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RECENT VIRGINIA TAX DEVELOPMENTS*

WILLIAM L.S. ROWE

By way of introducing my topic, recent Virginia tax developments, I would like to relate a couple of statistics that I think aptly describe Virginia tax law in the 1970's. They were compiled by Professor Timothy Philipps and will be published in the Washington & Lee Law Review in the very near future. Professor Philipps' survey shows that the Virginia Supreme Court decided more tax cases in the last ten years than in all the preceding twenty-five years. Moreover, his statistics show that from 1945 to 1980 the Commonwealth won 69% of these cases; that is, the taxpayer won less than one out of three cases. Now I actually thought Professor Philipps' statistics had overstated the situation, at least as far as the 1970's were concerned; so to prepare for this talk today, I made a very informal survey of Virginia Supreme Court decisions involving the Department of Taxation between the years 1973 and 1978. That survey showed that taxpayers won only one case out of twelve; that is, the Commonwealth prevailed 92% of the time.

Now that very impressive win record, I think, is attributable primarily to two factors. First of all, beginning early in the 1970's, following Virginia's adoption of a new constitution,¹ the Supreme Court began applying with great gusto a rule of strict construction in tax exemption cases.² Secondly, the court continued its previous policy of giving great weight to the interpretations of state officials charged with the administration of a tax.³ What that great weight in essence amounts to is the same weight given to a regulation, even though under the court's decisions the interpretation could be proved either by a published regulation,⁴ oral testimony⁵ or private letter rulings.⁶ That then provides the background for what I consider to be three of the most important recent developments in Virginia tax law: first, the Income Tax Allocation Cases;⁷ second, the procedural reform legislation passed in 1980;⁸ and third, the new income tax allocation statutes passed in 1981 effective for this taxable year and future taxable years.⁹

*Note: Additional citations can be found in the accompanying outline.

¹ Va. Const. art. X, § 6(f).

² E.g., *Commonwealth v. Community Motor Bus Co.*, 214 Va. 155, 157, 198 S.E.2d 619, 621 (1973).

³ *Department of Taxation v. Progressive Community of Washington County, Va., Inc.*, 215 Va. 732, 739, 213 S.E.2d 759, 763 (1975).

⁴ E.g., *Jefferson Publishing Corp. v. Forst*, 217 Va. 988, 234 S.E.2d 297 (1977).

⁵ See *City of Roanoke v. James W. Michael's Bakery Corp.*, 180 Va. 132, 21 S.E.2d 788 (1942). See also *County of Henrico v. Management Recruiters, Inc.*, 221 Va. 1004, 277 S.E.2d 163 (1981).

⁶ See *Richmond Food Stores, Inc. v. City of Richmond*, 177 Va. 592, 15 S.E.2d 328 (1941). See also *Forst v. Rockingham Poultry Marketing Corp.*, 222 Va. 270, 279 S.E.2d 400 (1981).

⁷ *Commonwealth v. Champion Int'l Corp.*, 220 Va. 981, 265 S.E.2d 720 (1980).

⁸ House Bill No. 990, 1980 Va. Acts, ch. 633.

⁹ Senate Bill No. 641, 1981 Va. Acts, ch. 402.

Income Tax Allocation Cases

The Income Tax Allocation Cases were three separate lawsuits brought by Champion International Corporation; Weaver Brothers, a mortgage banker doing business primarily in the Northern Virginia area; and Merrill Lynch, the stockbroker. The question in all three cases was the same: whether Virginia follows the distinction of the Uniform Division of Income for Tax Purposes Act between business and nonbusiness income. In determining the Virginia income tax liability of a multistate corporation, you must go through a two step process. First, you must determine the taxable income. Second, you then have to divide that taxable income among Virginia and the other states where the corporation does business. The latter step involves allocating certain classes of income either entirely to Virginia for taxation or away from Virginia for taxation. The remainder of the corporation's income then is apportioned among Virginia and other states based on the amount of business it does in each state.

The Department of Taxation took the position for a number of years that the only income allocated under the statutes was so-called nonbusiness income, that is, passive investment income. All business income in the Department's view was to be taxed by apportionment. The *Champion* case considered this issue in the context of capital gains. *Champion* for the 1972 taxable year elected to treat its cutting of timber as a sale or exchange under § 631 of the Internal Revenue Code, taxable as a capital gain under § 1231 of the Code. The Department of Taxation argued that the income was not a taxable gain for allocation purposes in Virginia because it was a "business" gain not a "nonbusiness" gain. *Champion's* position was that the statutes were clear in allocating capital gains¹⁰ as determined for federal tax purposes.¹¹

Weaver Brothers considered the identical issue except in the context of interest income. *Weaver Brothers* argued that all of its interest income from mortgage loans should be allocated to its principal place of business in Maryland under the Virginia statute.¹² The Department of Taxation on the other hand argued that the interest income was business income and should be apportioned among Maryland, Virginia and the other states where *Weaver Brothers* did business. *Merrill Lynch* considered the same question concerning interest income but added to it dividends. *Merrill Lynch* argued that its dividend and interest income should be allocated to its principal place of business outside of Virginia.

