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Good Intentions, But Unintended Consequences: Expanding Virginia's Manufacturing Tax Exemption Under *City of Winchester v. American Woodmark Corp.*

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GOOD INTENTIONS, BUT UNINTENDED CONSEQUENCES:
EXPANDING VIRGINIA'S MANUFACTURING TAX
EXEMPTION UNDER *CITY OF WINCHESTER V.*
AMERICAN WOODMARK CORP.

The Virginia Supreme Court recently opened the door to challenges by Virginia manufacturers requesting exemptions or refunds of local property taxes with its decision in *City of Winchester v. American Woodmark Corp.*¹ American Woodmark, a nationwide furniture manufacturer headquartered in Winchester, Virginia, filed suit against the City of Winchester in 1995 requesting a property tax refund of approximately half a million dollars.² Although American Woodmark did not perform any manufacturing functions within the Winchester city limits, the company argued that the computers and office equipment in its corporate headquarters were exempt from the local personal property tax because this equipment was "used in manufacturing" under § 58.1-1101(A)(2) of the Virginia Code.³ Counterintuitively, the Virginia Supreme Court agreed.

As a result of this decision, cities and counties in Virginia now face requests for tax refunds on a variety of property that businesses claim is "used in manufacturing."⁴ Prominent examples

1. 464 S.E.2d 148 (Va. 1995). The *American Woodmark* decision interpreted § 58.1-1101(A)(2) of the Virginia Code as excluding all tangible personal property of a manufacturer from local taxation regardless of how indirectly the property relates to the manufacturing function. *See id.* at 151.

2. *See American Woodmark Corp. v. City of Winchester*, 34 Va. Cir. 421 (1994), *aff'd in part, rev'd in part*, 464 S.E.2d 148 (Va. 1995). The exact amount of the refund request was \$464,637. *See id.* at 430.

3. *See id.* at 431-32; *see also infra* note 38 (providing the text of Virginia Code § 58.1-1101(A)(2)).

4. Businesses that have made this claim include Coca-Cola bottling companies, Goodyear, Sherwin Williams, Southern States, Lance Incorporated, IBM, and Xerox. *See William L. Heartwell, III, The "Tax Precluded" Manufacturer-Trying the Case, Address at the Virginia Association of Local Government Attorneys 2* (Oct. 1998) (on file with author). Businesses also appear to be targeting smaller jurisdictions with these requests, presumably because they have fewer resources to respond to the

include Coca-Cola, which claims that its vending machines are "part of the manufacturing" of Coke,⁵ and Sherwin Williams, which claims that equipment at its retail stores is "used in manufacturing" paint.⁶ Local governments stand to lose millions of dollars in tax revenues if these challenges succeed.⁷

This Note analyzes the impact of *American Woodmark* on Virginia's personal property tax exemption for manufacturers, comparing the recent consequences of the court's holding with legislative and judicial intent. The first section describes the constitutional and statutory background against which the *American Woodmark* decision took place. The second section presents an overview of *American Woodmark* and places the court's holding in the context of previous decisions granting tax exemptions to Virginia manufacturers. The third section compares Virginia's personal property tax exemption for manufacturers with similar tax exemptions offered by other states.

Next, the fourth section discusses the repercussions of the decision and argues that although Virginia's expansive exemption is consistent with the tax breaks offered in other states, the

challenges. For example, suits have been filed in various jurisdictions in Virginia, including Botetourt, Bristol, Grayson, Halifax, Henry, Montgomery, Wythe, Smythe, and Wise Counties. See Memorandum from Katherine Ashby, President, Commissioners of the Revenue Association, to Jean Marshall Crawford, Legal Counsel, Arlington County Commissioner of the Revenue (May 4, 1998) (on file with author). These jurisdictions range in size from approximately 16,300 to 75,500 persons. In comparison, Virginia's Arlington County has a population of approximately 178,800. See WELDON COOPER CTR. FOR PUB. SERV., VIRGINIA STATISTICAL ABSTRACT 555-58 (1996-97) [hereinafter VIRGINIA STATISTICAL ABSTRACT].

5. Joanne Poindexter, *Court Rules Against Coke*, ROANOKE TIMES & WORLD NEWS, Jan. 5, 1999, at B1.

6. See Heartwell, *supra* note 4, at 2.

7. Under Virginia's three-year statute of limitations, manufacturers can request refunds from three years ago. See D. French Slaughter, III, *Finding Coke in the SALT Mines* (1998) (unpublished manuscript, on file with author).

As of June 30, 1993, Virginia's cities and counties collected a little over \$10.3 billion annually from local, state, and federal sources. Of that amount 63.2 percent was locally generated, 30.3 percent state generated, and 6.5 percent federally generated. Of the locally generated portion, 63.26 percent came from property taxes, 22.5 percent from other local taxes, and 13.37 percent from other revenues such as fees, fines and forfeitures, and charges for services.

STATE & LOCAL GOV'T RESPONSIBILITY & TAXING AUTH. COMM'N, INTERIM REPORT, H. Doc. No. 62, Reg. Sess. 4 (Va. 1996).

court's convoluted interpretation of the Virginia Code may have unintended consequences for both consumers and Virginia cities and counties. This Note concludes with suggestions for ways in which local governments can defend against upcoming challenges by manufacturers.

CONSTITUTIONAL AND STATUTORY BACKGROUND OF THE AMERICAN WOODMARK DECISION

Unlike the manufacturing exemptions offered by most states, Virginia's exemption is fairly convoluted⁸ because it classifies tangible property as intangible property for tax purposes.⁹ In general, personal property is usually divided into two categories: tangible and intangible.¹⁰ Tangible personal property is "property which is touchable and has real [physical] existence."¹¹ Examples include motor vehicles, jewelry, books, or computer equipment.¹² Intangible property, on the other hand, is "property which cannot be touched because it has no physical existence."¹³ Intangible property also includes property that has only representational value;¹⁴ examples include corporate stock, bonds, goodwill, or franchises.¹⁵

Unlike most states, Virginia classifies a number of items of a manufacturer's tangible personal property as intangible for property tax purposes.¹⁶ According to the Virginia Constitution,¹⁷ the

8. See Jean Crawford, *Intangible v. Tangible Property Taxes: A Primer on Virginia's "Peculiar" Business Property Tax*, Address at the Virginia Association of Local Government Attorneys 1 (Oct. 1998) (on file with author).

9. See VA. CODE ANN. § 58.1-1101 (Michie 1997 & Supp. 1999).

10. See Christine E. Reinhard, Comment, *Tangible or Intangible—Is that the Question? Conflict in the Texas Tax Classification System of Computer Software*, 29 ST. MARY'S L.J. 871, 881 (1998).

11. *Id.* at 881 (citing BLACK'S LAW DICTIONARY 1218 (6th ed. 1990)).

12. See VIRGINIA STATISTICAL ABSTRACT, *supra* note 4, at 662.

13. Reinhard, *supra* note 10, at 882 (citing BLACK'S LAW DICTIONARY 1217 (6th ed. 1990)).

14. See *id.* (citing BLACK'S LAW DICTIONARY 809 (6th ed. 1990)).

15. See VIRGINIA STATISTICAL ABSTRACT, *supra* note 4, at 662.

16. See *supra* notes 8-9 and accompanying text; see also *infra* note 22 and accompanying text (providing examples of property classified as tangible in other states, but intangible in Virginia).

