Recent Tax Developments in Virginia: 2015-2016

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I. CORPORATE INCOME TAX

A. Legislation

1. Conformity. Virginia’s conformity date is advanced to December 31, 2015. The expiration date for conforming with enhancements to the federal earned income tax credit is repealed.

2. Port Tax Credits. The expiration of the international trade facility, barge and rail usage and Virginia port volume increase tax credits is extended to January 1, 2022.

3. Coal Tax Credits. The Governor vetoed HB 298 which would have amended Virginia Code §58.1-433.1 to extend and cap the coal tax credits claimed by electricity generators at $7.3 million per fiscal year.

4. R&D Tax Credit. Virginia Code §56-585.2 and 439:12:08 are amended to modify the existing R&D tax credit and establish a similar credit for businesses with such expenses in excess of $5 million for the year. The sunset date on the existing credit is extended to 2022 and the ceilings on the existing credit are increased to 15% of a base of $300,000 (20% if conducted with a Virginia college or university). The cap on total credits is increased to $7 million. Note: As of March 16, 2016, HB 884 bill had not been signed by the Governor.
5. **Single Sales Apportionment.** House Bill 966 providing for single sales factor apportionment and market based sourcing was continued in House Finance until 2017.

6. **Confidential Information.** Procedures for litigating state tax assessments are amended to provide confidentiality provisions with respect to taxpayer information that is protected by Virginia Code §58.1-3 and that is produced during discovery.

B. Cases

1. **Kohl's Department Stores v. Virginia Department of Taxation,** Record No. CL12001774-00 (Richmond City Cir. Ct., February 25, 2016). Taxpayer appealed the Department’s assessment holding royalties paid to out-of-state affiliate were not added back to taxable corporate income in Virginia based on Virginia Code §58.1-402(B) (8) (a)’s safe harbor. Taxpayer contended that the safe harbor’s “subject to” language required only that the royalty income be included in the calculation of the affiliate’s corporate income taxable in another state. Taxpayer argued that the royalty income need not actually be taxed by the other jurisdiction. The court disagreed and ruled that to qualify for the safe harbor, the other state must have actually imposed the income tax against royalty income. That matter is on appeal to the Supreme Court of Virginia.

PD 16-9 (February 25, 2016) is copy of the trial court opinion.

2. **Corporate Executive Board v. Virginia Department of Taxation,** Record No. CL13-3104, City of Arlington Cir. Ct., February 25, 2016). CEB, a multijurisdictional corporation, sold bundled products to customers, which they accessed mainly online. CEB’s offices, the majority of its employees, all costs of performance and its servers were in Virginia. CEB appealed the Department’s denial of its refund claim regarding the Department’s income apportionment based on CEB’s sales. CEB argued that the Statutory Method was unconstitutional and inequitable. It argued that a single-sales factor apportionment method with destination-based servicing in the sales factor was better calculated to assign its income (Zip Code Method). CEB wanted to eliminate from the calculation of its Virginia income any sales to customers with non-Virginia billing addresses. The court disagreed. The court ruled that the Statutory Method was not unconstitutional or inequitable. The court found that income captured under the Statutory Method was reasonably attributable to CEB’s instate activities. The Zip Code Method led to arbitrary results—customers could change their address and it bore no relationship to activity generating the income. Neither was there any double taxation attributable to Virginia’s apportionment method. Nor did the Tax Commissioner abuse his discretion or act arbitrary in applying the Statutory Method. The court observed that CEB’s argument was one for a
policy change, which was best aimed at General Assembly. That matter is on appeal to the Supreme Court of Virginia.

PD 16-8 (February 25, 2016) is copy of trial court opinion.