The taxpayers' positions in these cases produced some very startling results. For example, *Champion* had over \$29 million worth of capital gains from cutting timber in 1972, of which only \$122 was attributable to trees cut in Virginia. Therefore, if it could allocate those gains to the state where the trees were located, then it would pay only about \$8 in Virginia tax, whereas if those same gains were taxed by apportionment, it would pay about \$28,000 in Virginia tax.

¹⁰ Va. Code § 58-151.039 (1974) (repealed by 1981 Va. Acts, ch. 402).

¹¹ *Id.* § 58-151.01(a) (Supp. 1981).

¹² Va. Code § 58-151.040 (1974) (repealed by 1981 Va. Acts, ch. 402).

The Supreme Court's opinion in those three consolidated cases was in two parts. First, on the substantive issue it held that Virginia does not follow the distinction of the Uniform Act between business and nonbusiness income. This holding is very startling because it means that virtually every income tax audit conducted by the Department of Taxation prior to 1980 was conducted incorrectly. I will have more to say about that in a minute.

The second branch of the Supreme Court's holding deals with administrative interpretations. The Department had argued that its position concerning allocation and apportionment of income was a long-standing position which should be accorded great weight, that is, the weight of a regulation. It argued or tried to prove this position from private letter rulings, oral testimony of the State Tax Commissioner, and oral testimony of the Director of Corporate Income Taxes. What the record showed, however, was that the Department until 1974 had interpreted the allocation and apportionment statutes to apply without regard to a business, nonbusiness distinction. Beginning in late 1974 and early 1975, the Department publically changed that position and began applying its new position to all tax years then under audit, that is, retroactively to 1972. Under those circumstances the Supreme Court held that the Department's administrative interpretation was not entitled to great weight, and the court's opinion states not once, but three or four times, that an unpublished administrative interpretation is not entitled to great weight. Many Virginia tax practitioners concluded from this language that a new day had dawned, that never again could the State Tax Commissioner take the stand and have his testimony be given the weight of a regulation.

Procedural Legislation

About the same time as the *Champion* case was being tried and appealed, a group of tax practitioners formed what they called a joint task force to consider revisions to Virginia tax procedures. The joint task force was made up of members of the Tax Committees of the Virginia Society of Certified Public Accountants, the Virginia State Bar and the Virginia Bar Association. That joint task force made its report to the General Assembly in 1978. The General Assembly then formed a study committee of the House and Senate Finance Committees,¹³ and the committee's report¹⁴ led to legislation in 1980 that was numbered House Bill 990. Part of the recommendations of the study committee was to establish a Virginia Tax Court that would provide a much simpler, easier and more efficient tax contest procedure that could be used by both accountants and lawyers. Unfortunately, the tax court provisions were not enacted in law, but the recommendations of the study committee concerning regulations and the other refund procedures did effect sweeping changes in this area of Virginia tax law.

Regulations. Three major changes were made with regard to the Department of Taxation's administrative interpretations. First of all, effective

¹³ H.J.Res. No. 342 (1979).

¹⁴ Report of the Practices and Procedures in the Collection and Administration of State Taxes Committee, H. Doc. No. 30 (1980).

July 1, 1980, the Department must follow the Administrative Process Act.¹⁵ That means the Department must publish in advance any future regulations so that you and your clients will have the opportunity to comment on them. Second, the Department must publish all final regulations, private letter rulings, circuit court decisions, tax circulars, tax bulletins and any other documents that evidence an important administrative interpretation of Virginia law.¹⁶ We already are beginning to see this publication requirement produce a large volume of helpful research material because the national tax services are picking up the Department's announcements.