17. There are three provisions of the Virginia Constitution that pertain to the classification and assessment of intangible personal property. See VA. CONST. art. X, §§

General Assembly has the power to determine whether property should be taxed at the state or local level.¹⁸ In 1942, the Virginia Supreme Court in *City of Roanoke v. James W. Michael's Bakery Corp.*,¹⁹ extended this power to include the ability to classify tangible personal property as intangible property.²⁰ This extension essentially gave the General Assembly the authority to merge the intangible and tangible categories together.

Virginia has five statutes concerning the local government taxation of intangible personal property.²¹ As a result of *Michael's Bakery* and the language of these five statutes, "a taxpayer easily could owe tax on a number of tangible personal property items used in a manufacturing business which are now treated as if they were intangible personal property assets."²² This change in classification is important because under § 58.1-1100 of the Virginia Code, intangible personal property is segregated for state taxation only.²³ In 1994, however, Virginia dis-

1, 4, 6. For the purposes of this discussion, the most important of these is Article X, Section 1.

18. See VA. CONST. art. X, § 1. The text of this section reads:

The General Assembly may define and classify taxable subjects. Except as to classes of property herein expressly segregated for either State or local taxation, the General Assembly may segregate the several classes of property so as to specify and determine upon what subjects State taxes, and upon what subjects local taxes, may be levied.

Id.

19. 21 S.E.2d 788 (Va. 1942) (interpreting Article X, Section § 168 of the Virginia Constitution as it appeared after its amendment in 1928).

20. See *id.* at 798 (holding that the General Assembly had the power to classify the delivery trucks, furniture, and fixtures of a bakery as intangible personal property that was not subject to local taxation). But see *id.* at 799 (Holt, J., dissenting) ("If a truck is not tangible, then the great globe itself is not.").

21. See VA. CODE ANN. §§ 58.1-1100, -1101, -3507, -3508, -3508.1 (Michie 1997); *id.* § 58.1-1101 (Michie 1997 & Supp. 1999). For purposes of this Note, § 58.1-1101 is the most important. See *infra* notes 33-39 and accompanying text (discussing the current text of § 58.1-1101).

22. Craig D. Bell, *Taxation*, 30 U. RICH. L. REV. 1543, 1583 (1996). For example, the Virginia Code now provides that tangible property used in manufacturing, mining, radio or television broadcasting, dairy, dry cleaning, or laundry businesses shall be considered intangible. See VA. CODE ANN. § 58.1-1101 (Michie 1997 & Supp. 1999). As a result, local governments may only tax what is classified as "machinery and tools," "motor vehicles," and "delivery equipment" of such businesses. *Id.* § 58.1-3507.

23. See *id.* § 58.1-1100 (stating that "intangible personal property, including capital of a trade or business of any person, firm or corporation, except for merchants'

continued its state tax on intangible personal property.²⁴ As a result, property now classified as intangible personal property is not taxed by either the state or local government.

The court's decision in *Michael's Bakery* also made it difficult for cities and counties to challenge directly the constitutionality of Virginia's intangible personal property tax scheme.²⁵ As a result, recent challenges by local tax authorities focused on "carving out" items of tangible personal property, which would be subject to local tax, by narrowly interpreting the definition of intangible personal property.²⁶ *American Woodmark*, however, indicates that the Virginia Supreme Court is not receptive to these challenges.²⁷

AN OVERVIEW OF THE *AMERICAN WOODMARK* DECISION

In 1994, American Woodmark filed suit against the City of Winchester alleging that the company used its personal property in its manufacturing business, and therefore, the property was exempt from local taxation.²⁸ American Woodmark manufactures and sells wooden kitchen and bathroom cabinets nationwide.²⁹ The company's corporate headquarters, located in the City of Winchester,³⁰ established and monitored the overall corporate strategy, maintained the company's computer system, and engaged in the sales and marketing of cabinets and vanities produced by manufacturing facilities located outside of Virginia.³¹

The primary issue in *American Woodmark* was whether the law should treat a taxpayer's furniture, computers, and office

capital as defined in § 58.1-3510 which shall be subject to local taxation, is hereby segregated for state taxation only").

24. See 1984 Va. Acts ch. 729, § 58-405(D).

25. See Bell, *supra* note 22, at 1586.

26. See *id.*

27. See *City of Winchester v. American Woodmark Corp.*, 464 S.E.2d 148, 152 (Va. 1995) (holding that the taxpayer's property was capital used in a manufacturing business that was not subject to taxation by the city).

28. See *American Woodmark Corp. v. City of Winchester*, 34 Va. Cir. 421 (1994), *aff'd in part, rev'd in part*, 464 S.E.2d 148, 150 (Va. 1995).

29. See Collins Denny, III, *Personal Property, Tangible in Fact, Used In a Manufacturing Business—American Woodmark I*, Address at the Virginia Association of Assessing Officers Education Seminar 1 (July 11, 1996).

30. See *id.*

31. See *American Woodmark*, 464 S.E.2d at 150.

equipment, located in its corporate headquarters, as intangible personal property under the Virginia Code.³² At the time, the Code defined intangible personal property as:

Capital which is personal property, tangible in fact, used in manufacturing. . . . Machinery and tools, motor vehicles and delivery equipment of such businesses shall not be defined as intangible personal property for purposes of this chapter and shall be taxed locally as tangible personal property according to the applicable provisions of law relative to such property.³³

Affirming the circuit court's decision, the Virginia Supreme Court stated that "we decline the City's invitation to construe Code § 58.1-1101(A)(2) as requiring that a manufacturer maintain a manufacturing facility within the City's geographical boundaries or that the manufacturer's capital, which is personal property, tangible in fact, be used 'directly' in the manufacturing process."³⁴ The court placed the burden on the City of Winchester to prove that American Woodmark's corporate headquarters was not engaged in a manufacturing business, and it found that the evidence "fell short of carrying that burden."³⁵ In short, despite the fact that no actual manufacturing activity occurred at American Woodmark's corporate headquarters, the court held that the furniture, office equipment, and computers located at the site were "used in manufacturing," and therefore not subject to tax by the City of Winchester.³⁶

The Virginia legislature acted swiftly to codify the court's holding in *American Woodmark* by amending Virginia Code § 58.1-1101(A)(2).³⁷ The amendment added parenthetically the following language to the section: "[P]ersonal property, tangible in fact, used in manufacturing (including, but not limited to,

32. See *id.* at 151.

33. VA. CODE ANN. § 58.1-1101(A)(2) (Michie 1994). This section was amended in 1996 to reflect the decision in *American Woodmark*. See *infra* notes 37-39 and accompanying text.

34. *American Woodmark*, 464 S.E.2d at 152.

35. Denny, *supra* note 29, at 4.

36. See *American Woodmark*, 464 S.E.2d at 152.

37. See 1996 Va. Acts ch. 622, § 58.1-1101; see also Virginia General Assembly (visited Mar. 15, 2000) <<http://legis.state.va.us>> (indicating that the amendment was introduced in the House on January 22, 1996 and voted out of the Senate on March 1, 1996).

furniture, fixtures, office equipment and computer equipment used in corporate headquarters).³⁸ Unanimous votes of both the Virginia House and Senate approved the change, which became effective July 1, 1996.³⁹

The *American Woodmark* court adopted a very broad interpretation of tangible personal property under § 58.1-1101(A)(2). As a result of the court's decision and the subsequent statutory change by the General Assembly, tangible personal property for Virginia manufacturers is now defined as any property that is *owned* by a manufacturer, but such property need not be used directly in the manufacturing process.⁴⁰ Enlarging the exemption even further, the Virginia Supreme Court has narrowly defined what constitutes "machinery and tools" for purposes of manufacturing.⁴¹ As a result, Virginia businesses are exempt from an increasing number of local taxes. In short, after *American Woodmark*, any retailer who performs a small amount of manufacturing somewhere in its operation may claim an exemption from its personal property tax obligations.⁴²

There are three important parts of the *American Woodmark* holding: (1) further defining "manufacturing" under § 58.1-1101; (2) augmenting the definition of machinery and tools; and (3) the finding that the locality, not the taxpayer, bears the burden of refuting the tax exclusion.