C. Policy Announcements

1. **2016 Tax Bulletin on Virginia Conformity.** PD 16-1 (February 5, 2016). The Bulletin addresses several important points regarding Virginia’s conformity with certain deductions and exclusions provided under the IRC. For instance, the federal Protecting Americans from Tax Hikes of 2015 extended the following federal tax provisions including but not limited to:

   - The above-the-line deduction for certain expenses of elementary and secondary school teachers;
   - The increased deduction for certain types of property pursuant to IRC § 179;
   - The deduction for mortgage insurance premiums;
   - The deduction for qualified tuition and related expenses;
   - The deduction for state and local sales tax;
   - The exclusion from gross income for individual retirement account (IRA) distributions for charitable purposes; and
   - The exclusion from gross income for the discharge of qualified principal residence indebtedness.

   Virginia, however, will continue to disallow any bonus depreciation allowed for certain assets under IRC § 168(k) or income tax exclusions related to cancellation of debt income realized in connection with a reacquisition of business debt at a discount after December 31, 2008, and before January 1, 2011.

D. Rulings of the State Tax Commissioner

1. **Nexus/Commercial Domicile.** PD 16-141 (June 27, 2016). Corporation and its NOLs were excluded from the Virginia combined return on audit. Commissioner holds that taxpayer failed to prove that its commercial domicile was in Virginia. This appears to be a classic holding company with no employees or property. Its books and records are not kept in Virginia, and its income tax return was approved by an officer in another state. Its filings with the SCC list the other state’s address. The fact that the corporation paid rent for a Virginia office does not cause it to be included in the Virginia return either. Neither its amended returns nor its pro forma federal returns report any rent expense. Where taxpayer’s only activity in Virginia is the rental of property, the Commissioner has previously declined to find nexus with Virginia. **Comment.** This ruling illustrates the care that must be taken by multi-state corporations whose...
administrative functions may be divided between Virginia and another state.

2. **Flow Through Nexus.** PD 16-142 (June 27, 2016). Members of a corporate affiliated group were partners in a business that was subject to, and paid, the Ohio Commercial Activity Tax. Because that partnership was subject to tax in Ohio, each of its corporate partners also had nexus with that state and were entitled to allocate and apportion their Virginia taxable income.

3. **Nexus/Virginia Employee.** PD 16-15 (March 3, 2016). Software development company headquartered outside Virginia had one Virginia employee who worked from her home providing bookkeeping, accounting, human resources and other services to the corporation. Although these services were not related to the company’s sale of websites, they were not *de minimis* and were sufficient to create nexus with Virginia for income tax purposes.

4. **Nexus/Web Hosting Services.** PD 16-77 (May 11, 2016). Corporation sells medications and health care products in Virginia, utilizing web hosting services provided by an unrelated third party for its website. Under this arrangement, the company rents servers and related equipment located in Virginia. Unless the company can establish that this rented equipment is not connected with sales solicitation activities, the presence of property in Virginia produces a positive apportionment factor and creates nexus for income tax purposes. Nevertheless, based on previous rulings of the Commissioner, an out-of-state seller whose only presence in Virginia is the use of a computer server to create or maintain a site on the internet, does not have nexus for sales and use tax purposes, whether a “managed hosting” service or a “co-location hosting” service.

5. **Nexus/Cloud Computing.** PD 16-135 (June 24, 2016). Company licenses pre-written software programs from a developer, modifies the programs to fit its clients’ needs and resells them to its clients. There is no exchange of tangible personal property between the developer and the company. Although the modification of prewritten software is not an exempt “custom program,” there is no taxable event in Virginia as long as there is no transfer of any tangible personal property in Virginia. Whether the company’s activities are protected under PL 86-272 will depend upon whether the developer is an independent contractor, unrelated to the company. In terms of apportionment factors, the rental in Virginia of servers would likely create a positive apportionment factor; and the existence of a positive sales factor will depend upon whether a greater proportion of the costs associated with providing the company services are performed in Virginia.

6. **Sales Factor/Foreign Royalties.** PD 16-151 (April 11, 2016). Royalties received by a joint venture from foreign business entities operating
overseas were properly excluded from the denominator of one of the joint venturer's Virginia sales factors. These royalties were foreign source income which is deductible from Virginia taxable income.

