Pre-payment of the undisputed portion of the tax before appeal.
4. Payment of the disputed portion of the tax, or a bond, if judge rules:
   • the payment is in jeopardy.
   • the appeal is frivolous or filed merely to delay.
   • the amount is so large it poses a real hardship on the locality.

The business taxpayer gets:

1. Administrative appeals of one more tax: consumer utility tax.
2. No pre-payment of disputed portion of tax except in special circumstances.
3. Locality must make any refund or decide to appeal in timely fashion.
4. Payment of any undisputed portion of a refund before locality appeals.
5. Taxpayer can request refund of disputed amount if local appeal is frivolous.

Both sides still have:

1. Interest paid by loser from the start of the dispute.
2. A presumption that the Tax Commission’s ruling is correct.
3. The ability to get advisory opinions on these disputes from the state.
4. A non-judicial review that is far less expensive than court.

The new local business tax and BPOL appeals procedures apply to appeals filed on or after July 1, 2005.

3. Excise Tax Penalties for Late Payment. S.B. 1052 (Chapter 501) amends Virginia Code § 58.1-3916 to authorize localities to impose by ordinance a penalty for the delinquent remittance of excise taxes on meals, lodging, or admissions collected from consumers, not to exceed 10% for the first month the taxes are past due and 5% for each month thereafter, not to exceed 25% of the amount of taxes not remitted. Currently the penalty for delinquent remittance of these taxes is limited to 10%. The new penalty rates take effect July 1, 2005.
4. **SCC Tax Assessments – Statute of Limitations.** S.B. 796 (Chapter 21) amends Virginia Code § 58.1-2670 to clarify that any taxpayer, the Commonwealth, or any county, city or town may apply to the State Corporation Commission for review and correction of an assessment of value or tax within 3 months after receiving a certified copy of such assessment or tax. This legislation was enacted to ensure that once 3 months has expired, an applicant has no jurisdiction to file or refile and application with the SCC.

**B. Recent Court Decisions**

No recent court decisions.

**C. Recent Virginia Tax Commissioner Rulings**

1. **Guidelines for Local Mobile Property Tax Appeals.** P.D. 05-81 (June 9, 2005). The Tax Department established Guidelines for Appealing Local Mobile Property Taxes. The Guidelines were created to provide direction to those wishing to take advantage of the new administrative appeals process created by House Bill 464 (Chapter 534, 2004 Regular Session). These guidelines were designed to closely mirror the current BPOL appeals process.

**D. Recent Opinions of the Attorney General**

1. **Payments in Lieu of Real Property Tax for a Non-Tax-Exempt Entity.** Op. No. 04-095 (April 4, 2005). A county does not have the authority to negotiate a service fee in lieu of property taxes and other taxes unless the entity is tax-exempt. A county may only negotiate an arrangement pursuant to the Electric Authorities Act. There is also no authority for a county to negotiate a steady stream of payments in lieu of local taxes from a commercial entity.

2. **Progressive Real Property Tax Rates Are Unconstitutional.** Op. No. 05-028. (August 1, 2005). The adoption of progressive real property tax rates on residential housing would be violative of the property tax uniformity provision of the Virginia Constitution. The Attorney General noted however that there are other forms of permitted tax relief that a local government may provide to land annexed by cities or towns, real estate devoted to agricultural uses, and certain elderly and disabled individuals.

3. **Discrimination in Real Property Tax Assessments.** Op. No. 05-038. (August 19, 2005). The Attorney General opined that a variance among real property tax assessment percentages among a few taxpayers is not, per se, a violation of the applicable legal requirements. However, material, systematic, and intentional discrimination against a taxpayer or group of taxpayers would be violative of various constitutional requirements. Often it is due the inexact science of appraisals that variances may occur in property taxation. That is why it is necessary to have a Board of Equalization to minimize these variances.
VI. BUSINESS LICENSE TAXES

A. 2005 Legislation

1. Local Business and BPOL Tax Appeals. H.B. 2679 (Chapter 297) amends Virginia Code §§ 58.1-3703.1 and 58.1-3983.1 as they relate to the appeals process regarding local license and local business taxes. For complete discussion of this legislation See V.A.2 above.

B. Recent Court Decisions

No recent court decisions.