The third change brought about by House Bill 990 with regard to the Department's regulations reflected the concern of the study committee that requiring the Department to promulgate its regulations under the Administrative Process Act and then publish them was nice; but this requirement does not mean necessarily that the Department will in fact promulgate a regulation. As long as the State Tax Commissioner can take the stand and testify orally as to his view of the law and his testimony is given the weight of a regulation, then no incentive exists for the Department to publish any regulation. Therefore, the third requirement of the legislation was to specify the weight that will be given the Department's administrative interpretations. The simple rule that will be in effect beginning in 1985 is expressed nicely by the short hand phrase "publish or perish." If the administrative interpretation is not published, then it is not entitled to be admitted into evidence.¹⁷

Until 1985 we are in a transition period during which the Department is entitled to prove its unpublished administrative interpretations. That proof requires that the Department establish the terms of an administrative interpretation by documents that were in existence prior to July 1, 1980.¹⁸ Once the Department proves the terms of the interpretation, then it must show that the interpretation was in general application throughout the state. Oral testimony is not admissible for purposes of proving the terms of the interpretation, but may be admissible to show that the interpretation was applied throughout the state.

Let us assume that the Department can establish its administrative interpretation by proper proof. The statute then says that the interpretation is entitled to be given only such weight as the court deems appropriate.¹⁹ That statutory language was a compromise reached in the committee between the tax practitioners, on the one hand, who thought that unpublished interpretations should be entitled to no weight and the State Tax Commissioner's view, on the other hand, that under the case law his opinion was entitled to the weight of a regulation. That disagreement could not be resolved, so the issue was left up to the courts. What does the language mean? After the *Champion* case I would argue, and I think the law ought to be, that if the interpretation is not published, it is not entitled to any weight. Therefore, when the statute says "such weight as the reviewing authority deems appropriate," it basically

¹⁵ Va. Code § 58-48.6 (Supp. 1981).

¹⁶ *Id.* § 58-48.7.

¹⁷ *Id.* § 58-48.8 E.

¹⁸ *Id.* § 58-48.8 D.

means that the court at least will know that the interpretation exists but will not accord the interpretation the weight of a regulation.

On the other hand, I have noted in your outlines several cases decided after this legislation was passed in which the Supreme Court did accord weight to administrative interpretations that had not been published generally. In one case, the court accorded weight to a private letter ruling.²⁰ In another case, great weight was accorded to oral testimony of a license tax inspector.²¹ The court's opinions do not cite the legislation, possibly because the court was not made aware of the legislation by counsel. I think, however, that the more likely reason for the court's not citing the legislation is that the cases arose prior to its effective date. In any event, these cases may give some indication that during the transition period the court will give great weight to administrative interpretations that the Department proves properly. If the court does this, notwithstanding its language in *Champion* about unpublished interpretations, then I think the weight it accords probably will depend on a number of factors. Number one is the *Champion* factors — is the interpretation retroactively or prospectively applied; is it a consistent interpretation; is it in accord with legislative intent; has it been published? Second, the equities will be important — did the particular taxpayer abide by the interpretation for a number of years.²²

Finally, is the interpretation reasonable?²³ I think that the court will look to all of those factors in determining whether it will accord weight to unpublished administrative interpretations. The procedure will be very similar to what you are familiar with in the federal tax area concerning revenue rulings.²⁴ If the Internal Revenue Service publishes a ruling simultaneously with litigation, the courts generally do not pay too much attention to it. On the other hand, if a revenue ruling has been on the books for twenty or thirty years, is well known, and has been followed a number of times, and if a case turns squarely on the position set forth in that ruling, the courts often will give that ruling great weight. While the courts may not give the ruling quite the weight of a regulation, they will accord it significant weight. I think we may see our Supreme Court do much the same thing.

Should the weight accorded administrative interpretations during the transition period be a factual issue, discovery will be very important. I would recommend to anybody who gets into a dispute with the Department of Taxation that one of the first steps you would take in the litigation is to pin

¹⁹ *Id.*

²⁰ *Forst v. Rockingham Poultry Marketing Corp.*, 222 Va. 270, 279 S.E.2d 400 (1981).

²¹ *County of Henrico v. Management Recruiters, Inc.*, 221 Va. 1004, 277 S.E.2d 163 (1981) (involving a local tax technically not subject to Va. Code § 58-48.8 (Supp. 1981)).

²² *See Forst v. Rockingham Poultry Marketing Corp.*, 222 Va. 270, 279 S.E.2d 400 (1981).