7. **Nonresident Corporation.** PD 16-57 (April 11, 2016). Even though a corporation has no office or place of business in Virginia, it is required to withhold Virginia taxes on wages of its employees, that is, either (i) those who perform service in Virginia for wages or (ii) residents of Virginia. In the case of certain “reciprocity states” (Maryland, West Virginia and Pennsylvania) those states withhold Virginia income tax from wages paid in those states to Virginia residents.

8. **Withholding Ignorance of the Law.** PD 16-35 (March 23, 2016). Ignorance of the law is no excuse. Taxpayer should have withheld income taxes from employees and submitted them to the Department. Failure to do so is subject to penalties and interest.

9. **NOLs.** PD 16-22 (April 8, 2016). When a taxpayer's fixed date conformity additions exceed federal taxable income, the taxpayer will have NOL for Virginia even it does not report an NOL on its federal return. The NOL can be carried back and forward in accordance with the rules established under IRC §172, except for the five year carryback.

10. **Consolidated Filing.** PD 16-28 (March 17, 2016). Corporate parent erroneously filed consolidated returns in Virginia before more than one member of the affiliated group was subject to Virginia income tax. When a second member of the group became subject to Virginia income tax, the corporation was deemed to have made a consolidated election in that year. To the extent that other affiliates have been included in the consolidated return erroneously, amended returns can be filed to exclude them.

II. **TAX CREDITS**

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

1. **R&D/Filing Deadline.** PD 16-146 (July 6, 2016). Applications for Research and Development Expenses Tax Credit must be submitted by April 1. When submitted by mail, if the application does not bear a postmark, the date of receipt by the Department will be determinative. In this case, the application was received on April 6 and was deemed too late because there was no postmark.

2. **Healthcare Tax Credit.** PD 16-34 (March 23, 2016). Taxpayer claimed a small employer health insurance premium credit on its federal return and therefore could not take a federal deduction for its premiums. Because there is no specific provision in Virginia law allowing for a deduction of premiums in this circumstance, no deduction can be claimed on the Virginia return.
III. INDIVIDUAL INCOME TAX

A. Rulings of the State Tax Commissioner

1. Virginia Residents. The following rulings all deal with who is a domiciliary or resident of Virginia: PD 16-11 (February 29, 2016); PD 16-39 (March 31, 2016); PD 16-45 (April 7, 2016); PD 16-60 (April 20, 2016); PD 16-61 (April 20, 2016); PD 16-73 (May 6, 2016); PD 16-86 (May 17, 2016); PD 16-99 (May 20, 2016); PD 16-100 (May 20, 2016); PD 16-111 (May 31, 2016); PD 16-112 (May 31, 2016); PD 16-115 (June 8, 2016); PD 16-119 (June 13, 2016); PD 16-120 (June 13, 2016); PD 16-125 (June 22, 2016); PD 16-127 (June 22, 2016); PD 16-128 (June 22, 2016); PD 16-130 (June 22, 2016).

2. Virginia Residents/Insufficient Information. The Department was unable to determine the resident status of the Taxpayer. It gave the Taxpayer additional time to provide requested documentation before upholding the assessment. PD 16-14 (March 2, 2016); PD 16-18 (March 8, 2016); PD 16-19 (March 8, 2016); PD 16-20 (March 8, 2016); PD 16-21 (March 8, 2016); PD 16-26 (March 10, 2016); PD 16-31 (March 18, 2016); PD 16-38 (March 24, 2016); PD 16-47 (April 7, 2016); PD 16-137 (June 24, 2016); PD 16-138 (June 24, 2016); PD 16-143 (June 27, 2016).

