Recent Tax Developments in Virginia: 2002-2003

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I. CORPORATE INCOME TAX

A. 2003 Legislation

1. Virginia Tax Amnesty Program. HB 2454 added Va. Code § 58.1-1840.1 establishing a 60-75 day tax amnesty program during the period July 1, 2003 - June 30, 2004. Civil and criminal penalties and half of the interest assessed or assessable will be waived on payment of tax and interest owed. Excluded from participation are: (i) persons already under investigation or prosecution for filing a fraudulent return or failure to file a return with the intent to evade tax, (ii) assessments made within 90 days of the commencement of the program, and (iii) liability arising from failure to file a return due within 90 days of commencement of the program. Details of program to be established by regulation.

2. Fixed Date Conformity. HB 2455 and SB 1049 amend Va. Code § 58.1-301 to conform the Virginia tax code for taxable years beginning on and after January 1, 2001 to the IRC as it existed on December 31, 2002. Excluded from this conformity are (i) the IRC § 168(k) bonus depreciation and (ii) the 5-year carryback for certain net operating losses under IRC § 172(b)(1)(H).

3. Judicial Appeals. HB 2538 amends Va. Code § 58.1-1825 to eliminate “pay to play.” Specifically, payment of a contested state tax assessment is no longer a jurisdictional prerequisite to challenging the assessment in the circuit court. There are limited cases in which the taxpayer may be required to pay the assessment or to post a bond.

4. Change in Filing Date for Nonprofit Corporations. SB 935 amends Va. Code § 58.1-441 to change the filing date for nonprofit corporations from the fifteenth day of the fourth month following the close of the taxable year to the fifteenth day of the sixth month following the close of the taxable year. The change applies for taxable years beginning on and after January 1, 2003.

5. Change in Filing Basis. SB 1125 amends Va. Code § 58.1-442 to allow an affiliated group of corporations to change its filing status (i) from consolidated to separate or (ii) from separate or combined to consolidated under limited
circumstances designed to avoid any "revenue impact." Such a change would be allowed no more often than once every 20 years.

6. **Enterprise Zone Business Tax Credit.** SB 859 amends Va. Code § 59.1-280 to allow the credit for certain "high investment/limited job creation qualified business firms." Such a qualified firm makes an investment of $50 million or more but creates fewer than 50 permanent full time positions. The credit is allowed provided (i) the credit amount shall not exceed the percentages allowed small qualified businesses under the statute and (ii) the credit amount shall not exceed the amount that Virginia will recover in new income tax revenue from the new permanent full-time positions within a 5-year period. The new provision applies to taxable years beginning on and after January 1, 2003.

7. **Subtraction for Indemnification Payments.** HB 2554 amends Va. Code § 58.1-402 to allow a subtraction for indemnification payments received by contract poultry growers and table egg producers from the US Department of Agriculture for the depopulation of poultry flocks because of the 2002 avian flu. No deduction is allowed for indemnification payments made to poultry owners who contract with poultry growers. The subtraction applies in taxable years beginning on and after January 1, 2002 but before January 1, 2005.

8. **Subtraction for Peanut Quota Buyout Payments.** HB 2400 amends Va. Code § 58.1-402 to allow a subtraction for payments received under the Peanut Quota Buyout Program of the Farm Security and Rural Investment Act of 2002.

**B. Court Decisions**

1. **General Motors Corp. v. Virginia Dept. of Taxation,** 2003 Va. Cir. LEXIS 79 (Case No. L 192277, Fairfax Co. Cir. Ct., April 8, 2003). The Trial Court held that the taxpayer had established that a portion of its interest income was derived from investment funds, and, therefore, was not subject to taxation by Virginia. The interest was earned on funds in a single account maintained in New York. In support of its conclusion that the funds in the account served a hybrid function (investment and operational), the Trial Court cited the facts that the amounts in the account far exceeded the taxpayer’s working capital needs, and that the investments were not used as security to borrow working capital, acquire stock in other companies, or support bond issues.

   The Trial Court upheld the Department’s regulation excluding from the computation of “costs of performance” for financial corporations costs of activities performed by unrelated third parties.

   Finally, the Trial Court rejected the Department’s attempt to apply the IRC § 6621(c) federal interest rate applicable to large corporate underpayments.
C. Rulings of the State Tax Commissioner

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

2. **Amended Returns.** P.D. 02-166 (December 19, 2002). The Commissioner considered the application of interest in the context of amended returns for 8 years consisting of both overpayments and underpayments. He rejected the application of a zero rate of interest on overlapping overpayments and underpayments. Interest on each return was computed separately. In the case of the application of an overpayment to a prior underpayment, interest on the underpayment is computed from the due date of the underpayment return through the filing date on which the overpayment was made (as opposed to the original due date). He also confirmed that interest would be compounded.

3. **AlliedSignal.** P.D 02-124 (October 6, 2002). Taxpayer's sale of a 10% interest in a company was held not to be subject to Virginia income taxation by apportionment. There was no overlapping of services, processes or employees so there was no unitary relationship. The taxpayer's operations did not benefit as a result of the investment. With respect to certain interest income received by the taxpayer, the Commissioner held that only that part of the cash investment portfolio that was segregated and managed by an external source was beyond Virginia's ability to tax.

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

5. **AlliedSignal/Stock Sale.** P.D. 02-109 (July 1, 2002). The Commissioner considered whether gain from the sale of stock in two less than 50% subsidiaries was subject to taxation by apportionment under AlliedSignal. After finding that there was no unitary relationship (could there have been any with less than 50% ownership?), the Commissioner held that the investment in one entity served an operational function and the other entity did not. Sounding like an application of the Corn Products doctrine, the Commissioner holds that investment in one entity was essential to corporation's foreign marketing efforts. There was no such integration of marketing efforts and operational activities with respect to the other investment.
6. **Qualified Equity Credit.** P.D. 02-108 (July 1, 2002). A corporation that provided exchange services for like-kind exchanges was not a “qualified business venture.” Although not specifically listed as an excluded entity in the Code, its business activity was substantially similar to that of “financial, broker, investment and real estate businesses.” **Query:** Commissioner’s analysis treats tax credits in the same fashion as tax exemptions. Commissioner also notes that legislation authorizes the Department to designate certain types of business by regulation which do not qualify. Can Department do this by ruling, however?