C. Recent Virginia Tax Commissioner Rulings

1. BPOL Gross Receipts Attribution Outside Virginia. P.D. 05-1 (January 18, 2005). Internet service provider would be allowed to deduct from gross receipts those receipts attributable to its activity in other states in which it files an income or income-like tax return. Moreover, the Internet service provider would be entitled to deduct from its gross receipts allocated to Virginia those receipts attributable to business conducted in another state in which it is liable for income or income-like tax, even if it does not maintain a definite place of business in the state. In calculating the BPOL tax assessment, the out-of-state deduction for service revenues subject to an income or income-like tax in another state must be allowed before applying the payroll apportionment to the remaining receipts. Furthermore, the sales factor, as reported for Virginia corporate income tax purposes, would not control the standard for assessing the BPOL tax or in determining the receipts qualifying for the out-of-state deduction. The best method for measuring revenues from business done in other states would be based on actual receipts from the sale of goods or services generated in those states. In addition, payroll apportionment between the Internet service provider’s three definite places of business in Virginia would be the most efficient method of apportioning the Virginia receipts for purposes of the BPOL tax.

2. Manufacturer Rebates Excluded from Gross Receipts. P.D. 05-24 (March 3, 2005). Manufacturer incentives to a franchised automobile dealership in the form of rebates or discounts taken or received on the account of purchases made by it must be excluded from the dealership’s gross receipts for purposes of BPOL taxation. These incentives serve to reduce the dealership’s cost of items purchased and cannot be considered as gross receipts. Manufacturers’ incentives that are unrelated to purchases, such as cash incentives based on the volume of vehicles sold, are considered to be part of the dealership’s gross receipts. This is true if the incentive is paid by the manufacturer directly to the dealership or if it is paid to the customer, who assigns the incentive to the dealership in consideration of the purchase of an automobile.
3. **Accounting Firm Affiliate Credited with Receipts and Tax Payments on Consolidated Filing.** P.D. 05-25 (March 7, 2005). An accounting firm created an affiliated corporation. The accounting firm provided all payroll functions to the affiliated company. The accounting firm also included in its BPOL tax filings all of the gross receipts from the affiliated company. The Tax Commissioner held that the affiliated company must file its own business license tax return reporting its own gross receipts (independent of the accounting firm’s receipts). The Commissioner held that the locality correctly exempted only those receipts that were in fact intercompany transfers between the accounting firm and its affiliate. The Commissioner held the City correctly credited the affiliated company on the gross receipts that were reported by the accounting firm, however, it did uphold the penalties and interest on late payment and underpayment of taxes.

4. **Aircraft and Aviation Services to Medical Air Transport Program Exempt from BPOL Tax.** P.D. 05-50 (April 8, 2005). Taxpayer, a medical transport helicopter aviation and maintenance provider entered into a contract with a medical center to provide air transportation services. Taxpayer provided 24 hour, 7-day a week pilot staffing, record maintenance and operational maintenance in compliance with FAA Regulations. Taxpayer also performed its own aircraft maintenance on the helicopters through use of a full-time mechanic to enable the helicopter to be mission ready. The Tax Commissioner overruled a local BPOL tax assessment and held that taxpayer’s activities are exempt from the BPOL tax by virtue of the federal pre-emption in 49 U.S.C. § 40116 (Federal statute restricting state and local governments from taxing certain commercial aircraft operators) relying upon *Aloha Airlines, Inc. v. Director of Taxation* 464 U.S. 7 (1983). A full refund was ordered.

5. **Professional Staffing Service Entitled to Special Classification.** P.D. 05-51 (April 8, 2005). Locality agreed with taxpayer seeking to reclassify itself from business services to the special classification afforded by Va. Code § 58.1-3732.4 (Professional Staffing Service). City refunded overpaid taxes for tax years 2001-2003, but declined to refund overpaid taxes for 1999-2000 as a result of the reclassification. The Tax Commissioner overruled the City and held the taxpayer timely provided an application for review and ordered a refund of all excess taxes paid.