3. Domicile/Foreign Service Officer. PD 16-66 (May 2, 2016). The Taxpayer, a foreign service officer, was born in another state. He maintained a driver’s license and voter registration in that state. He did, however, register motor vehicles in Virginia. He accepted an assignment in February 2012 in a foreign country and moved there. The Department determined that the taxpayer never abandoned his domicile in his birth state and that he was not a domiciliary Virginia resident in 2012. He must, however, file a nonresident tax return to report his wage income earned from employment in Virginia during 2012. See PD 87-161 (June 2, 1987).


5. Nonresident Income. PD 16-56 (April 11, 2016). Taxpayer, a non-Virginia resident, contracted with a Virginia business to provide consulting services under a government contract. He spent 105 days in Virginia during the tax year. The Department ruled that the Taxpayer had Virginia source income for the year, was required to file a nonresident tax return, and made an assessment based on information available as to the taxpayer’s income allocated to Virginia.

6. Long-Term Capital Gain Subtraction. PD 16-79 (May 11, 2016). The Department denied the subtraction claimed by the taxpayer for long-term capital gain attributable to a sale or real property to the Commonwealth, which property was designated for future use as a park or green space.
The capital gain was not an investment in a qualified business, so it did not qualify for the subtraction in Va. Code § 58.1-322.C.35. Furthermore, it was not gain on the sale of property devoted to open-space use because the property was far less than 2 acres and did not meet the other restrictions in Va. Code 58.1-3230.

7. Federal Conformity/Milk Base. PD 16-83 (May 16, 2016). The Taxpayers, Virginia dairy farmers, requested guidance on whether any gain on the sale of “milk base” would qualify for the subtraction for long-term capital gain attributable to investments in a qualified business. The milk base is a quota set by a federal commission. The milk base may be sold among farmers, often at a price higher than purchase price. The Department ruled that federal law controlled whether the gain was included in federal AGI. If it were included, it would not be eligible for the subtraction because that subtraction is intended to relate only to long-term capital gain on the sale of equity and subordinated debt investments in a qualifying business. Milk base is not an equity or subordinated debt investment.

8. Subchapter S Pass-Through Income. PD 16-117 (June 8, 2016). Information provided by the IRS showed that the Taxpayer was allocated income from a Virginia subchapter S corporation. The Taxpayer contended the corporation did not have income from Virginia sources, but records showed that it remitted income tax withholding for employees within Virginia and reported income and expenses on its pass-through entity information returns. Absent additional information, the Department will assume that the corporation engaged in business in Virginia because it paid Virginia employees.

9. Substantiating Deductions. PD 16-53 (April 11, 2016). The Taxpayers’ medical and business deductions were adjusted by the Department. Bank statements are not acceptable proof of deductible medical expenses because they do not show the name of the patient, the service performed or items purchased. Also, the husband’s business deductions were eliminated because he was a partner in a partnership engaged in business. Expenses that arise out of a partnership’s operations belong to the partnership; an individual cannot make expenses belonging to a pass-through entity into his own by simply paying for it personally.

10. Burden of Proof. PD 16-29 (March 17, 2016). Taxpayer’s employer withheld Virginia income tax and the Taxpayer filed a Virginia nonresident tax return reporting no tax due. While it appears that the Taxpayer is a Maryland resident and would benefit from the reciprocity arrangement the Department has with Maryland, the Taxpayer refused to provide information to verify her residency status. As such, the assessment stands.
11. **IRS Documentation.** PD 15-33 (March 23, 2016). The Department adjusted the Taxpayer’s Virginia income tax return based on information it received from the IRS indicating that the federal AGI reported to the Department did not match the federal AGI reported to the IRS. Unless the Taxpayer provides information refuting the IRS records within 45 days, the Department’s assessment will stand.