7. **Conservation Credit.** P.D. 02-97 (June 25, 2002). Commissioner holds that applicant was not a “qualified charitable organization” under the Virginia Land Conservation Incentives Act because it was not the Commonwealth or an instrumentality of the Commonwealth, nor was it a private foundation (sic!) or controlled by a private foundation (sic!) which is one of the requirements of the Act. **Query:** Is the Commissioner’s statement of the rule a typo?

8. **Foreign Source Income.** P.D. 02-142 (November 15, 2002). Assuming that the procedures of IRC § 861, et seq., are followed in completing federal form 1118, the information on from 1118 is the appropriate starting point for computing the foreign source income subtraction allowed on the Virginia return. Foreign source dividends from a corporation in which the taxpayer owns 50% or more of the voting stock are not included in the foreign source income subtraction because they are the subject of the separate § 58.1-402(C)(10) subtraction. But expenses related to said foreign dividends are calculated in the same manner as other foreign source income.

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

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

A number of adjustments required by the taxpayer were denied based on lack of substantiation.
11. **PL 86-272.** P.D. 02-132 (October 8, 2002). Manufacturer's only presence in Virginia was location of a limited amount of inventory stored at a distributor’s warehouse pursuant to a sale and security agreement. Held: the location of inventory in Virginia exceeds the protection of PL 86-272.

12. **PL 86-272.** P.D. 03-22 (March 21, 2003). The sale by an out-of-state S corporation of services that are provided within Virginia is not protected by PL 86-272. Consequently, the S corporation’s shareholders are subject to Virginia tax on their Virginia source income.

13. **Nexus.** P.D. 02-159 (December 16, 2002). The following facts are not sufficient to create nexus for income tax purposes. Taxpayers have neither offices nor property in Virginia. They perform various administrative services (processing transactions, recordkeeping, collection and payment of commissions, income and expenses, handling license and compliance issues) on behalf of various independent securities brokers/dealers and money managers who operate in Virginia.

14. **Nexus/Virginia Source Income.** P.D. 02-80 (May 2, 2002). Commissioner confirms that even if a corporation is qualified to do business in Virginia and has income from Virginia sources (intangibles licensed to customers in Virginia), it is not subject to Virginia income taxation if it has no positive apportionment factors. Because it had no property, payroll or sales (cost of performance methodology) in Virginia, it was not subject to Virginia income taxation. Accordingly, corporation could not be included in the Virginia consolidated return. **Observation:** Consistent with this ruling, Virginia should not tax Delaware investment holding companies whose only connection with Virginia is income from intangibles licensed to affiliates or customers in Virginia on an arm’s length basis.

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

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

17. **Sale of Stock.** P.D. 03-23 (March 21, 2003). Corporation A, a non-Virginia corporation which qualified as a “financial corporation,” owned a 25% interest in a corporation that had Virginia operations and property. Corporation A sold this stock to an unrelated corporation, and the sale and related efforts occurred outside of Virginia. Held: no sale income was apportioned to Virginia because the costs of performance occurred outside Virginia.
18. **Allocations.** P.D. 02-127 (October 6, 2002). This ruling asserts that “the Department will exercise its authority [to reallocate income] if it finds that a transaction, or a party to a transaction, lacks economic substance.” Certain allocations of expenses among corporate affiliates were approved. Interest was allocated to Virginia taxpayers that could not be shown to benefit those taxpayers was not approved as a deduction. Only compensation that is reported to the VEC is deemed to be “Virginia compensation” for wage purposes, and wages that were simply allocated to Virginia entities were disallowed.

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

20. **Delaware Investment Holding Company.** P.D. 03-60 (August 8, 2003). Taxpayer had two investment subsidiaries located in Delaware. One owned all the stock of a foreign sales corporation (“FSC”) and one owned certain patents that had been purchased from a third party. Neither subsidiary had any physical location in Delaware, any employees, or any significant expenses. Loans were not evidenced by written agreements. Payments on the loans were not made so that the annual loan balance simply increased with the interest payable. Finally, there were indications that the parent corporation was taking certain tax benefits associated with the patents. The Commissioner holds that the subsidiaries’ “lack economic substance” and that the transactions themselves “lack substance.” He also concludes that the taxpayer has not proved that transactions between the related entities were conducted on an arm’s length basis.

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

21. **Royalty Companies/Apportionment.** P.D. 02-52 (April 16, 2002). Corporation domiciled outside of Virginia derived income from licensing intangibles to affiliates and unrelated parties in Virginia. In calculating the Virginia sales factors, sales are included in the numerator only if the costs of performance in Virginia with respect to these intangibles are greater than in any other state. In this case, the costs of performance were located at the company’s headquarters outside Virginia so the royalties were excluded from
the numerator of the sales factor. In addition, the Commissioner ruled that royalties from license transactions with affiliates are excluded from the denominator because they were eliminated in the consolidated income tax return.

22. Procedure/Limitations. P.D. 02-31. (March 15, 2002). Taxpayer appealed an audit assessment with respect to its 1996 year and prevailed in having certain foreign-sourced incomes subtracted. The audit assessment was corrected and refund issued. The taxpayer then asserted that its original return had overpaid tax and sought a refund of that overpayment. The Department denied that refund saying that no amended return had timely been filed. Query: Does this ruling indicate that an overpayment raised as a “set-off” during an audit will not be allowed unless an amended return is actually filed? It is unclear if this refund claim was raised after the conclusion of the appeal of the original audit.

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

24. Withholding/Alternative Method. P.D. 02-115 (August 16, 2002). Corporation had employees working in Virginia during a limited, two-week period. Compensation was paid only on an annual basis. These unusual factual circumstances caused excessive withholding and unusual burdens on both the employer and its employees, and on the Department. Pursuant to statutory authority, the Commissioner approved an alternative withholding methodology subject to conditions specified in the ruling.

25. Insurance Company/Lottery Withholding. P.D. 02-117 (August 30, 2002). Insurance company had acquired the right to receive proceeds of two Virginia lottery contracts. Commissioner ruled that it was entitled to a refund of income taxes that were withheld from those proceeds because the corporation, being taxable based on gross premiums from policies sold in Virginia was not subject to Virginia income taxation.