²³ *See County of Henrico v. Management Recruiters, Inc.*, 221 Va. 1004, 277 S.E.2d 163 (1981). *See also Commonwealth v. Baltimore Tank Lines Inc.*, 221 Va. 651, 272 S.E.2d 220 (1980).

down the administrative interpretations by a simple set of interrogatories. One of the important changes of House Bill 990 was to make clear that the rules of discovery are available in tax refund cases, at least at the state level under § 58-1130. The statutes are less clear that the rules of discovery are available in local tax refund cases under § 58-1145. That statute is susceptible to two interpretations one of which is that discovery is available in all but small real estate tax cases. The other interpretation is that discovery is available only in large real estate tax cases. My correspondence with the Fairfax County officials who proposed the legislation and lobbied for it indicates that their intent was to make discovery available generally and that this availability was cut back for the small real estate tax cases.²⁵ Nevertheless, if you find yourself in a court that reads the statute in such a way that you are not given the benefit of discovery in a local refund suit, remember that you have a number of other ways to get this information. Try a freedom of information request, or, if that fails, think about reinstating your suit in the form of a declaratory judgment action. The Rules of Court and discovery are available in declaratory judgment action proceedings. But be careful since refunds cannot be had in such cases.²⁶

Rulings. I have noted in your outlines a case involving Washington Gas Light Company and the question of whether revenue rulings in Virginia are reliable. That question should be moot as far as rulings given by the Department of Taxation since House Bill 990 specifically gives the State Tax Commissioner the authority to issue rulings and to apply or change them either prospectively or retroactively.²⁷ The statutory language is similar to the language used in the Internal Revenue Code to give the Commissioner of the Internal Revenue Service the authority to give a reliable ruling. You should note in the Washington Gas Light case, however, that our court assumed the reliability of the ruling but held that the taxpayer had not carried its burden of proving that it in fact had relied on the ruling and done so to its detriment. The standard that our court applied in that case was in essence that the taxpayer must prove the terms of the transaction that it did not undertake. Only by that type of proof would the court conclude that the taxpayer had relied on the ruling in taking another course of action, and only by that type of proof could the taxpayer have established firmly its damages. So I warn you, if you have a ruling from a Virginia tax official, before closing your files, make sure that you have preserved as much of a paper record as you can to establish the circumstances under which you requested the ruling; the degree of reliance placed on the ruling; and the alternatives considered by your client if it had not obtained the ruling. That evidence is exactly the kind you must have if you ever need to enforce the ruling as Washington Gas Light tried. The standard of proof is very difficult, but it is one to which our court likely will hold you.

²⁴ See generally J. Freeland, S. Lind, & R. Stephens, *Fundamentals of Federal Income Taxation* 29-31 (2d ed 1977); Rogovin, *The Four R's: Regulations, Rulings, Reliance, and Retroactivity: A View from Within*, 43 *Taxes* 756 (1965).

²⁵ Letter from Carroll R. Karr, Legislative Liaison for the County of Fairfax, to William L.S. Rowe (June 30, 1980).

²⁶ *Perkins v. County of Albermarle*, 214 Va. 416, 200 S.E.2d 566, *modifying and aff'g on rehearing* 214 Va. 240, 198 S.E.2d 626 (1973).

House Bill 990 also made a number of changes in the general refund procedures. If you have any dispute with the Department of Taxation, you should read the statutes carefully as they have changed substantially. One particular change is that the statute of limitations for refunds is now a uniform three years measured from the date of the assessment.²⁸ The statute of limitations no longer is measured on a calendar year basis. Moreover, you should note that the date of the assessment is deemed to be the date that the assessment is mailed to the taxpayer.²⁹ So keep that cover letter from the Department of Taxation so you will know when the mailing occurred. One of the purposes for this change was to end the Department of Taxation's practice of making thousands of year-end computer assessments and treating the date of the computer entry as the date of the assessment, even though the assessment was not mailed out to the taxpayer for four to six months thereafter. You also should keep in mind that as long as you have an administrative appeal pending in Virginia, your statute of limitations on a refund action has not been tolled. If you wait beyond the three-year period before filing suit and receive an adverse administrative determination, you will have no right to appeal to the courts. A number of things, however, are available to you for protection of your rights in that situation. Get the Department to execute a waiver, file a protective claim, or file a court refund suit. But you must do something within the three years other than file a protest with the Commissioner.

Income Taxes

Prior to 1981. Let us move on now to some substantive changes in Virginia tax law. In the income tax area most of the changes are a result of the Income Tax Allocation Cases. First of all, for the taxable years 1972-1980, the major question concerns refunds. You will recall my saying that virtually every audit of multistate corporations conducted by the Department for those years was done incorrectly. If you represent a multistate corporation that was audited within the last three years, and prior to the Supreme Court's holding in *Champion*, then the client probably will be entitled to a large refund if its headquarters is outside Virginia. So look at your statute of limitations and run the numbers.

The flip side of that coin is that if you represent a Virginia headquartered corporation that is under audit now for years prior to 1981, the client very likely will have a very large Virginia income tax liability. The reason in both situations turns on the holding in *Merrill Lynch and Weaver Brothers*. You will recall that the court held in those cases that interest and dividend income is allocated to the corporation's principal place of business. If that principal place of business is in Virginia, the holding means that Virginia will tax all of it. The holding also means that a double tax probably exists because most other states will tax that same income by apportionment.