6. **Attribution of Receipts by Non-Vessel Common Carrier.** P.D. 05-53 (April 8, 2005). Taxpayer sought to use alternative payroll apportionment for gross receipts after previously submitting gross receipts based on sales. City denied alternative attribution of receipts and this determination was upheld by the Virginia Tax Commissioner. The Commissioner held that taxpayer did not provide sufficient financial information to enable gross receipts to be allocated to offices located outside of the City. The Commissioner directed the taxpayer to provide receipts attributed solely to the City, as opposed to receipt allocated to its offices in other states where it is liable for an income or income-like tax and files are returned.
7. **Law Firm Partnership Entitled to Out-of-State Deduction for Receipts of its Partners Attributed to Other States.** P.D. 05-58 (April 12, 2005). Law firm conducted professional business services in several offices in Virginia, as well as in several other states and in foreign countries. Following a dispute as to how the law firm allocated gross receipts with a Virginia locality, the Tax Commissioner held that the law firm is entitled to a deduction from gross receipts for those receipts attributed to business conducted in other states and foreign countries where such receipts were subject to an income or income-like tax and filed accordingly. The Commissioner held that the law firm could use an apportionment methodology based on “hours worked” in the Virginia locality. The law firm maintained suitable records to substantiate this approach. The law firm was entitled to an out-of-state deduction for the receipts of its partners attributed to other states where the partners were liable to file and did file an income tax or an income tax-like return.

8. **Determination of Situs and Research and Development Provider.** P.D. 05-75 (May 16, 2005). The Tax Commissioner determined that the taxpayer did have a business situs in the city dating to September 2002 despite the contentions that the Taxpayer was actually controlled by out-of-state entities. The Tax Commissioner also found that the Taxpayer is a provider of research & development services. The Tax Commissioner however returned this case to the City to determine the extent to which the Taxpayer qualifies for the special rates and classifications under the research and development qualification.

9. **Classification of Certain Retirement Communities.** P.D. 05-79 (May 23, 2005). A taxpayer requested an advisory opinion on how a retirement community would be classified for BPOL purposes when the retirement community provides two very different and distinct levels of service. On one level the community provides independent living units for senior citizens. A number of services are included with the rental of each unit. On another level the community provides assisted living services, which includes room and board, for senior citizens. The assisted living service provides around-the-clock care for senior citizens. The Tax Commissioner opined that such a community is in fact operating as two separate businesses. The gross receipts from the independent living unit rentals would be exempt from the BPOL tax whereas the gross receipts from providing assisted living would be subject to the BPOL tax.

10. **Payroll Apportionment.** P.D. 05-117 (July 19, 2005). The Tax Commissioner determined that the taxpayer’s operations were such that the taxpayer’s gross receipts could be assigned to any single one of its multiple locations. Therefore, the Commissioner agreed with the taxpayer that payroll apportionment should be used to apportion its gross receipts.

11. **Payroll Calculation and Sales in Other States.** P.D. 05-118 (July 19, 2005). The Commissioner ruled that the payroll of those personnel directly involved in the business of catalog and Internet sales must be included for purposes of determining payroll apportionment. A factual determination must be made regarding the extent to which employees in the Taxpayer’s creative and marketing departments are
directly involved in the business of catalog and Internet sales. Also, the Taxpayer is entitled to deduct those receipts attributable to sales made in other states where the Taxpayer files an income or income-like tax return.

12. **Personal Service Business Classification.** P.D. 05-119 (July 19, 2005). The Tax Commissioner ruled that the taxpayer is in the business of providing staffing and protocols to facilitate the provision of medical services to inmates. The business of the Taxpayer, not the profession of the business's employees, is subject to the BPOL tax. Therefore the taxpayer is not liable for the BPOL tax as he provides personal services in the form of staffing rather than professional services. The medical personnel would be liable for BPOL for the services they provide to the taxpayer.

13. **Charitable Thrift Stores.** P.D. 05-143 (August 26, 2005). The Tax Commissioner ruled that charitable organizations that operated thrift stores to generate revenue to further their charitable purpose were not subject to the BPOL tax based on their receipts from the thrift store. To be subject to the BPOL, the receipts must qualify as unrelated taxable business income under IRC § 511 et seq. IRC § 511 contains an exception for income earned from thrift stores where substantially all of the merchandise is donated. Because of the exception, the charitable organization is not subject to the BPOL on its thrift store revenues.