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

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

II. INDIVIDUAL INCOME TAX

A. 2002 Legislation

Refunds. HB 39 and SB 530 amend Va. Code § 58.1-1833 to provide for the payment of interest on refunds beginning 30 or 60 days after payment of tax, depending on whether the taxpayer files electronically or by some other means. Effective January 1, 2003.

B. 2003 Legislation

1. Foreign Source Income. HB 1914 amends Va. Code § 58.1-322 to eliminate the subtraction for foreign source income for individuals only. The amendment is effective for taxable years beginning on and after January 1, 2003.

2. Subtraction for Military Death Gratuity Payments. HB 1624 amends Va. Code § 58.1-322 to allow a subtraction for a military death gratuity payment made after September 11, 2001 to survivors of the deceased; the subtraction amount is reduced by the amount allowed as an exclusion from federal gross income to the survivor on the federal income tax return.


5. Withholding Tax Filing. HB 2351 amends Va. Code § 58.1-202.1 to require that any firm that remits withholding taxes on behalf of 100 or more employees must do so by electronic funds transfer.

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

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

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

4. **Credit/Puerto Rico.** P.D. 02-13. (February 21, 2002). Credits are allowed only for income taxes paid to another state. This does not include Puerto Rico.

5. **Qualified Equity and Subordinated Debt Credit.** P.D. 02-141 (November 12, 2002). Membership interests in the taxpayer, an equity investment, did not qualify for the credit because, under the operating agreement, each member was entitled to a 10% guaranteed distribution each year for 10 years. Based on the language of the operating agreement, the Commissioner concluded that the guaranteed distributions were intended as a repayment of the investor's initial capital contribution over 10 years; as such, the membership interest do not qualify as "equity investments" under Va. Code § 58.1-339.4. Furthermore, the fact that the return of capital commences within 5 years of the date of issuance of the interest renders it ineligible for the credit.

6. **Virginia Land Preservation Tax Credit/Historic Rehabilitation Tax Credit.** P.D. 02-158 (December 10, 2002). Taxpayer proposed to purchase and rehabilitate an historic structure located on undeveloped land, and then to establish a preservation or conservation easement to prevent development of the property. He asked about the availability of the land preservation credit and historic rehabilitation credit. Va. Code § 58.1-513A precludes the claiming of the historic rehabilitation tax credit for costs related to the project for which the land preservation credit is claimed. If the taxpayer rehabilitated the structure before conveying the property to the conservation agency, then the rehabilitation would increase the value of the interest conveyed, and the taxpayer could claim only the land preservation credit. However, if the rehabilitation expenses do not increase the value of the preservation or conservation easement, then the taxpayer could claim both credits.
7. **Virginia Land Preservation Tax Credit.** P.D. 03-12 (February 27, 2003). This credit is equal to 50% of the fair market value of Virginia land or an interest in Virginia land that is for certain uses related to land preservation. The credit can be transferred from one taxpayer to another; there is no limit on the number of transfers. However, a transferee taxpayer may not use the credit for any taxable year prior to that in which he acquired the credit, even if he acquired the credit prior to the due date of the prior year return (e.g., a credit transferred after 12/31/02 but prior to the deadline for filing the 2002 return may not be used against the 2002 tax liability). See also P.D. 03-13 (March 4, 2003).

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

9. **Domiciliary Resident.** P.D. 02-149 (December 9, 2002). The taxpayer was employed outside the United States for the majority of each year in issue, and presented copies of his foreign income tax returns, letters from employers attesting to his assignments, and foreign apartment leases, driver’s licenses and work permits. Nevertheless, the Commissioner determined that he was a Virginia domiciliary based on the following facts: he registered to vote in Virginia (thereby swearing that he was a Virginia domiciliary); he and his wife obtained Virginia driver’s licenses (after swearing that they were Virginia residents); he applied for and obtained in-state tuition rates for his children who attended Virginia universities (after representing that he had lived in Virginia for at least 2 years, paid Virginia income tax, held a Virginia driver’s license and was registered to vote in Virginia). In addition to the unpaid tax, the taxpayer was liable for a 100% fraud penalty, which the Commissioner refused to abate.

10. **Domiciliary Resident.** P.D. 02-168 (December 17, 2002). Taxpayer who worked as a merchant seaman, and was outside Virginia for more than 183 days held to have a Virginia domicile based on fact that he maintained a Virginia home for himself and his family. The ruling notes that the taxpayer provided no other information relevant to the residency determination.

11. **Change of Domicile and Retirement Income.** P.D. 02-118 (September 3, 2002). Taxpayers domiciled outside Virginia retired in August, 1999 and moved to their Virginia vacation home. In October, 2001, taxpayer became licensed as a professional in Virginia. Taxpayer received certain retirement payments in January, 2000. Taxpayers filed a resident income tax return in 2000 but, in a request for refund, asserted that they did not become domiciliary residents until August, 2000 and should not be taxable on the retirement income payments received in January, 2000. No surprise, the Commissioner held that the taxpayers were residents during the entire year 2000, just as their income tax return said. In addition, he holds that they were
part year residents in 1999. Retirement income was taxable in Virginia in the year received, even though earned in another state in prior years.

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

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

14. **Domicile/Part-Year Resident.** P.D. 02-160 (Date December 17, 2002). Taxpayer moved from State A to Virginia in 1998 and then to State B in 1999. Commissioner holds that evidence supports finding that taxpayer changed his domicile to Virginia in 1998 and did not change his domicile to State B until he purchased a home there in 1999. Accordingly, as a part-year resident in 1999, his income was based on the place earned. That is, items of income earned while a domiciliary of State B are taxable in State B, but earned in Virginia prior to moving to State B, they are taxable in Virginia. Payments under a noncompete agreement with his previous employer taxable as earnings, part in Virginia and part in State B depending upon place of domicile at time of receipt. **Observation:** Be careful of the potential disaster that can occur if substantial gains are recognized while a Virginia resident, and taxpayer then waits until year-end to recognize offsetting losses when a resident of another state.

15. **Prorating Income.** P.D. 02-106 (June 28, 2002). Stockbroker worked at offices in both Florida and Virginia. Commissioner held that broker properly apportioned his income between Virginia and Florida based on number of days spent in each. Commissioner further ruled that broker had established that he was a domiciliary resident of Florida.