²⁷ Va. Code § 58-48.6 B (Supp. 1981).

²⁸ *Id.* § 58-1118.1 (amended return), § 58-1119.1 (protective refund claim), § 58-1130 (court refund action).

²⁹ *Id.* § 58-1117.20.3.

At a meeting of the Tax Executives Institute in Richmond last year it was pointed out that the holding presents a very severe problem for the Virginia headquartered corporation that had substantial interest paid and interest received during taxable years prior to 1981. The reason for this problem is that the Department of Taxation's auditors are allocating the interest income to Virginia and reducing apportionable income by the interest paid. Say, for example, you have a corporation that engaged in a large construction program, borrowed \$50 million to pay for the construction, and, while it was making the progress payments on the construction loan, invested that \$50 million in interest bearing accounts. The position taken so far by the Department's auditors is that the income earned on those interest bearing accounts is allocable to Virginia, but the interest paid on the \$50 million loan is subtracted from apportionable income. Therefore, that corporation is hurt severely and unfairly.

This issue is pending now before the State Tax Commissioner in several cases. I think that the answer to the issue is fairly clear. What ought to be allocated to Virginia, at least I would argue, is net interest income, that is, the excess of interest received over interest paid. That ought to be the result because Virginia has a net income tax. It also should be the result because of the five classes of allocable income under the statutes in existence prior to 1981, four of them, excepting only interest income, were either expressly or implicitly classes of net income.³⁰ Capital gains and losses by definition represents a netting out process. As for rents and royalties, the statute specifically allocated *net* rents and royalties. As to dividend income, by definition you cannot have a dividend unless you have a net profit to pay out to your stockholders. Therefore, in line with the intent of a net income tax, allocating only net interest income seems fair to me. Seeing whether the Department reaches that result will be interesting.

Apparently, the State Tax Commissioner is concerned because the last time he read words into the statute — “business” and “nonbusiness” — the Supreme Court slapped his hands pretty hard. So he is reluctant to read the word “net” into the interest allocation provisions. In my opinion though, when you are talking about net interest income versus business, nonbusiness income you have very different situations. In one case the Department changed an administrative interpretation to conflict with the legislative intent, and applied it retroactively. On the other hand, an administrative interpretation that allocates “net” interest income would reflect fairly the General Assembly's intent of a net income tax, and also would reflect the tax instructions that were in effect for the years after 1974.

Post 1980. For the 1981 and later taxable years, the big news is the adoption by Virginia of a whole new set of allocation and apportionment statutes. In essence, those statutes reverse *Champion*, *Merrill Lynch* and *Weaver Brothers*. They do it by eliminating all the classes of allocable income except for one. The only class of allocable income will be dividends to the

³⁰ *Id.* §§ 58-151.035 to .041 (1974 & Supp. 1980) (sections 58-151.036, .038 to .040 repealed by 1981 Va. Acts, ch. 402; sections 58-151.037, .041 amended by 1981 Va. Acts, ch. 402).

extent received from a corporation in which the recipient owns less than 50% of the stock. Therefore, a very small amount of income will be allocable for Virginia tax purposes. The rest will be apportionable.

The second major feature of these income tax statutes is in essence the adoption of the so-called Mathias Bill that has been pending in Congress for a number of years. The purpose of the Mathias Bill, I believe that I am stating this accurately, is to provide a uniform method of taxation by the states of multinational, multistate corporations. Virginia was the first and, I believe, still the only state to have adopted that system of taxation. The express purpose for adopting it was to make Virginia an attractive place for businesses to locate.

The primary feature of this legislation, designed to make Virginia a good place for industry to locate, was to exclude from Virginia taxable income all foreign source income. This exclusion is done in a number of ways. First, dividends received from corporations in which you own 50% or more of the stock are taken out of taxable income. Taxable income also is reduced by Subpart F income and foreign source income as defined in the Internal Revenue Code. Finally, the statute expressly prohibits the Department of Taxation from taxing worldwide income via a so-called "combined return." The combined return is the method used by California and a number of other states for reaching foreign source income among an affiliated group of corporations. The Virginia statutes now expressly prohibit the use of a "worldwide combined return."

The legislation also changes somewhat the three factor formula utilized by Virginia. The property, payroll and sales formulas have been amended so that they include only property, payroll or sales effectively connected with the trade or business carried on in this country. They exclude property, payroll and sales attributable to business conducted outside the United States.