38. VA. CODE ANN. § 58.1-1101(A)(2) (Michie 1997 & Supp. 1999). The section now reads:

Capital which is personal property, tangible in fact, used in manufacturing (including, but not limited to, furniture, fixtures, office equipment and computer equipment used in corporate headquarters) Machinery and tools, motor vehicles and delivery equipment of such businesses shall not be defined as intangible personal property for purposes of this chapter and shall be taxed locally as tangible personal property according to the applicable provisions of law relative to such property.

Id.

39. See 1996 Va. Acts ch. 622, § 58.1-1101; see also Virginia General Assembly (visited Mar. 15, 2000) <<http://legis.state.va.us>> (indicating that the House voted 100 to zero in favor of the amendment, while the Senate approved the change by a vote of 40 to zero).

40. See *American Woodmark*, 464 S.E.2d at 152.

41. See *infra* notes 63-76 and accompanying text (explaining interpretations of the "machinery and tools" exemption under Virginia Code § 58.1-1101(A)(2)).

42. See Heartwell, *supra* note 4, at 2.

Defining Manufacturing

The Virginia Code did not define "manufacturing" under § 58.1-1101,⁴³ but over the years Virginia case law established the essential elements of what constitutes "manufacturing."⁴⁴ Businesses included as manufacturers under Virginia law are those (1) transforming livestock into different meat products;⁴⁵ (2) curing hams and bacon and making sausage;⁴⁶ and (3) producing and selling personal computers, file servers, and computer parts.⁴⁷ Businesses not qualifying as manufacturers include those (1) pasteurizing milk and producing buttermilk;⁴⁸ (2) killing and plucking chickens;⁴⁹ and (3) blending rock and gravel.⁵⁰ As the Virginia Code indicates, classification as a manufacturer is important not just for intangible personal property tax exemptions,⁵¹ but also for exemptions relating to the Business, Professional, Occupational and License (BPOL) tax,⁵² sales and use tax⁵³ and

43. See Michael Long, Notes on Manufacturers' Claims 2 (Aug. 9, 1998) (on file with author). As Long indicates, the Virginia Code provides definitions of the terms "manufacturing, processing, refining, or conversion," but these definitions are limited to applications of the retail sales and use tax. *Id.* at 2 n.2 (citing VA. CODE ANN. § 58.1-602); see also 1996 Op. Va. Att'y Gen. 212, 213 n.2 (noting that the definition of manufacturing in § 58.1-602 is controlling in determining exemptions from local taxation); 1983-1984 Op. Va. Att'y Gen. 372, 372 (noting that the definition of "manufacturing" in § 58-441.3(1) of the Virginia Retail Sales and Use Tax is not controlling for local license tax purposes).

44. See *Prentice v. City of Richmond*, 90 S.E.2d 839, 843 (Va. 1956) (holding that a city business license tax could be imposed on a business that cleaned and dismembered chickens because the business was not a manufacturer). The *Prentice* court found that manufacturing had three essential elements: "(1) original material referred to as raw material; (2) a process whereby the raw material is changed; and (3) a resulting product which, by reason of being subjected to the processing, is different from the original raw material." *Id.*

45. See *Morris & Co. v. Commonwealth*, 83 S.E. 408, 409 (Va. 1914).

46. See *Commonwealth v. Meyer*, 23 S.E.2d 353, 353 (Va. 1942).

47. See *Fairfax County v. DataComp Corp.*, 36 Va. Cir. 60 (1995).

48. See *Richmond v. Dairy Co.*, 157 S.E. 728, 728 (Va. 1931).

49. See *Prentice*, 90 S.E.2d at 843-44.

50. See *Solite Corp. v. County of King George*, 261 S.E.2d 535, 535 (Va. 1980).

51. See VA. CODE ANN. § 58.1-1101 (Michie 1997 & Supp. 1999).

52. See *id.* § 58.1-3703(c)(4) (Michie 1997) (stating that "[n]o county, city or town shall impose a license fee or levy any license tax . . . [o]n a manufacturer for the privilege of manufacturing and selling goods, wares and merchandise at wholesale at the place of manufacture . . .").

53. See *id.* § 58.1-609.3(2) (stating that property directly used in manufacturing or

tax credits.⁵⁴ As a result, an important aspect of *American Woodmark* involves the court's analysis of who qualifies as a manufacturer.

Over the years, the relevant question in defining manufacturing for tax purposes changed from "what is manufacturing?"⁵⁵ to "who is a manufacturer?"⁵⁶ *American Woodmark* adds another layer to this analysis by holding that the exact location where the manufacturing occurs does not matter.⁵⁷ In its arguments before the Virginia Supreme Court, the City of Winchester attempted to limit the definition of manufacturer to a business that carries on actual manufacturing operations within the taxing locality.⁵⁸ The City argued that American Woodmark, despite its extensive manufacturing operations throughout the country, should not be classified as a manufacturer because it did not conduct any manufacturing within the City.⁵⁹

The court's *American Woodmark* holding essentially means that location is irrelevant in determining whether the branch of a business is a manufacturer. The components of the business are taxable under the rules applicable to manufacturers generally, no matter where the components, including the manufacturing plant, are located.⁶⁰ The court rejected the City's argument that

processing is not subject to sales and use tax).

54. See *id.* § 58.1-439(c)(2) (indicating that tax credits are available for facilities in qualifying industries, including manufacturing).

55. See *Solite Corp.*, 261 S.E.2d at 536 (stating that manufacturing must "transform[] the new material into an article or a product of substantially different character, . . . [even if] the processing increases the value or usefulness of the product").

56. See *County of Chesterfield v. BBC Brown Boveri, Inc.*, 380 S.E.2d 890 (Va. 1989). Brown Boveri repaired used turbine generators used by electric power companies. See *id.* at 891. The Virginia Supreme Court held that even though Brown Boveri was engaged in both manufacturing and nonmanufacturing activities, it would "be classified as a manufacturer for tax purposes if the manufacturing portion of its business [was] substantial" in comparison to its total activities. *Id.* at 893 (citation omitted). The court held that in order to be considered "substantial" the manufacturing component of a business must not be "*de minimis*, merely trivial, or only incidental to its principal business." *Id.* at 893-94.