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

17. **Federal Adjustments.** P.D. 02-143 (November 15, 2002). Where the taxpayer failed to file amended Virginia returns for three years following federal adjustment of those years, the Department assessed the additional tax separately, rather than including the entire assessment under the last of the three years.

18. **Statute of Limitations.** P.D. 02-92 (June 13, 2002). Taxpayers failed to file returns in another state which then audited and assessed tax for the years 1992-1996. No refund allowed of Virginia taxes paid on the same income because statute of limitations had expired.

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

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

21. **Unified Nonresident Returns.** P.D. 02-137 (October 28, 2002). Partnership had both resident and nonresident partners in Virginia, and many of those partners were also members of an LLC with income from Virginia sources. Request to file “unified returns” for both the partnership and LLC was denied based on the Department’s policy that such returns can include only persons who have no other Virginia source income than what is reported on the “unified return.” Allowing two returns to be filed creates many problems, including allowing too much income to be taxed at the lower brackets. **Query:** Could the Commissioner’s objections have been overcome if the taxpayer had agreed for all Virginia source income of the nonresident partners and LLC members to be taxed at the highest rate?

22. **Tax Fraud.** P.D. 02-119 (September 3, 2002). Same as above. Even “a citizen in the Virginia Republic” who has filed a “Declaration of Expatriation/Repatriation” with the President of the United States and claims thereby not to earn any income “subject to the jurisdiction of the United States” still has to pay Virginia income taxes. If he does not, 100% fraud penalties apply.

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

A. 2003 Legislation

Probate Tax. HB 1921 amends Va. Code § 58.1-1712 to raise from $10,000 to $15,000 the value of an estate that is subject to probate tax.

B. Rulings of the State Tax Commissioner

1. Resident Trust. P.D. 02-01 & -104 (June 24 & 27, 2002). Trusts established by nonresident was administered by banks located outside Virginia where all books and records were kept and financial transactions were conducted. The corporate trustee, however, was overseen by a five member committee which had broad powers concerning both discretionary and administrative matters. The Commissioner held that the trust will not be considered to be “administered in Virginia” solely because one member of the five member committee is a Virginia resident. Observation: This is an important ruling for Virginia residents (e.g., lawyers and accountants) whose clients have moved to other states and who wish to have some continuing fiduciary involvement in the clients’ fiduciary affairs.

2. Virginia Estate Tax. P.D. 02-40 (April 2, 2002). Because of the federal credit for tax paid on prior transfers, Virginia decedent’s estate owed no federal estate tax, but tax was payable to the Commonwealth based on calculation of the credit for state death taxes. Taxpayer argued that no Virginia tax should be payable because intent of legislature was simply to absorb amount of the federal credit, that is, no Virginia tax should be due if no federal tax is due. The taxpayer’s position was rejected. Observation: This ruling may offer an important preview of the Department of Taxation’s interpretation of the phased in “now you see it, now you don’t” federal estate tax repeal. Elimination of the federal estate tax in 2010 should eliminate the Virginia estate tax as well. Until that time, however, Virginia’s estate tax will continue to be not less than the federal credit that was “allowable” under I.R.C. § 2011 as in effect January 1, 1978. This provides yet another reason not to die during the next seven years.

3. Fiduciary Income Tax/Charitable Remainder Trust. P.D. 02-145 (November 20, 2002). The Commissioner confirms that a charitable remainder trust that is exempt from federal income tax is also exempt from Virginia income tax. No return is required unless the trust has UBTI for federal income tax purposes.

IV. RETAIL SALES & USE TAXES

A. 2002 Legislation

1. Food Tax Reduction Program. HB 86 amends Va. Code § 58.1-611.1 to exclude from the definition of “food” food sold by a retailer for whom more
than 80% of the gross receipts are derived from the sale of food prepared by the retailer for immediate consumption on or off premises.

2. **Misuse of Tax Preferences**. HB 1054 adds Va. Code § 58.1-608.4 providing for the suspension of a sales tax exemption letter/certificate if an organization knows or should have known that an individual or entity has used its exemption certificate/letter to make unlawful purchases aggregating in excess of $1,000 in any calendar year.

3. **Accelerated Sales & Use Tax Collection**. The Budget Bill contains a provision requiring some dealers to make an accelerated payment of their June 2002 tax. Provision applies to dealers who reported taxable sales and purchases of $1.3 million or more for the period July 1, 2000 through June 30, 2001 (excluding consumer's use tax filers who report on Form ST-7). Tax in the amount of 90% of the tax liability reported for June 2001 will be due on June 25, 2002 for dealers who pay by mail and June 30, 2002 for dealers who pay electronically. Dealers then reconcile their accelerated payment with the actual June liability when they file their June report in July, 2002. The law authorizes similar accelerated payments in June 2003 and June 2004. Similar provisions may be authorized for future years.

### B. 2003 Legislation


2. **Exemptions for Nonprofit Entities**. HB 2525 and SB 743 add Va. Code § 58.1-609.11 which alters the procedure for granting exemptions to nonprofit entities. Under the new system, the Department grants exemptions administratively according to the criteria set forth in the bill. The effective date is July 1, 2004.

3. **Virginia Public Procurement Act**. HB 2533 adds Va. Code § 2.2-4321.1 to prohibit a state agency from contracting to purchase goods and services from a vendor that is required to register as a dealer and to collect and remit tax, but who fails to do so with respect to sales delivered by any means to Virginia locations. The prohibition also extends to affiliates of such vendor. The Department of Taxation is responsible for determining whether a potential vendor is a prohibited vendor; there is a mechanism for a vendor to appeal such determination.

### C. Court Decisions

**Chesapeake Hospital Authority v. Commonwealth**, 262 Va. 551 (2001). The Hospital was both a political subdivision of the Commonwealth and a hospital operated on a not-for-profit basis. Despite this status, the Tax Department assessed use tax with respect to food that the Hospital provided free of charge to attendees at staff meetings, physicians' meetings, Hospital Authority meetings,
and various other meetings that the Hospital conducted. The Hospital claimed exemption from the use tax under two sections of the Virginia Code: § 58.1-609.1(4) (exemption for tangible personal property for use or consumption by the Commonwealth or any political subdivision); and § 58.1-609.7(4) (exemption for tangible personal property for use or consumption by a non-profit hospital). The Virginia Supreme Court concluded that the exemptions applied.