14. **Attributing Revenue from National Call Center.** P.D. 05-144 (August 26, 2005). The Tax Commissioner ruled that revenue derived from a call center located within the county may be taxed by the locality. However, the taxpayer is allowed to deduct the receipts that are also taxable in another state via an income tax.

15. **Exterminators who also Repair Damaged Homes.** P.D. 05-147 (August 30, 2005). The Tax Commissioner ruled that an exterminator who also repaired damage caused by insects, etc., which could potentially qualify him as a contractor, should be assessed separately on each part of his business so long as he maintains separate licenses for each segment of the business. However, if the taxpayer elects to have one license, then the business should be assessed as a whole.

**D. Recent Opinions of the Attorney General**

1. **Localities May Impose Greater Threshold Amounts for BPOL.** Op. No. 05-027 (August 19, 2005). Section 58.1-3706(A) of the Code of Virginia prohibits localities from imposing the BPOL tax on businesses whose revenue does not exceed certain threshold amounts. A locality may set a higher threshold limit if it chooses to do so, but may not lower the threshold amount under any circumstances. In addition, localities may create business subclassifications and raise the threshold amount specifically for those subclassifications. However, if a locality does create a subclassification and raises the threshold amount, such action may not be arbitrary and must be based on a reasonable distinction.
VII. MISCELLANEOUS TAXES

A. 2005 Legislation

1. **Apple Harvest Excise Tax Referendum.** H.B. 1746 (Chapter 875) and S.B. 1008 (Chapter 864) amend Virginia Code § 3.1-626 and enact Virginia Code §§ 3.1-636.1, -636.2, -636.3, -636.4, -636.5, -636.6, -636.7, -636.8, -636.9, -636.10, -636.11, and -636.12 directing the Board of Agriculture and Consumer Services to authorize the holding of a referendum on the levy of an excise tax on 2.5 cents per tree run bushel of ungraded apples grown in Virginia by producers of at least 5,000 tree run bushels per calendar year. The excise tax would be established if more than one-half of those voting are in favor of the excise tax on apples. The Department of Taxation would collect the tax on an annual basis and the tax would be paid over to the Virginia Apple Fund. There are approximately 55-65 Virginia orchards that produce at least 5,000 tree run bushels per year.

2. **Motor Fuels Tax – Agricultural Vehicles Refund.** H.B. 1641 (Chapter 782) and S.B. 794 (Chapter 243) amend Virginia Code § 58.1-2259(B) to provide a 55% refund of the motor fuels tax paid by any person purchasing fuel for consumption in a vehicle designed or permanently adapted solely and exclusively for bulk spreading or spraying of agricultural liming materials, chemicals or fertilizer, where the vehicle's equipment is mechanically or hydraulically driven by an internal combustion engine that propels the vehicle.

3. **Motor Vehicle Sales and Use Tax – LLC Exemption.** H.B. 1508 (Chapter 274) amends Virginia Code § 58.1-2403(8) to add limited liability companies to the existing motor vehicles sales and use tax exemption for certain transfers from individuals or partnerships to corporations or from corporations to individuals or partnerships. Prior to this legislation, the Department of Motor Vehicles would not apply the exemption to LLC's as a result of legal advice provided by the Virginia Attorney General's Office.

4. **Motor Vehicle Sales and Use Tax – Limited Family Gift Exemption.** S.B. 836 (Chapter 246) amends Virginia Code § 58.1-2403(7) to provide that a gift of a motor vehicle to a spouse, son, or daughter shall be exempt from motor vehicle sales and use taxes. Currently, such gifts are exempt unless the person receiving the motor vehicle assumes an unpaid obligation relating to the vehicle. This legislation ensures the exemption applies even if the transferee family member assumes the unpaid obligation as a result of the transfer.

5. **Motor Vehicle Sales and Use Tax – Daily Rental Fee.** H.B. 1745 (Chapter 449) amends Virginia Code § 58.1-2402(5) to provide that the daily rental vehicle fee will be implemented, enforced, and collected in the same manner as rental taxes.
6. **Transient Occupancy Tax—Overnight Accommodations Required.** S.B. 793 (Chapter 20) enacts Virginia Code § 58.1-3826 to limit the imposition of the transient occupancy tax to charges for rooms or spaces occupied by transients that are intended or suitable for dwelling, sleeping, or lodging purposes. Any county may impose a transient occupancy tax at a maximum rate of two percent, upon adoption of an ordinance, on hotels, motels, boarding houses, travel campgrounds, and other facilities offering guest rooms (for periods of less than 30 continuous days). This legislation is intended to codify the interpretation of the meaning of the transient occupancy statute by the Attorney General in Opinion 04-063 (advising Chesterfield County that it may not impose the 2% TOT on rentals of meeting rooms, banquet facilities, conference rooms and similar rental charges for space that does not include living accommodations).