57. See *Slaughter*, *supra* note 7.

58. See *City of Winchester v. American Woodmark Corp.*, 464 S.E.2d 148, 151 (Va. 1995).

59. See *id.*

60. See *Slaughter*, *supra* note 7.

the manufacturer's capital, which is personal property, tangible in fact, must be used "directly" in the manufacturing process.⁶¹ Even though no manufacturing activity occurred at the company's corporate headquarters, equipment used at this site for issuing payroll checks, paying bills, and processing credit applications was still considered "used in manufacturing" under the Virginia Code.⁶²

Defining Machinery and Tools

Under Virginia Code § 58.1-1101(A)(2), machinery and tools are not treated as intangible personal property and, therefore, are subject to local tax.⁶³ In *American Woodmark*, the court for the first time defined "machinery and tools" for Virginia tax purposes,⁶⁴ holding that only equipment used *directly* in the manufacturing process fell under this definition.⁶⁵ The City of Winchester argued that even if the company's office and computer equipment was "used in manufacturing," this equipment should be classified as machinery and tools under the Virginia Code and therefore should be subject to local tax.⁶⁶ The court disagreed with this argument, and cited with approval the definition used for decades by the Virginia State Tax Commissioner and the Virginia Attorney General: "'[M]achinery and tools used in a particular manufacturing business' are the machinery and tools which are necessary in the particular manufacturing business and which are used in connection with the operation of machinery which is *actually and directly* used in the manufacturing process.'" ⁶⁷

61. See *American Woodmark*, 464 S.E.2d at 151.

62. See VA. CODE ANN. § 58.1-1101(A)(2) (Michie 1997 & Supp. 1999); *American Woodmark*, 464 S.E.2d at 151; *supra* notes 36-38 and accompanying text.

63. See VA. CODE ANN. § 58.1-1101(A)(2); *supra* note 38 (containing the text of this section).

64. See Long, *supra* note 43, at 4-5 (stating that although the Virginia Code has not defined "machinery and tools," the *American Woodmark* court adopted the Attorney General's interpretation of the phrase in 1995).

65. See *American Woodmark*, 464 S.E.2d at 153.

66. See *id.* at 152.

67. *Id.* (quoting 1985-86 Op. Va. Att'y Gen. 316, 317 (quoting Letter from C.H. Morrisett, former State Tax Commissioner, to the Honorable Fred G. Pollard (June

Using this test, the court found that American Woodmark's furniture, office equipment, and computer equipment were not "machinery and tools"⁶⁸ within § 58.1-1101(A)(2) because these items were not "used in connection with the operation of machinery which is actually and directly used in the manufacturing process."⁶⁹ The court bolstered its opinion by noting that the General Assembly failed to change the Attorney General's opinion regarding the definition of machinery and tools, arguing that this failure amounted to "legislative acquiescence"⁷⁰ to the Attorney General's opinion.

One criticism of this holding is that it relies unnecessarily on a narrow definition of what constitutes "machinery and tools." Though the Tax Department *has* construed narrowly the machinery and tools definition to limit the manufacturing equipment taxable by localities,⁷¹ one reason for its narrow construction is that historically, manufacturing property that was not taxed locally as machinery and tools was taxed by the state as capital.⁷² This may help explain the Attorney General's narrow reading of "machinery and tools" as only that equipment used "directly in" the manufacturing process.⁷³ Prior to 1985, property that was not taxed on the local level could be taxed by the state.⁷⁴ Because the state currently does not tax capital or other intangible personal property,⁷⁵ however, this narrow interpretation may go too far in eliminating manufacturing property from the local government tax base. In addition, the enabling statute also allows for a broader reading, permitting local taxation of all machinery and tools "... used in a manufacturing ... business" under § 58.1-3507 or "of such [manufacturing] businesses ..." under § 58.1-1101(A)(2).⁷⁶ Contrary to the court's holding in

27, 1950))) (alteration in original) (emphasis added).

68. See *American Woodmark*, 464 S.E.2d at 153.

69. *Id.*

70. *Id.*

71. See Crawford, *supra* note 8, at 4.

72. See *id.*

73. *Id.*

74. See *id.*

75. See *supra* note 24 and accompanying text (stating that Virginia has discontinued the state tax on intangible personal property).

76. Crawford, *supra* note 8, at 4; VA. CODE ANN. §§ 58.1-3507, -1101(A)(2) (Michie

American Woodmark, "machinery and tools" used in manufacturing could easily include equipment that is not used "directly" in manufacturing.

A Tax Exception, Not a Tax Exemption

In *American Woodmark*, the Virginia Supreme Court also held that Code sections 58.1-1100 and 58.1-1101(A)(2) are not tax exemptions, but rather tax exceptions.⁷⁷ According to the court, these exceptions simply classify certain personal property, tangible in fact, as intangible personal property and segregate that property for state taxation.⁷⁸ This distinction is important because tax exemptions and tax exceptions involve different rules of statutory construction under Virginia law.⁷⁹ In most cases, when a taxpayer claims an *exemption* from a tax, the exemption is construed against the taxpayer and in favor of the taxing authority.⁸⁰ In *American Woodmark*, however, the court found that the intangible property tax under § 58.1-1101 was simply a general tax statute, not an exemption from a tax. The court stated "statutes imposing taxes are to be construed most strongly against the government, and in favor of the citizen, and are not to be extended by implication beyond the clear import of the language used. Whenever there is a just doubt, 'that doubt should absolve the taxpayer from his burden.'"⁸¹ As a result, the court found that the statute should be construed in favor of *American Woodmark* and against the City.⁸²

1997 & Supp. 1999).

77. See *City of Winchester v. American Woodmark Corp.*, 464 S.E.2d 148, 151 (Va. 1995).

78. See *id.* at 151-52.

79. See Bell, *supra* note 22, at 1593.

80. See VA. CONST. art. X, § 6(f); see also *Carr v. Forst*, 453 S.E.2d 274 (Va. 1995) (holding that the burden was on the taxpayer to prove that the ruling was contrary to law or that the commissioner abused his discretion and acted unreasonably); *Roberts v. Board of Supervisors*, 453 S.E.2d 258 (Va. 1995) (holding that the burden was on the taxpayer to show that he comes within the terms of the exemption).

81. *American Woodmark*, 464 S.E.2d at 152 (quoting *Commonwealth Natural Resources, Inc. v. Commonwealth*, 248 S.E.2d 791, 796 (Va. 1978)).

82. See *id.*

INTANGIBLE PERSONAL PROPERTY TAXES ON MANUFACTURING EQUIPMENT IN OTHER STATES

American Woodmark extends the benefits of Virginia's personal property tax exemption far beyond the factory gate,⁸³ and highlights the potentially broad scope of tax relief available for manufacturers. Like Virginia, many states struggle with the appropriate method for taxing the intangible property of businesses. For example, while Texas taxes both tangible and intangible property,⁸⁴ a number of states do not allow intangible property to be taxed at all.⁸⁵ In West Virginia, the 1997 legislature introduced legislation to implement a constitutional exemption for intangible personal property.⁸⁶ The law provides for a five-year phase-out beginning in the property tax year 1998.⁸⁷ Similarly, in North Carolina, the 1997 General Assembly approved Session Law 1997-23, exempting most business intangible personal property from the *ad valorem* local property tax base.⁸⁸ In Georgia, House Resolution 734 amended the state constitution to provide that intangible personal property may be a separate class of property for purposes of taxation and authorized the repeal of any intangible personal property tax by general law without approval in a referendum.⁸⁹

While most states do provide some sort of tax incentive for businesses,⁹⁰ Virginia appears to be the only state with the con-

83. See Slaughter, *supra* note 7.

84. See TEX. CONST. art. VIII, § 1(b), (c).

85. See, e.g., MICH. CONST. art. IX, § 3 (providing for *ad valorem* taxation of only real and tangible property); MO. CONST. art. X, § 6 (proclaiming intangible property exempt from taxation); N.M. CONST. art. VIII, § 1 (levying a property tax only on tangible property).