D. Rulings of the State Tax Commissioner

1. **Agency/Penalty.** P.D. 02-156 (December 17, 2002). Merchant purchased goods and resold them to third party, collecting the sales tax from the third party but not remitting that tax to the Commonwealth. Merchant tried to argue that the purchase was made in an agency capacity. Documentation did not support that. 50% penalty reduced to 30%.

2. **Audio Visual/R&D.** P.D. 03-2 (January 18, 2003). Taxpayer developed and sold on-line games to internet service providers. It claimed an exemption for its computer hardware and software used in its business under both an R&D exemption and the audio visual exemption. The Commissioner denied the R&D exemption because the taxpayer could not establish that the usage of computers by employees for administrative, e-mail and similar activities was "de minimis." When the auditors requested an opportunity to review the taxpayer's place of business, that request was denied. The segment of the business was then sold just before the taxpayer's appeal. Thus, the Commissioner held that there was no way for the taxpayer to meet its burden of proof and no audit record on which it could rely. With respect to the audio visual exemption, the Commissioner concluded that computer games do not qualify because they are not like taped radio programs, feature films, movies and similar works.

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

4. **Government Contracts/Sale of Property.** P.D. 02-130 (October 6, 2002). The Commissioner determined that the true object of the contract is the sale of tangible personal property. The taxpayer is taxable on materials, tools, equipment or machinery that it purchases for its own use in performing services under the contract.

5. **Government Contract.** P.D. 02-161 (December 18, 2002). Commissioner holds that contract was for the provision of various services in connection with a telephone network sold to the Government. In particular, note that the contractor was expected to operate the telecommunications network. Held that this was a contract for the provision of services so that equipment could not be purchased for resale.
6. **Government Contract/Construction** P.D. 02-147 (December 2, 2002). Contractor operated in a dual capacity, fabricating products for resale and for its own use or consumption in real property construction. Raw materials could be purchased for resale to the extent that the taxpayer, at the time of purchase, could identify the raw materials that would be resold to the governmental entity. **Observation:** Note how this position of the Department is directly contrary to its position that a service provider cannot purchase items under a resale exemption even if it knows at the time of purchase the items will be resold.

7. **Leases.** P.D. 02-123 (September 27, 2002). The Commissioner ruled that customer agreement that provided that the cost of the coffee service provided by the taxpayer included the lease of the coffee machines and related supplies and the coffee was a service agreement, not a lease. The agreement did not specify a lease amount. The Commissioner advised that, in order for the agreement to be treated as an equipment lease, it had to contain separate provisions specific to the lease of equipment. Alternatively, he advised, the taxpayer could draw the lease as a separate contract.

8. **Maintenance and Repair.** P.D. 02-122 (September 26, 2002). The taxpayer provided parts, maintenance and repair for computers owned by its customers. In order to perform its contracts, it purchased and maintained an inventory of computer spares for loan to customers while the customers’ equipment is being repaired. Occasionally, the spares were used as spare parts. The taxpayer classified these spares as assets, and depreciated them. The Commissioner ruled that the spares were used in the performance of repair services, and, as such, were taxable to the taxpayer.

9. **Manufacturing/Gravure Printing.** P.D. 02-135 (October 11, 2002). A K-Walter System was held to be directly used in a subprocessing activity because it allowed the taxpayer to direct personnel on how to set engraving machines during the engraving process. By contrast, a Shirar/Gypsy System was held to be taxable because it was used in a pre-production process by which the taxpayer received printing materials from customers in electronic forms.

This ruling was modified by P.D. 02-12 (February 19, 2002). Commissioner confirmed that computers and software used (i) to ensure that customer-provided disks and CDs are properly configured, and (ii) to format customer-provided information into electronic commands so they may be output as film or paper on imagesetting output devices are part of “electronic prepress” and, on that basis, are exempt.

10. **Manufacturing/Direct Use.** P.D. 02-152 (December 11, 2002). Cable trays were held to be taxable and not part of the wiring of exempt manufacturing equipment.

11. **Manufacturing/Packaging.** P.D. 02-126 (October 6, 2002). Air bags contained within strapping materials and used to protect the taxpayer’s
products during transit are not exempt packaging materials. The audit revealed that the air bags were used between bundles of the taxpayer's products. As such, they are taxable transportation devices, not exempt packaging.

12. **Fabrication.** P.D. 02-134 (October 8, 2002). Paper manufacturer provided a printer with bleached board paper for use in making sample printing runs. Once quality and other adjustments are made, a final product is run. The Commissioner holds that the charges for these trial runs do not qualify as quality control or research and development. He further holds that the printing process, though performed out of state, was taxable in Virginia because it was fabrication that was delivered in Virginia. **Observation:** It is unclear from the ruling if the ultimate purchases of printed product were exempt, perhaps on a resale basis. If so, then the tax on these "trial runs" may have been imposed simply because charges for those trial runs were separately stated on invoices.

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

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

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

16. **Procedure/Sampling.** P.D. 02-163 (December 18, 2002). Taxpayer sought to change the sampling methodology used by the auditor to eliminate certain purchases which it contended were unusual. The Commissioner rejected this attempt to "manipulate the data."

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

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

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

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

21. **Statute of Limitations.** P. D. 02-140 (November 5, 2002). During the period that the taxpayer was building a new semiconductor chip plant, it filed use tax returns on an erratic basis. Department’s auditor assessed tax under a six year statute of limitations for those months when no returns were filed. Commissioner approved this exception from the usual 3 year statute. **Observation:** The audit contains a number of items that the Commissioner, under the usual “strict construction” rule, concludes were not used directly in semi-conductor manufacturing. Any business locating in Virginia would be well advised to obtain an advance ruling from the Department during the “courtship phase” to avoid this type of unexpected sales tax treatment.

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

23. **Real Estate/Fixtures.** P.D. 02-162 (December 18, 2002). Conveyor system installed in specially designed warehouse was held to be tangible personal property subject to sales taxation. There was no indication in the various construction and other installation documents indicating that the contracts were considered to be real estate construction contracts. The system did not enhance the value of the real estate as a warehouse. The system was not taxed as part of the real estate for property tax purposes.