7. **Cigarette Tax—Exclusive Distributor Exemption.** H.B. 2899 (Chapter 856) amends Virginia Code §§ 58.1-1000 and 58.1-1012 to exempt exclusive distributors and manufacturers from the requirement to affix tax revenue stamps to cigarettes if they are being shipped, sold, or delivered to wholesale dealer stamping agents in Virginia. Under existing law, a manufacturer or distribution that makes any sales as a wholesale dealer to retail dealers must stamp all cigarettes it sells, unless an exemption applies. NOTE: This legislation has no impact on state revenues because the cigarette tax would be paid by the stamping agent. The state cigarette tax is currently 20 cents per pack and will increase to 30 cents per pack on July 1, 2005.

8. **Cigarette Tax Enforcement—Penalties.** S.B. 876 (Chapter 28) makes a number of changes to the cigarette tax laws to provide consistency with the Non-Participating Manufacturer ("NPM") reporting requirements and to enhance compliance and administration.

9. **Tobacco Products Tax.** H.B. 1885 (Chapter 71) makes several changes to the tobacco products tax including requiring licensure of distributors who (i) sell tobacco products in Virginia; (ii) bring or cause to bring tobacco products into Virginia; (iii) manufacture or store tobacco products in Virginia; or (iv) possess in Virginia for retail sale untaxed tobacco products; and changing the basis upon which the tax is computed. The effective date for this legislation is January 1, 2006.

**B. Recent Court Decisions**

No recent court decisions.

**C. Recent Virginia Tax Commissioner Rulings**

1. **Tobacco Products Tax Guidelines and Rules.** P.D. 05-17 (February 18, 2005). The Tax Department released guidelines and rules to wholesale dealers and to those retailers who purchase untaxed products from out-of-state wholesale dealers of cigars, smoke-less tobacco, pipe tobacco, and roll-your-own tobacco regarding the tobacco products tax that took effect March 1, 2005. The guidelines define what products are subject to the tobacco products tax, defines wholesale and retail dealers,
defines sales price and purchase price, imposes a registration requirement and a monthly
tax return filing requirement, recordkeeping requirements, and penalties for
noncompliance with the tobacco products tax law.

2. **Recordation Tax Refund on Deed of Trust.** P.D. 05-20 (February 28, 2005). A taxpayer would be entitled to a refund of Virginia recordation tax for recording a deed of trust memorializing a note with a lender that refinanced two previous outstanding notes, because the deed of trust secured obligations greater than the fair market value of the underlying real estate on which the recordation tax was based. The recordation tax is not imposed on the total amount of obligations described in a deed of trust, but on the amount that is secured by the property conveyed. Therefore, the amount secured by a recorded deed of trust can never be more than the fair market value of the property described and conveyed by the deed. The tax will be limited to the fair market value of the property conveyed whenever the amount of the obligations described in a deed of trust exceeds the value of the property conveyed.

3. **Motor Fuels Tax Exemption.** P.D. 05-77 (May 26, 2005). The Tax Commissioner opined that authority does not exist anywhere in Virginia law to grant an exemption to certain businesses from having to collect the additional 2% Motor Vehicle Fuel Sales tax when the county in which the business resides joins either an existing transportation district or forms a new district. In addition, the Commissioner opined that local government officials also lack the authority to grant such an exemption.

4. **Recordation Tax Refund.** P.D. 05-82 (June 8, 2005). The Tax Commissioner issued a refund of erroneously paid recordation taxes as the ultimate conveyances never occurred which therefore removed all basis for the tax.

5. **Fiduciary Income Tax.** P.D. 05-89 (June 9, 2005). The Tax Commissioner ruled that a trust that owns real estate in Virginia through limited partnership interests and receives income from these partnerships is liable for Virginia income tax if a portion of the income is Virginia source income.