Another important feature of the legislation is the introduction of a new type of tax return, the so-called "combined return." This return is in addition to the separate return and the consolidated return previously available to corporations under Virginia's income tax statutes. The combined return in essence includes all the members of an affiliated group that are subject to Virginia tax. Each member of the group computes its Virginia taxable income or loss utilizing its own income and its own apportionment and allocation factors. The group then combines all of the income into a single return. There is some thought that, because 1981 is the first year in which this new type of return is available, a corporation can, as a matter of right, change the method in which it reports its income for Virginia tax purposes. If the corporation has been reporting separately in the past, arguably it now can report under a consolidated return or combined return. I discussed this very informally with the Department, and I understand that, while the Department has not taken a position yet, the Department anticipates allowing any corporation that asks to change the method in which it reports its tax.

Income Tax Litigation. I have appended to your outline a list of pending tax cases in Virginia. You will see that a number of those tax cases involve determinations of the amounts of refunds due under *Champion, Weaver Broth-*

ers and *Merrill Lynch*. The major new income tax case involves General Electric and its DISC, that is, its Domestic International Sales Corporation. Stipulated in that case is that General Electric's DISC does not do business in Virginia and is not subject to Virginia tax. The Department of Taxation, however, takes the position that the federal DISC rules produce such a good tax benefit that they distort Virginia taxable income. Therefore, the Department argues that it should be entitled to combine the income of General Electric, which is subject to Virginia tax, with the income of its DISC. In essence, the Department makes a § 482 allocation. The taxpayer's response is very simple. It argues that Virginia has conformity with the federal income tax laws, and if the DISC rules are proper for federal tax purposes, then they are per se proper under Virginia tax law. I think that the case will tell us a lot about how Virginia's conformity statutes should be construed.

Sales Taxes

In the sales tax area, most of the legislation is what I would refer to as reactionary legislation. That is, taxpayers are reacting to the results produced by the rule of strict construction and amending the statutes to do what they thought the statutes did before they were audited. A fair amount of very important litigation has occurred though. Some of the early sales tax cases involved very specialized exemptions, exemptions for broadcasters, publications and medicines. Some of the more recent cases, however, involve two very important exemptions those for industrial manufacturing and processing and the distinction in the statutes between exempt service transactions and taxable sales of tangible personal property.

Industrial exemptions. Under Virginia Code § 58-411.6 materials, supplies and machinery used directly in manufacturing and processing are exempt. The Department of Taxation took the position for a number of years that processing and manufacturing were essentially synonymous terms so that a taxpayer was engaged in exempt processing only if he applied a treatment to raw materials that turned them into a substantially different product. The Department also took the position that exempt processing could occur only if the product was sold at wholesale and not retail. In a case involving Orange-Madison Cooperative, the Supreme Court of Virginia rejected both of these positions.

First of all, the court held that exempt processing exists whenever the taxpayer applies any treatment or process to raw materials that makes them more useful or valuable. Secondly, it held that whether the product was sold at wholesale or retail was irrelevant. The specific facts of the case centered around the blending of chemicals to produce fertilizer, and the blending of grains and additives to produce feed for cattle. In both situations the court held that these blending activities, which did not transform the raw materials in any respect, were exempt processing.

A second case decided the same day as *Orange-Madison Cooperative* involved Solite Corporation. Solite crushed and blended stone and gravel. It claimed that it was manufacturing so that it was exempt from local license

taxation. The court, referring to its *Orange-Madison* decision, held that this was processing not manufacturing, the distinction between the two being that manufacturing requires a substantial change in the raw materials whereas processing does not.

Lest you think that almost anything will constitute exempt processing, I have noted in your outlines the *Flow Research Animals* case in which a corporation engaged in the business of raising laboratory animals under controlled conditions claimed that it was engaged in exempt processing. The Supreme Court, with two justices dissenting, a fairly unusual feature in and of itself, held that this was not processing. To be processing you must apply a process. Letting nature take its course just does not qualify.

In late 1978 the Supreme Court decided a very important case involving Webster Brick. *Webster Brick* concerns the restriction in the industrial sales tax exemptions that the materials used in processing, manufacturing or mining are exempt only if directly used in the exempt activity. In *Webster Brick* the Supreme Court drew a very narrow line right at the assembly line of the manufacturer, in essence holding that if something is one step removed from the production line, it is taxable. At issue in the case was, first of all, an overhead crane that removed large items of machinery from the assembly line to repair them and then put them back on the assembly line. The court held that the overhead crane was not involved directly in production. It was one step removed; it was taxable. Similarly, an oil storage tank was involved. The oil itself was conceded to be used directly in manufacturing the brick, but the storage tank that held the oil was not used directly in manufacturing. The tank was one step removed — a very narrow interpretation.