24. **Real Estate Construction/Government.** P.D. 02-154 (December 13, 2002). This ruling exemplifies how a governmental entity can purchase construction materials directly and avoid the payment of use tax by its contractor.

25. **Real Estate Construction/Outside Va.** P.D. 02-144 (November 20, 2002). Construction materials withdrawn from Virginia inventory and incorporated into an exempt real estate job outside Virginia are exempt.
26. **Resale/Child Care Facilities.** P.D. 02-125 (October 6, 2002). The Commissioner determined that the sales made by a wholesale food and beverage distributor to child care facilities did not qualify for the resale exemption. Nonetheless, because the distributor accepted the exemption certificates in good faith, he is not liable for the tax (but it was notified not to accept such certificates in the future).

27. **Resale/Hotels.** P.D. 02-148 (December 6, 2002). Ingredients used to bake cookies for hotel guests held taxable upon purchase by hotel. These items were not purchased for resale. They were used or consumed in the rendition of the hotelier’s service.

28. **R&D Exemption.** P.D. 02-155 (December 16, 2002). R&D exemption was denied for software when the purchase agreement permitted the taxpayer to incorporate the software into its products which were then sold. Ignoring the actual use of the software, the Commissioner held that the software did not meet the exclusivity requirement of the R&D exemption because it might be used in something other than research and development. **Observation:** What is the statutory basis for this position? If the taxpayer has never made a use inconsistent with the R&D exemption, can the Commissioner tax some use that has never occurred on the theory that it might occur?

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

30. **Spaceport Activities.** P.D. 02-114 (August 14, 2002). The Commissioner reviews the requirements for the Va. Code § 58.1-609.3(13) exemption for spaceport activities. He confirms that it applies to activities directed or sponsored by the Virginia Commercial Space Flight Authority, not by NASA.

31. **True Object/Automobile Services.** P.D. 02-116 (August 16, 2002). The taxpayer attaches labels containing a summary of features to cars at dealerships. It also enters the same data on to a website with a digital photo of the car. The dealership pays a set fee per car. The Commissioner ruled that the true object of the transaction is advertising; therefore, the dealer is not subject to tax on the charge for the services rendered by the taxpayer.

32. **True Object/Locksmith.** P.D. 02-164 (December 18, 2002). Charges by a locksmith are considered to be charges for keys and thus taxable.

33. **True Object/Digital ID.** P.D. 02-113 (July 26, 2002). The taxpayer provided an online digital identification to companies and individuals. The service consisted of delivering a digital ID to the customer over the internet; this enabled customers to identify one another before engaging in internet transactions. The Commissioner ruled that the taxpayer was providing a nontaxable service, and was not required to collect tax from its customers.

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However, the taxpayer was liable for tax on any non-custom software that is transmitted to it in tangible form.

34. **True Object/Management Contract.** P.D. 02-129 (October 6, 2002). The Commissioner ruled that a management fee paid by a medical practice to a management entity for management services and the provision of some tangible personal property was services. The management fee was a fixed amount plus a percentage of the practice’s gross revenue. As such, the management fee was not taxable.

35. **True Object/Printing Services.** P.D. 02-110 (July 12, 2002). The Commissioner ruled that the entire charge to the taxpayer’s client for printed materials, including charges for design, mailing, and printing services, is taxable because the true object of the transaction is the printed materials.

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

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

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

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

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

A. 2002 Legislation

1. BPOL Tax Appeals. HB 317 amends Va. Code § 58.1-3703.1 to allow a taxpayer to apply to the local assessing officer for a correction of an assessment within 1 year of the last day of the year for which the assessment was made, or within 1 year of the “appealable event.” “Appealable event” is defined as “an increase in the assessment of a local license tax payable by a taxpayer, the denial of a refund, or the assessment of a local license tax where none previously was assessed, arising out of the local assessing official's (i) examination of records, financial statements, books of account or other information for the purpose of determining the correctness of an assessment, (ii) determination regarding the rate or classification applicable to the licensable business, (iii) assessment of a local license tax when no return has been filed by the taxpayer, or (iv) denial of an application for correction of erroneous assessment attendant to the filing of an amended application for license.” Additionally, if the local assessing officer does not issue a determination within 2 years, the taxpayer may treat the lack of action as an adverse determination and appeal to the State Tax Commissioner on 30 days written notice to the local assessing officer.

2. Certain Receipts of Real Estate Brokers and Agents. HB 503 amends Va. Code § 58.1-3732.2 to allow brokers to exclude from their gross receipts commissions paid to agents so long as the agent pays BPOL tax on the excluded fees. Also allows agents to exclude desk fees and other overhead costs paid to brokers so long as he identifies the broker to whom the fees have been paid and the broker reports the fees.


B. Opinions of the Attorney General

1. Confidential Tax Information. Op. No. 02-113 (December 19, 2002). A commissioner of the revenue is not prohibited by Virginia Code § 58.1-3 from releasing, pursuant to a FOIA request, a list of the names and addresses of persons licensed to do business in his community.

3. **Interstate Receipts.** Op. No. 02-114 (December 12, 2002). Attorney General first holds that a Commissioner of the Revenue should apply the BPOL Guidelines’ definition of “definite place of business” because it is consistent with, and a reasonable interpretation of, the statute. He then holds, however, that the deduction provided by Virginia Code § 58.1-3732(B)(2) should be interpreted “so that the assessments are fairly apportioned between the activities in your jurisdiction and the activity outside the Commonwealth.”

**Observation:** This conclusion is not consistent with the statute or the original purpose of the statute. If all that was required was fair apportionment, the United States Constitution will do that of its own force without the help of a Virginia statute. The purpose of this statute was to avoid debates between taxpayers and local governments above the requirements of “fair apportionment” by simply requiring the locality to deduct from taxable receipts “any receipts attributable to business conducted in another state or foreign county in which the taxpayer is liable for an income or other tax based upon income.”

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

5. **Real Estate Brokers and Agents.** Op. No. 02-146 (January 27, 2003). The Attorney General opined that the amendment to Va. Code § 58.1-3732.2 applies to a real estate broker if the agents receive their full commission from the broker less an adjustment for the business license tax paid by the broker and the agents pay a desk fee to the broker. He further opined that the amendment does not have retroactive effect.