12. **Refund; Statute of Limitations.** PD 16-63 (April 20, 2016). The Department issued assessments for the Taxpayer’s 2001-2003 tax years in 2005. The Taxpayer paid the 2001 assessment in 2010 and the 2002-03 assessments in April, 2013. The Taxpayers’ claim for refund, filed in October 2015, was not filed within the statute of limitations. Under Va. Code § 58.1-1823A(iv), an amended return may be filed within two years of the payment of the assessment, provided that the amended return raises issues relating solely to such assessment and the refund does not exceed the amount of such payment.

13. **Statute of Limitations/Overpayment Credit.** PD 16-82 (May 16, 2016). The Department disagreed with the Taxpayer’s position that the three year statute of limitations for claiming a refund in Va. Code § 58.1-499D does not apply to requests for an overpayment credit. The Taxpayer reasoned that Va. Code § 58.1-499D refers only to refunds and that an overpayment credit is inherently different than a refund request. The Department rejected this approach, noting that its longstanding policy is to apply the statute of limitations in § 58.1-499D to overpayment credits and refunds. Requiring the Department to review taxable years more than three years in the past for overpayment credit purposes present the same administrative challenges that the statute of limitations is designed to address.

14. **Requirement to File Return.** PD 16-116 (June 8, 2016). Taxpayer failed to file a Virginia tax return so the Department issued an assessment based on information available from the IRS. The Taxpayer contests the assessment, asserting that he intends to file a Virginia tax return after he files a federal income tax return to report a casualty loss. The Department noted that his requirement to file a Virginia income tax return by the filing deadline is not waived by his desire to first report the casualty loss on his federal return.

15. **Erroneous Refund.** PD 16-126 (June 22, 2016). Taxpayer electronically filed her 2014 tax return requesting a refund, which was issued. She later filed a second return reporting an increase in her federal AGI but made no corresponding tax payment. The Department issued an assessment. An erroneous refund is considered an underpayment of tax on the date the refund is made, and the Department has five years from the date of the erroneous refund to issue an assessment if the refund results from inadvertent taxpayer errors of a material fact.
16. **National Guard Pay.** PD 16-10 (February 29, 2016). Taxpayers claimed a subtraction for basic military pay, which was denied by the Department. It was denied because the husband was called to National Guard duty, which is not considered active duty eligible for the basis military pay subtraction.

17. **Reservist Pay.** PD 16-129 (June 22, 2016). Income from service in a military reserve unit is not eligible for the subtraction for active or inactive service in the Virginia National Guard. The Taxpayer was denied the subtraction because his Form W-2 stated that the income was derived from the Reserve Units of the Department of Defense.

18. **Out-of-State Credit/California.** PD 16-30 (March 18, 2016). Taxpayer, a resident of Virginia and member of a pass-through entity (PTE), claimed a credit on his Virginia income tax return for capital gains income from the sale of rental property located in California and owned by the PTE. The Taxpayer had paid tax on this income on his nonresident California return. The Department denied the credit. Under California law, the Taxpayer is entitled to claim a credit on his California nonresident return for income taxes paid to Virginia. Accordingly, the Taxpayer is not allowed to claim an out-of-state tax credit on his Virginia resident return for taxes paid to California.

19. **Out-of-State Credit/District of Columbia.** PD 16-41 (March 31, 2016). Taxpayers claimed a credit for income taxes paid to DC. The wife was a domiciliary resident of Virginia and an actual resident of DC because she lived in DC for an aggregate of 183 days or more during the tax year. The credit can be claimed only on income derived from sources outside of Virginia and otherwise subject to Virginia income tax. The Department requested that the Taxpayers provide information supporting their contention that the income on which the credit was claimed was derived from sources outside of Virginia.

20. **Out-of-State Credit/Composite Return.** PD 16-91 (May 19, 2016). The Taxpayer was a partner in a partnership engaged in business throughout the United States and claimed a credit on his Virginia income tax return for income taxes paid to a number of different states. The auditor denied the credit for taxes paid to states for which the Taxpayer had participated in composite income tax returns the partnership filed. The Department will return those credits to the Taxpayer’s return because documentation was provided indicating (1) that the reciprocity states do not allow credits to be claimed on the composite tax returns and (2) the pro rata taxable income and tax paid per state in conformity with PD 10-68.