What I think is an even more interesting aspect of the case is the part dealing with the Department of Taxation's position that materials incorporated into real estate construction are taxable. Applying that interpretation, the Department held that ventilator fans located in the ceiling of the building and the reinforced concrete and steel flooring for the brick factory were both taxable. The ventilator fans cut on automatically when it got too hot. If they did not cut on and the building got too hot, the machinery would stop working. The concrete and steel flooring was necessary to support the weight of the machinery because all of the controls and gauges were underneath the flooring. Without the special flooring, the weight of the machinery would crush the electronics that ran it. The court held that both the ventilator fans and the flooring were taxable. But it did not rest its holding on the real estate construction test. Rather it held that these items were indirectly part of manufacturing. They were important to the process, but they were not a direct part of manufacturing itself. If you will, they were both one step removed. They were part of the building, not part of the assembly line in the building.

An important case is now on appeal to the Supreme Court from the Circuit Court of Buchanan County involving Wellmore Coal Corporation. The case concerns both the direct use exemption for miners and processors. Wellmore owns coal mines where it mines coal, and it owns a fine coal cleaning plant, a tippie, where the coal is crushed, cleaned and blended. On the mining side of the case, the trial court held that the equipment and supplies used to reclaim strip mined lands were taxable. Wellmore had argued that

these supplies should be exempt because, as a matter of law, it is not able to begin mining or conduct mining operations unless it reclaims the land. Wellmore argued that reclamation was an integral part of mining and exempt. It has appealed the trial court's adverse determination.

The trial court also held that repair parts and supplies for trucks that hauled coal from the coal mine to the tippie were taxable. Wellmore had argued that mining begins at the coal face and continues through to the tippie where the coal is cleaned and processed. Therefore, it argued that trucking should be a direct part of production. Wellmore's argument was very similar to the position in the Internal Revenue Code that you can have percentage depletion for trucking expenditures when the person who owns the coal mine also owns the processing plant.³¹ In that case, the trucking is part of mining.³² The trial court ruled in Wellmore's case, however, that the supplies for the trucks were taxable, apparently being of the view that coal mining, for sales tax purposes, begins at the coal face and ends at the mine's mouth. The taxpayer also has filed a cross-appeal on this issue.

On the processing side of the case, the trial court held that large scales at the coal tippie that were used to weigh in trucks delivering coal were used directly in processing. Under the statutory provisions, processing is deemed to include the handling and storage of raw materials at the plant site.³³ The court held, in essence, that these scales were the first step in handling and storing the raw materials. The Department argued that the scales had nothing to do with processing and should be taxable. The Department has appealed that holding. If the Department prevails, manufacturing concerns in this state that are obtaining an exemption now for handling and storage equipment and supplies will become taxable. Thus, this issue is an important aspect of the case.

The most important aspect of the case though, I think, concerns once again the real estate construction rules. At issue is concrete and steel used to erect Wellmore's fine coal processing plant, a tippie. For those of you who have never seen a plant of this sort, it is a huge structure. It is about seven stories tall and is chock-full of equipment. Workmen have no space inside this structure. A repairman has barely enough room to walk between the machinery and repair it if it breaks down. The machinery is set up in a seven story, if you will, vertical assembly line. The coal comes into the top of the structure and goes by gravity flow from one process to the next. The coal comes in, is crushed, cleaned, washed, blended, and then comes out the bottom of the tippie ready for sale.

The taxpayers' position is that the structural steel and concrete was an integral part of its vertical assembly line; that is, the tippie is a single machine that is seven stories tall. The steel and concrete were as much a part of the machine as a carburetor is a part of an engine. The Department's position is that the individual pieces of machinery are exempt but that the

³¹ I.R.C. § 613(c).

³² See Treas. Reg. § 1.613-4(f)(1).

³³ Va. Code § 58-441.3(p) (Supp. 1981).

concrete and steel that erect and hold them into a working configuration are taxable. The trial court held that the tippie itself was a single purpose machine and was exempt. This holding is very important for industry in this state because, if affirmed on appeal, it means that many of the concepts of the investment tax credit area will become part of Virginia sales tax law. Concrete and steel used to construct special purpose structures will be sales tax exempt.