86. See Charles O. Lorensen, *Lawmakers Vote to Phase Out Intangibles Tax*, 12 STATE TAX NOTES 1378, 1378 (1997), available in LEXIS, Sttax Library, Stnmag File. A 1984 amendment to the West Virginia Constitution exempted intangible personal property, but "[t]he effectiveness of the constitutional amendment was tied to the implementation of a reappraisal program that was not directly implemented by the Legislature." *Id.*

87. See *id.*

88. See Jack Cummings, Jr., *Governor Signs Bill to Exempt Business Intangibles*, 12 STATE TAX NOTES 1365, 1365-66 (1997) (describing the enactment of North Carolina House Bill 295), available in LEXIS, Sttax Library, Stnmag File.

89. See Georgia HR 734, *As Signed by Governor, Relates to Intangible Personal Property*, 96 STATE TAX NOTES, at *1, available in WESTLAW, 96 Stn 96-17.

90. See, e.g., Chris Micheli, *A 50-State Comparison of Tax Incentives for Manufac-*

volved system of defining certain tangible property as intangible to avoid taxing business equipment. Although this makes direct statutory state-to-state comparisons difficult, underlying most state statutes are general policies regarding how far to extend exemptions for manufacturers.⁹¹ For example, in the category of sales and use tax, the rationale behind manufacturing exemptions divides easily into two main schools of thought: (1) the Ohio-Georgia rule, or physical change theory, and (2) the integrated plant theory.⁹² Even though these two categories have not been applied directly to Virginia's manufacturing tax statutes, they provide useful insight into how different states approach their own manufacturing exemptions.

Both the Ohio-Georgia rule and the integrated plant theory are aimed at determining whether manufacturing machinery and equipment is "used directly" in the manufacturing process.⁹³ Whereas the Ohio-Georgia rule restrictively construes the exemption provisions and has its origin in administrative agency rulings,⁹⁴ "integrated plant theory is a doctrine of judicial origin."⁹⁵ As such, the two theories approach the question of what is "used directly" in manufacturing from fairly different perspectives.

The Ohio-Georgia rule helps to "fulfill a revenue agency's function of raising tax revenues."⁹⁶ This is accomplished under the Ohio-Georgia rule by limiting the tax exemption to "machin-

turing Equipment Purchases, 12 STATE TAX NOTES 1739, 1739-43 (1997), available in LEXIS, Sttax Library, Stnmag File. Thirty-four states provide a full sales/use tax exemption, seven states provide a partial sales/use tax exemption, nineteen states provide an income or excise tax credit, five states do not levy a sales or use tax, four states do not levy a corporate income or franchise tax, and three states do not provide any tax incentives. *See id.*

91. *See generally* Douglas A. Hager, *Kansas' Sales and Use Tax Law: Exemptions for Manufacturing Machinery and Equipment and the Integrated Plant Theory*, 37 WASHBURN L.J. 543, 561 (1998) (detailing the three typical inquiries involved in applying an exemption: (1) whether the operations classify as "manufacturing"; (2) whether tangible personal property classifies as "machinery and equipment" under state law; and (3) whether the machinery and equipment are "used directly" in manufacturing).

92. *See id.*

93. *Id.* at 562.

94. *See id.* at 563.

95. *Id.*

96. *Id.* at 562.

ery and equipment which perform a function involving a change of the raw material involved into the finished product and excludes machinery and equipment used in preparation for manufacturing or after completion of the manufacturing process."⁹⁷ The items excluded under this rule, "machinery used before the . . . [manufacturing] process begins or after it ends," are not considered to be used directly in manufacturing.⁹⁸ Jurisdictions that follow the restrictive view of the Ohio-Georgia rule appear to focus their conclusions on "the strict rule of construction applicable to exemptions, and on applicable statutory or regulatory provisions delineating when manufacturing begins and ends."⁹⁹

In contrast, "[u]nder the integrated plant theory, machinery and equipment are exempt if they perform an essential or indispensable function in the taxpayer's manufacturing operations, irrespective of whether they actually cause a physical change in raw materials."¹⁰⁰ The rule "excludes machinery involved in incidental activities such as managerial and administrative functions, and repair or maintenance activities."¹⁰¹ Whereas the Ohio-Georgia rule is favored generally by state revenue agencies,¹⁰² state judicial branches have expressed their views that exemptions dealing with manufacturing "should not be construed in an impractical or overly restrictive fashion"¹⁰³ by relying on integrated plant theory in their decisions.¹⁰⁴

The Virginia Supreme Court's holding in *American Woodmark* does not fit neatly into either of these categories. First, while the Ohio-Georgia rule is based on the strict rule of construction

97. *Id.* (quoting *Floyd Charcoal Co. v. Director of Revenue*, 599 S.W.2d 173, 176 (Mo. 1980)).

98. *Id.*

99. *Id.* at 563.

100. *Id.* at 566 (quoting JORDAN M. GOODMAN ET AL., TAX MANAGEMENT PORTFOLIO, SALES AND USE TAXES: THE MACHINERY AND EQUIPMENT EXEMPTION 1330.0008 (1997)); see also *Niagara Power Corp. v. Wanamaker*, 144 N.Y.S.2d 458, 462 (N.Y. App. Div. 1995) (stating that the words "directly and exclusively" should not be construed to require the division into theoretically distinct stages of what is in fact continuous and indivisible." (citation omitted)).

101. Hager, *supra* note 91, at 566-67.

102. See *id.* at 568.

103. *Id.* at 567.

104. See *id.*

applicable to tax exemptions,¹⁰⁵ the court in *American Woodmark* specifically rejected this argument,¹⁰⁶ classifying Virginia's manufacturing tax as an exception rather than an exemption. Second, the computers, furniture, and office equipment in American Woodmark's headquarters would not meet the Ohio-Georgia rule test, which excludes machinery and equipment used in preparation for manufacturing or after the completion of the manufacturing process.¹⁰⁷ According to the Virginia Supreme Court, however, this equipment was indeed "used in manufacturing" under the Virginia statute.¹⁰⁸

American Woodmark defies categorization under the integrated plant theory as well, because the rule specifically excludes machinery involved in managerial and administrative functions.¹⁰⁹ The furniture, office equipment, and computer equipment in question in *American Woodmark* certainly fall into this category. The court nevertheless found that it was "used in manufacturing" under Virginia law.¹¹⁰

Because the *American Woodmark* decision does not adhere to either of these theoretical constraints, it is helpful to examine how other states handle their manufacturing tax exemptions. For example, some states take a narrower view of manufacturing exemptions than Virginia. Vermont adopted a regulation interpreting a sales and use tax exemption for fuel used in manufacturing.¹¹¹ The regulation carves out administration, sales, retail operations, and parking as activities that are not direct or indirect uses in manufacturing.¹¹² If the taxpayer engages in these activities in addition to exempt activities, the regulation requires him to determine "by any reasonable means" the

105. See *id.* at 562-63.

106. See *supra* notes 77-82 and accompanying text.

107. See *supra* notes 96-98 and accompanying text.

108. See *American Woodmark v. City of Winchester*, 464 S.E.2d 148, 152 (Va. 1995); *supra* notes 58-62 and accompanying text.

109. See *supra* notes 100-01 and accompanying text.

110. See *American Woodmark*, 464 S.E.2d at 152; *supra* note 62 and accompanying text.

111. See Manufacturing Energy Regulation, Reg. 19741(34)-1 (Vt. Dep't of Taxes (1995)) (visited Jan. 14, 2000) <<http://www.state.vt.us/tax/regs.htm>>.