21. **Out-of-State Credit/New York.** PD 16-52 (April 11, 2016). The Department adjusted the Taxpayers’ 2014 tax return, reducing the credit for income tax paid to New York and decreasing the Taxpayers’ 2014 refund. The Taxpayer filed claims for refunds for the 2012 and 2014 years. The 2012 claim was denied because of the statute of limitations.
The 2014 claim was denied because the credit was correctly calculated by the Department in accordance with the allocation percentage described in PD 94-91 (March 28, 1994). Under this guidance, Virginia allows a credit equal to the lesser of the amount of tax actually paid to New York or the amount of Virginia tax actually imposed on the taxpayer on the income earned or derived in New York.

22. **Property Settlement Agreements**, PD 16-12 (February 29, 2016). A property settlement agreement between the taxpayer and his ex-wife, which allocated Virginia tax liabilities to the ex-wife, does not relieve the taxpayer from tax liabilities stemming from an assessment for the 2011 tax year, in which the taxpayer filed jointly with his ex-wife. The Department was not a party to the property settlement agreement and is not obligated to abide by its terms.

23. **Use of Federal Forms**, PD 16-24 (March 8, 2016). On his Virginia tax return, the Taxpayer mistakenly reported his federal AGI as the amount of Virginia income tax withheld from his wages. Using the information reported on the Taxpayer’s IRS Form W-2, the Department made adjustments to the Taxpayer’s tax liability.

IV. FIDUCIARY INCOME TAX & ESTATE TAX

A. Rulings of the State Tax Commissioner

1. **Power of Appointment/Resident Trust**, PD 16-62 (April 20, 2016). When Virginia domiciliary by his will exercised a power of appointment to establish a trust for the benefit of his spouse and descendants, that was a “new trust” created by Virginia domiciliary and therefore a “resident trust” for fiduciary income tax purposes.

V. RETAIL SALES & USE TAXES

A. Legislation

1. **Beer Brewing**. Exemption provided for machinery, tools, materials, etc. used in manufacturing beer so long as preponderance of use is in the manufacture of beer by a licensed brewer. Legislation reverses the Department of Taxation’s position that brewing facilities associated with a restaurant are not entitled to the manufacturing exemption.

2. **Solar Manufacturing**. Extends the manufacturing exemption to machinery and equipment used to generate energy from sunlight or wind by a public service corporation.

3. **Oil and Gas Drilling**. Virginia Code §58.1-609.3(12) is amended to extend the exemption for oil and gas drilling to 2022.
4. **Interest on Refunds.** Virginia Code §58.1-623 provides that a taxpayer who fails to provide an exemption certificate at the time of purchase of certain property is allowed interest on a refund of sales and use tax only from the time that a refund claim is filed with the Department. This bill is apparently aimed at data centers which had not been providing exemption certificates at the time equipment was purchased but were aggregating refunds into a single claim, the result of which was a large claim that was causing budgeting issues for local governments.

B. **Policy Announcements**

1. **Meals.** Tax Bulletin 16-3 (May 2, 2016). Announcing a change in policy effective April 22, 2016, the Department of Taxation will now recognize that purchases of prepared meals and catering by governmental entities, non-profit organizations and non-profit churches can be exempt. In the case of governmental entities, a three part test is applied: (1) the provision of the meals, etc. must further a governmental or non-profit entity function; (2) the charge must be billed to and paid directly by the exempt entity; (3) the entity claiming the exemption must determine how the meals or food are served and consumed. The examples are helpful:
   - **Employee banquet** – State agency that honors employees with an annual banquet can make its purchases tax exempt provided that the invoice is paid from the agency’s official account.
   - **Feeding the homeless** – A church that purchases meals and catering to feed the homeless in the church sanctuary can make those purchases exempt.
   - **Team pizza** – When a coach purchases pizzas for the team, the pizza is taxable even if the coach may be reimbursed by the exempt Little League later.
   - **Credit cards** – Government employees traveling on state business and using a state government issued credit card are taxable on their meal purchases even though reimbursed by the government at a later date. The charge is not billed directly to the government, and the government does not determine to whom, when and how the meal is consumed.