C. **Rulings of the State Tax Commissioner**

**Nexus:**

1. **Vending Machines/Office.** P.D. 02-150 (December 9, 2002). Vending machine business is taxable in the locality where it has its definite place of business, not in every locality where it has vending machines. Different rule applies only with respect to amusement devises.

2. **Real Estate Contractor/Development Management.** P.D. 02-153 (December 11, 2002). Taxpayer had two contracts with property owner, one to provide
management and supervisory assistance for the owner's development project and the second to manage construction of the project. Taxpayer's offices were located in City A and project was in City B. Commissioner holds that use of a construction trailer in City B on a regular and continuous basis by the one employee of taxpayer who supervised actual construction constituted a definite place of business. Commissioner, however, treated the development contract and construction supervision contract separately with the former being taxable by City A and the latter being taxable by City B.

Classification

3. **Certified Home Inspector.** P.D. 02-136 (October 25, 2002). Recent legislation puts home inspectors under the regulatory authority of the Virginia Department of Professional and Occupational regulation beginning July 1, 2003. Nevertheless, the Commissioner rules that such businesses should be classified as "business services" (the catch-all category) and are not under the higher rate classification applicable to professional, financial and real estate services. This is not one of the businesses listed specifically as a "professional service."

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

5. **Pharmacy/Retail Merchant.** P.D. 02-146 (December 2, 2002). Pharmacy owned by a professional pharmacist sold both prescription items and other goods and merchandise at retail. The entire business was classified as a retail merchant and was not taxable at professional rates.

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

Apportionment

7. **Professional Corporation.** P.D. 03-11 (February 24, 2003). Taxpayer sought a refund of BPOL taxes erroneously paid by a professional corporation based on former Virginia Code § 13.1-554 and various administrative interpretations of the Commissioner and Attorney General. Locality refused. Commissioner reversed locality. **Observation:** The statutory distinction between professional corporations and other businesses for license tax purposes was changed effective July 1, 2002.
8. **Audit Methodology: Income Tax Returns.** P.D. 03-15 (March 10, 2003). Service business had offices in Virginia and throughout the United States and world. Locality asserted the right to tax “Virginia sales” as shown on income tax return notwithstanding taxpayer’s ability to show receipts by office. Locality’s use of income tax apportionment methodology was wrong. Commissioner notes that apportionment of sales for income tax purposes is based on a different methodology than is used for BPOL purposes. **Observation:** Note the importance of the taxpayer’s being able to show correct receipts in addition to demonstrating that the locality’s methodology was wrong.

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

10. **Audit Methodology: Subtraction Method.** P.D. 02-50 (April 9, 2002). Locality asserted right to tax all gross receipts not actually taxed by another locality. Commissioner rejected this analysis and directed the locality to focus on taxpayer’s activities and to “work with other interested localities in order to determine the correct attribution of taxpayer’s gross receipts under the situs rules.” **Observation:** Although the Commissioner’s conclusion is correct, the right of any one locality to tax does not depend on how any other locality may tax except in the unusual situation where the taxpayer is subject to double taxation under the apportionment rules.

### Exclusions, Exemptions and Reductions

11. **Manufacturing/Printer.** P.D. 02-128 (October 6, 2002). The Commissioner reaffirms the Department’s view that a printer is a manufacturer under Virginia law. The ruling questions, however, whether the sales of this “job printer” are at “wholesale” and therefore exempt from BPOL taxation.

12. **Manufacturing.** P.D. 03-36 (April 15, 2003). Taxpayer’s industrial process for producing rubber blankets used in a variety of press applications held to be manufacturing. Locality had argued “rubber in, rubber out.” Although component parts might be recognizable as rubber, metal, etc., Commissioner holds that the character and nature of the product was far different from the original materials and met the requirement of a “substantial, well-recognized transformation in form, quality and adaptability ....”

13. **Manufacturing/Computer Software.** P.D. 02-120 (September 25, 2002). Taxpayer was engaged in the development of computer software which it then resold in tangible form. Although the Department apparently recognizes that
this can constitute "manufacturing," it held that the manufacturing activities were not "substantial" so that the taxpayer was subject to business license taxation. In analyzing the substantiality test, the Department rejected the position that engineering, design, research and development expenses were part of manufacturing expenses. The Commissioner, however, does question whether the locality is correct in assessing the taxpayer as a "business service" instead of a "wholesale merchant."

14. **Interstate Receipts/Professional LLP.** P.D. 02-165 (December 19, 2002). Professional LLP had offices in, and its partners filed income tax returns with, over 40 states. Based on legislation effective July 1, 2002, the Commissioner holds that partnership can deduct from its tax base gross receipts "attributable to business conducted in any state in which either the taxpayer or its partners are liable for an income or other tax based upon income." **Observation:** Is the Commissioner's attempt to make this deduction effective July 1, 2002 correct? Clearly not if the locality assesses BPOL tax on each individual partner, in which case that partner should be able to deduct from his taxable base gross receipt reported on his income tax returns in other states. The issue may be confused if locality taxed partnership as an entity.

**Procedure**

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

**VI. PROPERTY TAXES**

A. 2002 Legislation

1. **Biotechnology Equipment.** HB 574 and SB 209 amend Va. Code § 58.1-3506 to add equipment used primarily in biotechnology research and development and the production of related products (but not for human cloning purposes or purposes relating to human embryo stem cells) as a separate classification for personal property tax purposes.

2. **Tax Day.** P.D. 02-88 (June 10, 2002). After the January 1 tax date, locality reduced its exemption for certified pollution control facility from 100% to 50%. Commissioner, following numerous opinions of the Attorney General, holds that the exempt status of property is fixed on January 1. Although the locality can change its tax rate (applicable to all property in the class), it cannot change the exempt status of any property after tax day.

3. **Merchants Capital/BPOL.** P.D. 02-131 (October 8, 2002). Localities in Virginia are prohibited from imposing both a BPOL tax and a merchants capital tax. The Commissioner holds that a business license fee is the same as a business license tax. A locality that imposes such a fee cannot impose a merchants capital tax. Similarly, Virginia law prohibits a county from
imposing a business license tax within the limits of a town without the town's permission.