112. See *id.* at Reg. 19741(34)-3.

amount exempt from tax.¹¹³ Idaho recently expanded its personal property tax exemption for intangible property to include, for example, goodwill, patents, custom computer programs, franchises, and licenses.¹¹⁴ Before the bill passed, however, the legislature amended it to "tighten the language by removing general references to 'other intangible personal property' in describing property exempt from the . . . tax."¹¹⁵ The estimated value of property that would be exempted from the tax is about \$250 million,¹¹⁶ and the loss in tax revenue is expected to cause a slight increase in tax rates in Idaho.¹¹⁷

On the other hand, much like Virginia, other states appear to be broadening their manufacturing exemptions. For example, in 1997, the Colorado Department of Revenue approved new regulations to clarify its sales and use tax on machinery.¹¹⁸ Under the new rules, purchases of machinery or machine tools are exempt from state sales tax if they are "to be used in Colorado directly and predominantly in manufacturing tangible or personal property."¹¹⁹ The old law required the machinery be used "exclusively" in manufacturing; the addition of the term "predominantly" expands the prior law.¹²⁰

Similarly, the Texas Court of Appeals rejected an attempt to narrow the sales and use tax exemption for equipment in manufacturing.¹²¹ The Texas Comptroller of Public Accounts found

113. *Id.* at Reg. 19741(34)-4.

114. See John McGown, *Bill Would Exempt More Intangible Personal Property from Tax*, 14 STATE TAX NOTES 868 (1998). Idaho had previously exempted such intangibles as "capital stock, bonds, and deposits in national banks, state banks, and savings and loan associations." *Id.*

115. John McGown, *Governor Signs Bill Broadening Intangibles Tax Exemption*, 14 STATE TAX NOTES 1139 (1998).

116. See McGown, *supra* note 114, at 868.

117. See *id.*

118. See Robert A. Wherry, Jr., *State Adopts Sales and Use Tax Regs on Machinery Exemption*, 12 STATE TAX NOTES 1283 (1997).

119. *Id.*; see also COLO. REV. STAT. § 39-26-114(11) (1998) (exempting purchases of machinery or machine tools by a person engaged in manufacturing to be used in manufacturing tangible personal property).

120. Wherry, *supra* note 118, at 1283 (noting that "the term 'predominantly,' as used in the regulations, is defined . . . [as] more than 50% of any use").

121. Michael W. McLoughlin, *Comptroller's Policy Held to Contradict Legislative Intent*, 10 STATE TAX NOTES 1159 (1996).

that the mold-making equipment of a pipe manufacturer did not qualify for the exemption because the equipment did not come into direct contact with the finished, manufactured product.¹²² The court of appeals rejected this limit, holding that a strict statutory interpretation conflicted with legislative intent in enacting the statute.¹²³

Finally, the Illinois Appellate Court recently held that equipment involved in the transporting of goods from one manufacturing plant to another qualifies for the manufacturing and equipment exemption under Illinois law.¹²⁴ In *Zenith Elec. Corp. v. Illinois Dep't of Revenue*,¹²⁵ the court found that trays used to protect cathode ray tubes used in televisions and computer monitors were exempt even though identical goods were sold to third parties as finished goods,¹²⁶ and therefore would not be exempt.

Other states have interpreted the exemption more broadly. In the case of a clothing wholesaler that used independent contractors in the manufacturing process, the Texas Comptroller permitted the wholesaler to invoke the exemption even though third parties performed the actual manufacturing.¹²⁷

Although the *American Woodmark* decision is not easily categorized by either of the theoretical rationales for providing manufacturing tax exemptions, on a more practical level, Virginia, like many other states, seems willing to enlarge the tax breaks offered to manufacturing businesses. By expanding the types of manufacturing property included as intangible personal property, while excluding machinery and tools of a manufacturing business from the same definition, the Virginia Supreme Court has greatly narrowed the business property taxable by cities and

122. See *id.* at 1159.

123. See *id.* at 1159-60 (noting that "the statute was enacted to (1) encourage economic development in the state, (2) to avoid pyramiding of the sales tax, and (3) to strike a balance between avoiding multiple taxation and the need to raise revenue").

124. See Garland Allen et al., *Appeals Court: CRT Trays Fall Under Manufacturing Exemption*, 13 STATE TAX NOTES 1463 (1997).

125. 688 N.E.2d 747 (Ill. App. Ct. 1997).

126. See *id.*; Allen et al., *supra* note 124, at 1463.

127. See Cynthia M. Ohlenforst et al., *Taxation*, 51 SMU L. REV. 1345, 1350 (1998) (citing Tex. Comp. Pub. Acc'ts, Hearing No. 35,448, 1997 Tex. Tax LEXIS 84, at *8 (Jan. 30, 1997)).

counties. Though the repercussions of this trend are undoubtedly favorable for Virginia business,¹²⁸ they may bear some response from Virginia local government.

REPERCUSSIONS OF *AMERICAN WOODMARK*

Virginia businesses are undoubtedly aware of the broad potential for tax relief resulting from the *American Woodmark* decision and continue to push for further expansion of the statutory language on the circuit court level. For example, Coca-Cola recently filed suit in the Circuit Court for the City of Clifton Forge, Virginia, claiming that equipment used in the retail and distribution functions of its manufacturing business could be excluded from property tax after *American Woodmark*.¹²⁹ In yet another counterintuitive decision, the court held that the vending machines and advertising scoreboards used by Coca-Cola were not subject to local property tax under the manufacturer's exemption.¹³⁰

The circuit court ruled that Coca-Cola, although engaged in both manufacturing and retail sales, was a manufacturing business for purposes of the Virginia Code.¹³¹ Encouraged by this

128. *But see* Laura Ellen Johnson, Note, *Spurring Economic Development in Kansas Through Property Tax Exemptions—Are We Getting the Results We Want?*, 30 WASHBURN L.J. 82 (1990) (criticizing the ability of a manufacturing inventory tax exemption in Kansas to spur economic development).

129. *See* A.W. Hauslohner, *Coke Machine Tax Revolt Underway*, ROANOKE TIMES & WORLD NEWS, Jan. 9, 1998, at A1, available in LEXIS, News Library.

130. *See id.* This holding, however, is contrary to decisions in other states that have considered the taxation of vending machines. *See, e.g.,* Associated Beverage Co. v. Board of Equalization, 273 Cal. Rptr. 639, 648 (1990) (stating that the soft drink bottler was a "distributor" of the product for purposes of the statute imposing sales tax at retail rate); *Macke Co. v. State Dep't of Assessments & Taxation*, 285 A.2d 593, 599 (Md. 1972) (explaining that hot and cold vending machines did not fall within the manufacturing equipment exemption provisions of the tax statute because "the average man would not think of vending machine operation as manufacturing").

131. *See* Hauslohner, *supra* note 129, at A1. *But see* Poindexter, *supra* note 5, at B1 (describing a similar case involving Coca-Cola in Botetout County in which the judge ruled that vending machines are not part of the manufacturing process). According to the judge in this case:

we may infer that selling a Coca-Cola from a vending machine aids the principal operation of manufacturing the product, . . . since, again, the product has no commercial meaning if it is not sold and consumed. Thus the machines may in fact be "used in" the manufacturing process.

decision, other manufacturers filed requests for tax refunds with Virginia local government in hopes of cementing expansion of the exemption.¹³² Not surprisingly, local governments are trying to fight the effects of the Clifton Forge holding in an attempt to fend off further erosion of the local tax base.¹³³

The *American Woodmark* decision also raises the question of whether the manufacturer's exemption can be extended to equipment leased, as opposed to owned, by a manufacturing business.¹³⁴ This may provide Virginia businesses another avenue by which to extend *American Woodmark*. For example, in *City of Martinsville v. Tultex Corp.*,¹³⁵ the Virginia Supreme Court held that personal property leased to and used in a manufacturing business is classified as intangible personal property segregated for state taxation only, despite the fact that the property actually was owned by a nonmanufacturer.¹³⁶ Thus, leased equipment used by a manufacturing business may not be subject to local personal property tax, regardless of the status of the actual title holder.¹³⁷

Virginia consumers also have a reason to be concerned about *American Woodmark*. As legislative and judicial constraints relieve Virginia businesses of an increasing amount of the state's tax burden, consumers may end up carrying more of this burden.¹³⁸ For example, as personal property tax exemptions for

On the other hand, the retailing of the product may be a separate trade or business carried on by the Petitioner whose left hand, so to speak, is engaged in brewing and bottling Coca-Cola and whose right hand is engaged in marketing and retailing the product as a separate activity.