6. **Cigarette Tax Increase Guidelines.** P.D. 05-102 (May 13, 2005). This Bulletin provided guidelines on the second cigarette tax increase in Virginia history. The increase was handled similarly to the September 2004 increase where wholesalers were limited in the number of stamps they could purchase prior to the increased tax stamps becoming available. This approach is designed to prevent hoarding of $0.20 stamps.

7. **Machinery & Tools Tax Appraisal Method.** P.D. 05-129 (August 3, 2005). The taxpayer an assessment of its locality’s Machinery and Tools tax based on the method of valuation used by the locality. The locality used a percentage of cost method. The taxpayer argued that based on an independent appraisal, the fair market value of its applicable equipment is actually less than the amount upon which the tax was assessed. The County argued that it could not consider the outside appraisal based on
P.D. 04-16. The Tax Commissioner ruled that the outside appraisal could be considered and any interpretation of P.D. 04-16 is thus superseded.

8. **Linen Services.** P.D. 05-142 (August 26, 2005). The Tax Commissioner ruled that for Business Tangible Personal Property tax classification purposes, a linen service business is separate and distinct from a laundry business. When the General Assembly added dry cleaning and laundry businesses to the list of property that is tangible in fact but classified as intangible, they did not include the linen service business. The Tax Commissioner did find that the Taxpayer is engaged in processing at its laundry facility. Therefore, the Taxpayer's machinery and tools used in processing are segregated, as machinery and tools for the special tax rate. Likewise, the machinery and tools it leases from a vendor are also subject to the special machinery and tools tax rate.

9. **Carpet Fiber Drying Machinery is Subject to M&T Tax.** P.D. 05-148 (August 30, 2005). The Tax Commissioner ruled that machinery used to dry carpet fibers was being used in the manufacturing process even though the only change to the fiber was the removal of moisture. Therefore, the machinery would be subject to the Machinery & Tools tax just as all other machinery used in a manufacturing process.

D. **Recent Opinions of the Attorney General**

1. **Secrecy of Taxpayer Information.** Op. No. 05-021 (June 14, 2005). The Attorney General opined that a Commissioner of the Revenue must determine if a data system containing confidential taxpayer information is adequately secure enough to protect the confidential taxpayer information. In addition, if a commissioner uses employees not under his supervision to build and maintain such a system, those employees are permitted access to the confidential taxpayer information as it is necessary for the performance of their duties through the “line of duty” exception in Virginia Code § 58.1-3.

E. **Legislative Study – Accountability on Business Incentives and Tax Credits**

1. The 2005 General Assembly took two steps in an effort to get a better handle on the cost of Virginia’s business incentives and tax credit. First, the legislature passed Senate Bill 867 (Chapter 216) that requires the Tax Commissioner to issue an annual report to the members of the House Appropriations Committee, the House Finance Committee, and the Senate Finance Committee providing a comprehensive view of tax relief in Virginia during the preceding tax year. A preliminary report is to be submitted by December 1, 2006 and each year thereafter. A final report, with data additions or revisions, is to be submitted by April 15, 2007 and each year thereafter. This legislation amended Virginia Code § 58.1-202 by creating a new subsection 14.
The annual report is to detail the amount of income tax relief granted to corporations in Virginia. The report will include the total dollar amount of income tax subtractions, deductions, exclusions and credits claimed cumulatively by corporations. The report will not reflect all of the exemptions and exclusions available to corporations because not all of them are reported on Virginia income tax returns. For example, a corporation that receives interest on Virginia obligations would exclude the interest from federal taxable income and, therefore, no indication of this exclusion would appear in the Virginia income tax return. Furthermore, many pass through entities such as Subchapter S corporations, limited liability companies, and partnerships earn the same tax relief provisions granted to corporations. The subtractions, deductions, exclusions, exemptions and credits are reported on individual income tax returns.

2. The second step taken by the legislators was to pass Senate Joint Resolution Number 308. This resolution directs the Virginia Code Commission to identify tax preferences located outside of Title 58.1 (State Tax Code) in the Code of Virginia, and to report biennially to the General Assembly with recommendations for legislation to cross-reference these preferences in Title 58.1 or to generally make the preferences in the Code easier to identify.