B. 2003 Legislation

1. **Business Vehicles.** HB 2323 and SB 1033 amend Va. Code § 58.1-3511 to provide that the situs of a business vehicle weighing 10,000 pounds or less is the locality in which the business owner has a definite place of business and from which he directs or controls the use of the vehicle.

2. **Condemnation; Reimbursement of Property Tax.** SB 990 amends Va. Code § 15.2-904 to require that localities reimburse property owners (or persons legally responsible for paying property taxes) for the pro-rata portion of the real property taxes paid with respect to the condemned property from the earlier of the vesting of title in the locality or the effective date the locality takes possession of the property.

3. **Exemption for Pollution Control Equipment.** HB 2726 amends Va. Code § 58.1-3660 to allow the exemption for equipment used to convert trees, tree stumps, underbrush and vegetative cover into mulch, compost or fuel for reuse. The exemption applies regardless of whether the property has been certified to the Department of Taxation by a state certifying authority. Note, however, that certification is still required to get the sales and use tax exemption.

4. **Special Land Use Assessment.** HB 2056 amends Va. Code § 58.1-3233 to allow local special land use assessments for land used for aquaculture and certain specialty crops even if the land is less than the standard 5 minimum for such treatment.

5. **Assessments of Substantially Completed Buildings.** SB 1284 amends Va. Code § 58.1-3292.1 to allow Arlington, Loudoun and Prince William Counties and the cities of Alexandria, Falls Church, Fairfax, Manassas and Manassas Park to assess real estate tax on new buildings when they are substantially complete or fit for occupancy regardless of the date of completion or fitness.
C. Court Decisions

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

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

3. Shenandoah Associates v. County of Shenandoah, 2003 Va. Cir. LEXIS 89 (Law Nos. CL 98-132 & CL 01-140; July 2, 2003). Trial Judge held that the County's failure to consider the fact that restrictions on certain property rendered the property not freely marketable constituted the disregard of controlling evidence. He further held that the taxpayer overcame the presumption that the assessment was correct. Specifically, the property, a housing facility for the elderly and handicapped, was subject to a deed of trust under which the debtor has no right to prepayment unless HUD approved such prepayment. The deed of trust prevented conveyance or encumbrance of the property, and the loan on the property was not assumable. \textit{See also} Woodstock Assoc. v. Shenandoah County, 2003 Va. Cir. LEXIS 88 (Law Nos. CL 98-131 & CL 01-139; June 19, 2003).

D. Opinions of the Attorney General

1. Exemption from Tax. Op. No. 03-49 (August 5, 2003). The Attorney General opined that the local property tax exemptions granted by the General Assembly 2003, either by designation or by classification, prior to January 1, 2003, were not repealed by the amendment of Va. Const., Art. X, § 6(a)(6) or by the enactment of Va. Code § 58.1-3651. He further opined that the localities lack any authority to repeal an exemption enacted by the General Assembly. Rather, the General Assembly has the authority to repeal any law that it has passed.
2. **Exemption from Tax.** Op. No. 03-043 (August 5, 2003). The Attorney General opined that the Va. Code § 58.1-3221 partial real estate tax exemption for rehabilitated property is available when a registered historic structure has been demolished so long as the property owner claiming the exemption is not the person responsible for the demolition.

VII. **MISCELLANEOUS TAX ISSUES**

A. **2002 Legislation**

1. **Local Business Tax Appeals.** HB 318 amends Va. Code § 3983.1 to allow a taxpayer to apply to the local assessing officer for a correction of an assessment within the later of 1 year of the last day of the year for which the assessment was made, or within 1 year of the date of the assessment. Additionally, if the local assessing officer does not issue a determination within 2 years, the taxpayer may treat the lack of action as an adverse determination and appeal to the State Tax Commissioner on 30 days written notice to the local assessing officer.

2. **Bank Franchise Tax.** HB 319 amends Va. Code § 58.1-1201 to add to the definition of the term "bank," for purposes of the tax, any savings bank that is a member of the Federal Reserve System.

3. **Bank Franchise Tax.** SB 174 amends Va. Code §§ 58.1-1205 and 58.1-1206 to provide a deduction for a portion of goodwill created in connection with the acquisition or merger of a bank in determining the bank's capital subject to bank franchise tax. The deduction applies beginning with the returns due March 1, 2002.

4. **Local Consumer Utility Tax.** SB 122 amends Va. Code § 58.1-3812 to incorporate uniform federal sourcing laws that determine which jurisdictions may impose tax on local mobile telecommunications services. Beginning August 1, 2002, federal law allows taxation only by the jurisdiction of the customer's primary place of use. This is defined as, essentially, the customers residential or primary business street address.

B. **2003 Legislation**


2. **False or Fraudulent Returns.** HB 1576 amends Va. Code §§ 58.1-348 and 58.1-452 (i) to make an individual's or fiduciary's willful failure to file an income tax return a class 1 misdemeanor, (ii) to make a false statement a false statement made by an individual or fiduciary with the intent to defraud the Commonwealth on an income tax return a class 6 felony, and (iii) to make a fraudulent return or statement made by a corporate officer with the intent to evade taxes a class 6 felony.

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3. **Local Business Tax Appeals.** HB 1932 amends Va. Code § 58.1-3983.1 to require that the Commissioner determine within 30 days whether he had jurisdiction to hear an appeal of a local business tax assessment, and generally to limit to 60 days the additional time that the Commissioner may take to issue his final determination on the merits.

4. **Local Consumer Utility Tax.** SB 858 amends Va. Code § 58.1-3812 to allow nontaxable service to continue to be nontaxable when bundled with taxable telecommunications services if the provider can segregate the taxable and nontaxable components in its books and records. Likewise, where different rates apply, tax will not be assessed at the highest rate if the provider can segregate the services subject to a lower rate in its books and records.

**C. Opinions of the Attorney General**

1. **Recordation Tax.** Op. No. 02-057 (August 13, 2002). The recordation tax on deeds of trust (normally paid by the grantor) applies to deeds of trust under which the federal government is a guarantor or a beneficiary. As a guarantor of the payment, or a beneficiary entitled to collect the payment, the federal government is not the grantor responsible for payment of the tax.

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

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

**D. Rulings of the State Tax Commissioner**

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

Dated: 10/1/2003