Letter from Judge George E. Honts, III, Botetourt County Circuit Court, to D. French Slaughter, III, McGuire Woods Battle & Boothe and William L. Heartwell, III, 3-4 (July 16, 1998) (on file with author).

132. See, e.g., *supra* notes 4-7 and accompanying text.

133. See, e.g., Poindexter, *supra* note 5, at B1.

134. See, e.g., VA. CODE ANN. § 58.1-1101(A)(2) (Michie 1997 & Supp. 1999) (referring to property "used in manufacturing," not property owned by a manufacturing business); see also Slaughter, *supra* note 7, at 15 (identifying the same question).

135. 381 S.E.2d 6 (Va. 1989).

136. See *id.* at 8.

137. See *id.*

138. See, e.g., Johnson, *supra* note 128, at 82 ("Individuals, organizations, and businesses that have property remaining on the tax rolls bear a greater burden of supporting the needs of local and state governments when other properties are exempt-

businesses expand, Virginia cities and counties stand to lose millions of dollars in tax revenue.¹³⁹ On the state level, Virginia Governor Jim Gilmore proposed to phase-out the individual personal property tax on items like cars, boats, and motor homes, causing some members of the Virginia legislature to claim they will be forced to raise other taxes to offset the lost revenue.¹⁴⁰ This situation parallels the tax trade-off faced by other states. For example, Milwaukee recently proposed exempting computer equipment of businesses from personal property tax, a move estimated to remove about \$346 million from the city's property tax rolls.¹⁴¹ While business leaders argued that the exemption was necessary to spur economic development, critics countered that the move was "nothing more than property tax shifting."¹⁴² Because businesses generally are more influential lobbyists than are consumers, it is reasonable to assume that Virginia consumers may well bear some of the burden of a subtly expanding manufacturing tax exemption, despite state-level efforts to reduce personal property taxes for individuals.¹⁴³

LEGISLATIVE INTENT AND THE COUNTERINTUITIVE RESULTS OF *AMERICAN WOODMARK*

As the foregoing discussion indicates, the *American Woodmark* decision has the potential to cause significant expansion of Virginia's property tax exemption for manufacturers.¹⁴⁴ Although

ed.").

139. See Long, *supra* note 43, at 1; see also *supra* note 7 (describing the breakdown of federal, state, and local revenue collected by Virginia cities and counties).

140. See Mark Yost, *Gilmore's Plans for Virginia Are Tall Order*, WALL ST. J., Dec. 5, 1997, at A12.

141. See Avrum D. Lank, *Bill Would Kill Tax on Computers: Exemption for Businesses Could Force 2.4% Property Tax Increase in Milwaukee*, MILWAUKEE J. SENTINEL, July 15, 1997, at 1, available in LEXIS, News Library.

142. *Id.* The change was estimated to increase Milwaukee's property tax rate by about 2.4%. See *id.*

143. See STATE AND LOCAL GOV'T RESP. AND TAXING AUTH. COMM'N, FINAL REPORT, H. Doc. No. 88, Regular Sess. 8 (Va. 1998). According to the Virginia Municipal League (VML) and the Virginia Association of Counties (VACo), the estimated annual cost of a \$20,000 exemption on personal vehicles would be more than \$1.3 billion in 2003 when the plan is fully implemented. See *id.* Both VML and VACo expressed concerns about the state consistently funding such an amount. See *id.*

144. See *supra* notes 36, 40-42, 60-62 and accompanying text.

the Virginia legislature signaled its approval of *American Woodmark* by amending Virginia Code § 58.1-1101(A)(2) to codify the court's holding,¹⁴⁵ in the end the resulting tax loophole may be much greater than Virginia lawmakers intended. For example, one goal of the manufacturing exemption is to encourage manufacturing businesses to locate or expand their operations in Virginia.¹⁴⁶ As noted above, however, the practical effect of *American Woodmark* is to exempt all tangible personal property used in a manufacturing business *except* the machinery and tools actually used in the manufacturing process.¹⁴⁷ This holding "discourages the location of labor intensive (job creating) manufacturing operations in Virginia, while giving a major tax exemption to the non-revenue producing labor-conserving aspects of a manufacturing business such as warehousing and administrative operations."¹⁴⁸ In this respect, both the court and the legislature have approved a counterintuitive manufacturing tax break that exceeds the original intent behind the exemption.

Recommendations

In the tax arena, local government has been hurt by recent decisions in *Brown Boveri Inc.*,¹⁴⁹ *American Woodmark*,¹⁵⁰ and *Coca-Cola Bottling Co.*¹⁵¹ If businesses continue to win expansions to Virginia's manufacturing exemption, even at the circuit court level, local governments will have a difficult time trying to

145. See *supra* notes 37-39 and accompanying text.

146. See Crawford, *supra* note 8, at 1; see also *American Woodmark Corp. v. City of Winchester*, 34 Va. Cir. 421, 434 (1994), *aff'd in part, rev'd in part*, 464 S.E.2d 148 (Va. 1995) ("The term manufacturing is to be construed liberally because 'the public policy of Virginia is to encourage manufacturing in the Commonwealth.'" (citing *County of Chesterfield v. BBC Brown Boveri, Inc.*, 380 S.E.2d 890, 893 (Va. 1989))).

147. See Crawford, *supra* note 8, at 1.

148. *Id.*

149. See *supra* note 56 and accompanying text (discussing the *Brown Boveri* holding that a business could be classified as a manufacturer even if it engaged in both manufacturing and nonmanufacturing activities).

150. See *supra* notes 4-7 and accompanying text (listing some of the cities and counties in Virginia who have requested tax refunds and discussing the dollar amounts at stake in refund challenges).

151. See *supra* notes 129-33 and accompanying text (describing how businesses are attempting to cement the *American Woodmark* holding on the circuit court level).

narrow the exemption when these cases reach the Virginia Supreme Court. The following approaches should help counties and cities defend against these challenges at the circuit court level.

The first applicable defense for local governments is to argue that the business in question is not a manufacturer.¹⁵² In *Prentice v. City of Richmond*,¹⁵³ the Virginia Supreme Court laid out the test for what constitutes manufacturing.¹⁵⁴ The court stated, "[m]anufacture implies a change, but every change is not manufacture, and yet every change in an article is the result of treatment, labor, and manipulation. But something more is necessary There must be transformation; a new and different article must emerge, 'having a distinctive name, character or use.'"¹⁵⁵ Although Virginia precedent does not establish a bright-line rule describing exactly what type of business qualifies as a manufacturer,¹⁵⁶ a challenge to manufacturing status may be relevant whenever the process can be characterized as mixing, blending, or processing.¹⁵⁷ Although this approach will not be relevant in every case, local governments should not overlook this argument as a first step in relevant tax refund challenges.