Sales versus service. The second important group of sales tax cases concerns the distinction between nontaxable services and taxable sales of tangible property. The landmark decision in this area was made by the Supreme Court several years ago in *WTAR Radio-TV*. In that case the Supreme Court held taxable charges by a television station for creating and producing an advertisement for one of its customers. The television station provided the actors. It provided the camera crew and everything necessary to make a video taped advertisement that it then aired. The Supreme Court held that the true object of the customer in that case was to obtain the video tape. Since the tape was an item of tangible property, the court held that the total charge for the acting services, camera crews and everything was taxable. The fact that the video tape was never delivered to the customer, that is, no transfer of possession of the tape ever occurred, was irrelevant in the court's mind. It held that the broadcasting of the commercial over Virginia airwaves was a transfer of possession.

Immediately after the *WTAR* decision the Department of Taxation began nibbling at the edges of many other service transactions. The first case involved an advertising design group in Northern Virginia appropriately called Designing Women. Designing Women would sit down with people, for example, people running for political office, and give them ideas of how to put together campaign posters. Customers then would take those designs and have their posters printed. The Department of Taxation said that the charges of Designing Women were taxable. What an enterprising lawyer in Northern Virginia did was to take the customers, one of whom was the clerk of the circuit court, put them on the stand as witnesses and ask them what was their true object in this transaction — to obtain the design skills or to obtain a tangible design. Surely enough, the clerk of court, who obviously did not want to pay sales tax, said that his true object was to obtain the intangible knowledge. The trial court held that the transactions were not taxable. The Department appealed the decision to the Supreme Court. Although the Department's petition for appeal was denied, I would warn you, I understand that it was denied on procedural grounds and not on the merits.

Another circuit court decision involves Charlottesville Newspapers. In this case the Department tried to tax the monthly charges for the AP and UPI wire services. It argued that tangible transfers were involved because (1) the services were rendered through equipment and machinery, and (2) when the newspaper got a story from the wire service, it was in printed form. The Department held that the true object of the newspaper was to obtain that printed story. The trial court, however, ruled that the transaction was essentially a service transaction, that the printed product was an inconsequential element of that transaction, and that no tax liability existed. The Supreme Court denied the Department's petition for appeal on the merits.

Two recent letter rulings by the Department of Taxation are noted in your outline. One concerns the taxability of paging devices. If you ever have been in a theater and heard a beeping sound, you know that a doctor has been paged back to the hospital. The question in the first letter ruling was whether the charge for that paging service was taxable because the service is rendered through a tangible beeper. The Department held that the beeper itself was an inconsequential element of the service transaction and thus no tax.

In a second letter ruling, though, the Department held that the charges for "canned" computer programs were taxable because a magnetic tape delivered the computer program into the computer. Therefore, a transfer of something tangible occurred just like in *WTAR*. The interesting thing about this ruling is that the computer program need not be delivered in a tangible form. It could have been transferred from the seller to the buyer's computer over the telephone or by manual entry into the computer. The magnetic tape or punch cards were not necessary to the transaction. This transfer seems to me to smack of an intangible transfer, not a tangible one. This issue could be a very interesting piece of litigation if it ever comes about.

Capital Taxes

In the capital tax area — Virginia's tax on capital not otherwise taxed — once again, a lot of reactionary legislation has been enacted. Taxpayers are reacting to interpretations of the Department, reacting not by litigation but by going to the General Assembly and amending the statutes. I have noted in your outline a couple of major changes, one affecting the taxability of intercompany advances, a problem that has been resolved for future tax years. Another change affects the way contractors are taxed. Contractors who account for their income on the completed contracts method or percentage of completion method in the past have been taxed on their underbillings without any offset for overbillings. In the future, the two will be netted out.

The big news in the capital tax area is the promulgation of proposed regulations by the Department in February of this year. These proposed regulations are very important. They are the first ones that the Department has issued under the Administrative Process Act. They give us a good idea of how the Department is going to approach this process and also of the Department's interpretations in this very difficult tax.

The one area in the regulations that has drawn the most adverse taxpayer comment is the Department's definition of "money on hand and on deposit." Money on hand and on deposit is exempt under the CNOT tax. The Department defines this, however, to include only savings accounts, checking accounts and certificates of deposit with a bank. Under the Department's view and under its regulations, it does not include commercial paper and notes issued by a corporation even if the issuer is a bank.

One other point that you might note in the CNOT tax regulations is that they apparently acknowledge that the statutory requirement is actual value. Many corporations in their accounting procedures will retain an item on their books that may be worthless. They will retain it on the books and create a

reserve to offset the worthlessness. The Department's audit position has been that you include the asset and exclude the reserve. If you get caught in one of those positions in an audit, you ought to take an appeal because as long as you can show that the reserve is necessary to establish actual value, then you should win.

Now that is all the prepared remarks that I have. I think that we have about five or ten minutes left, and I will be glad to try to answer any questions that you may have.