In a related approach, it is essential that the locality find out as much as possible about the original material that is being used by the petitioner in the manufacturing process during pre-trial discovery.¹⁵⁸ "The evidence in these cases is almost totally within the Petitioner's control,"¹⁵⁹ and "[t]he locality must be aggressive at the discovery stage if the evidence at trial is to be

152. See Heartwell, *supra* note 4, at 3.

153. 90 S.E.2d 839 (Va. 1956).

154. See *id.* at 842.

155. *Id.* (quoting *City of Richmond v. Richmond Dairy Co.*, 157 S.E. 728 (Va. 1931) (quoting *Anheuser-Busch Ass'n v. United States*, 207 U.S. 556, 562 (1907))).

156. See *supra* notes 44-50 and accompanying text (describing businesses classified as manufacturers under Virginia law).

157. See *Commonwealth v. Orange-Madison Coop. Farm Serv.*, 261 S.E.2d 532, 534 (Va. 1980).

158. See Heartwell, *supra* note 4, at 8.

159. *Id.*; see also Letter from Judge George E. Honts, III to D. French Slaughter, III, *supra* note 131, at 1-2 (denying summary judgment in *Coca-Cola Bottling Co. v. County of Botetourt* and stating "[i]t appears from the argument of both counsel that the Petitioner receives a mysterious blend of ingredients, the composition of which or the recipe for which is one of the most jealously and zealously guarded secrets known to man . . .").

fairly tested.”¹⁶⁰ Another possible strategy is for local government to argue that manufacturing and retail operations should be considered as a separate line of business.¹⁶¹ Although the trial court in *American Woodmark* found that the Commissioner of Revenue cannot “vivisection” a business into its component parts,¹⁶² the Virginia Supreme Court did not address this argument in its decision.¹⁶³ However, Virginia Code § 58.1-5 states “[w]hen any person, firm or corporation is engaged in more than one business which is made by law subject to taxation, such person, firm or corporation shall pay the tax provided by law on each branch of his, their or its business.”¹⁶⁴ Similarly, under *Caffee v. City of Portsmouth*,¹⁶⁵ the Virginia Supreme Court held that a manufacturer’s use of equipment in distribution and retail sales made that property subject to local tax.¹⁶⁶ Although *Caffee* involved a Business, Professional, Occupational and License (BPOL) tax, in which retail and wholesale sales are treated differently, the case still may serve as effective precedent for the argument that the “separate business” distinction should carry over to the property tax exemption, as these two taxes have a number of similarities. For example, the Virginia Tax Department’s guidelines for the BPOL tax incorporated the three-element analysis used by the Virginia Supreme Court in *Prentice* to determine whether a business activity should be considered manufacturing.¹⁶⁷ Therefore, the manufacturing tests for both the property tax and the BPOL tax overlap.¹⁶⁸ Second, the Virginia General Assembly recently passed a major bill to reform the BPOL tax with the goal of administering this tax

160. Heartwell, *supra* note 4, at 8.

161. *See id.* at 9.

162. *See American Woodmark Corp. v. City of Winchester*, 34 Va. Cir. 421, 435 (1994), *aff’d in part, rev’d in part*, 464 S.E.2d 148 (Va. 1995).

163. *See City of Winchester v. American Woodmark Corp.*, 464 S.E.2d 148 (Va. 1995).

164. VA. CODE ANN. § 58.1-5 (Michie 1997).

165. 128 S.E.2d 421 (Va. 1962).

166. *See id.* at 424.

167. *See VIRGINIA DEPT’ OF TAXATION, REQUEST FOR AN ADVISORY OPINION—BUSINESS, PROFESSIONAL, AND OCCUPATIONAL LICENSE (BPOL) TAX 2-3* (Mar. 5, 1998).

168. *See supra* note 44 (describing the three-part test articulated by the court in *Prentice v. City of Richmond*).

uniformly throughout the Commonwealth.¹⁶⁹ This signals the legislature's intent to promote consistency among Virginia's various tax statutes, which could include eliminating discrepancies between the BPOL tax and the personal property tax exemption for manufacturers.

On the other hand, the separate line of business defense is weakened by *Brown Boveri*,¹⁷⁰ which found the nonmanufacturing activities of a business were "ancillary to its primary business [activity] of manufacturing" and therefore not subject to local tax.¹⁷¹ "Resolving the legal tension between section 58.1-5 and *Caffee* on the one hand, and *Brown Boveri* on the other, is the obvious key to the success of the separate lines of business defense."¹⁷²

Finally, Virginia cities and counties should consider legislative remedies to slow the expansion of the *American Woodmark* holding because the Virginia Code seems to contain opposing incentives in its sales tax and property tax provisions. For example, property that is "used directly" in manufacturing is exempt from sales tax,¹⁷³ but is taxable as machinery and tools for property tax purposes.¹⁷⁴ This creates an incentive for manufacturers to pursue the already broad property tax exclusion. Amending § 58.1 to read "equipment used directly in manufacturing" to match the current interpretation of the machinery and tools exemption would eliminate these inconsistent definitions in Virginia's sales and use tax and personal property tax provisions.

Changing the language of the statute is also an appropriate remedy to keep pace with technological change. In many states, statutes have not evolved with the advances in technology that have changed profoundly taxpayers' businesses, particularly in the areas of computers, software, and telecommunications dur-

169. See Bell, *supra* note 22, at 1603.

170. See *County of Chesterfield v. BBC Brown Boveri, Inc.*, 380 S.E.2d 890, 894 (Va. 1989); see also *supra* note 56 (discussing the court's distinction between manufacturing and nonmanufacturing activities).

171. *Brown Boveri*, 380 S.E.2d at 894.

172. Heartwell, *supra* note 4, at 8.

173. See VA. CODE ANN. § 58.1-609.3 (Michie 1997).

174. See *American Woodmark v. City of Winchester*, 464 S.E.2d 148, 151 (1995); *supra* notes 69-70 and accompanying text.

ing the last ten to twenty years.¹⁷⁵ As a result, "taxpayers and state auditors struggle with determining the taxability of a transaction by applying obsolete definitions which are forced to fit current business practices."¹⁷⁶ This can result in both opportunities and pitfalls in the taxation of intangibles,¹⁷⁷ and becomes increasingly important as Virginia attempts to draw more technology and computer companies into the state.¹⁷⁸

CONCLUSION

The *American Woodmark* case has important implications for the tax base of local government. If businesses are successful in their attempts to expand Virginia's manufacturing tax exemption, the financial impact on localities will be significant. Although the goal behind the tax incentive is to create a favorable environment for Virginia manufacturers, the current exemption benefits businesses already established in Virginia without any requirement that they create new jobs, expand, or otherwise promote economic development. In addition, it apparently gives manufacturers with a retail component a competitive advantage over those businesses that engage solely in retail. Further interpretations of the statute may extend the exemption to include equipment leased by manufacturing businesses and may have unintended consequences if Virginia consumers are forced to bear more of the state's tax burden. Even though expanding the manufacturing tax exemption undoubtedly benefits Virginia businesses, local government should take precautions to ensure that the state's long-term tax base is both balanced and equitable.

Stacey L. Wilson

175. See Virginia A. Gates, *Coming to Grips with the Taxation of High-Tech Intangibles*, 6 STATE TAX NOTES 1017 (1994).

176. *Id.*

177. See *id.*

178. See, e.g., Yost, *supra* note 140 (noting that parts of Virginia have become known as the "Silicon Crescent", home to companies such as White Oak Semiconductor, CyberCash, and Iridium World Communications, Ltd.).