**Comment.** It only took the Department fifteen years to recognize the holding in *Chesapeake Hospital Authority v. Commonwealth*, 262 Va. 551 (2001) (food served to employees and other non-patients by a hospital/governmental authority was exempt). The Tax Bulletin nowhere mentions this case nor explains why the change in policy is made “prospective only” and not from 2001.

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

**Taxable Transactions & Measure**

1. **Subcontractor.** PD 16-107 (May 25, 2016). Taxpayer is an out-of-state business that does construction work in Virginia—typically installing
floors for other subcontractors. It generally has no contact or interaction with the property owner. The floors it installs are wood or cement, not mats or wall to wall carpeting. The Department determined the Taxpayer to be a using and consuming contractor with respect to real estate. It must pay sales or use tax on all purchases made for Virginia construction work.

2. **Governmental Exemption.** PD 16-131 (June 23, 2016). The Department will revise the audit of a real property construction company that designed and constructed governmental facilities in Virginia. Tangible personal property that is not affixed to the real estate can be purchased exempt for resale to the Government. Separately, the Department ruled that the contract line item numbers corresponding to tangible property were not independent contracts, separate from the contract to construct real property.

3. **Software/Electronic Delivery.** PD 16-5 (February 3, 2016). Taxpayer failed to meet its burden that items in the assessment constitute computer software delivered electronically. In one case, the description “freight charge” on the invoice indicated tangible property was delivered. In another case, a charge for “contract labor” in connection with a renewal of a software license was held taxable because the taxpayer failed to establish that the contract was only for labor. Because none of the contested items was removed from audit, the Department denied the taxpayer’s request to reduce the liability assigned to it based on the Department’s Invoice Capture Tool (ICT) model.

4. **Nexus/Web Hosting Services.** PD 16-77 (May 11, 2016). Corporation sells medications and health care products in Virginia, utilizing web hosting services provided by an unrelated third party for its website. Under this arrangement, the company rents servers and related equipment located in Virginia. Unless the company can establish that this rented equipment is not connected with sales solicitation activities, the presence of property in Virginia produces a positive apportionment factor and creates nexus for income tax purposes. Nevertheless, based on previous rulings of the Commissioner, an out-of-state seller whose only presence in Virginia is the use of a computer server to create or maintain a site on the internet, does not have nexus for sales and use tax purposes, whether a “managed hosting” service or a “co-location hosting” service.

5. **Nexus/Cloud Computing.** PD 16-135 (June 24, 2016). Company licenses pre-written software programs from a developer, modifies the programs to fit its clients’ needs and resells them to its clients. There is no exchange of tangible personal property between the developer and the company. Although the modification of prewritten software is not an exempt “custom program,” there is no taxable event in Virginia as long as there is no transfer of any tangible personal property in Virginia. Whether the company’s activities are protected under PL 86-272 will depend upon whether the developer is an independent contractor, unrelated to the
company. In terms of apportionment factors, the rental in Virginia of servers would likely create a positive apportionment factor; and the existence of a positive sales factor will depend upon whether a greater proportion of the costs associated with providing the company services are performed in Virginia.

6. **Handling Charges**, PD 16-59 (April 20, 2016). The Taxpayer operates a truck repair dispatch center. When it receives a call from a stranded motorist, it discharges a repairman to assist. The repairman sends its bill to the Taxpayer, who in turn bills the customer for the repairs. Included in the Taxpayer’s bill is a handling charge. The Department determined the handling charge is for a service in connection with the sale of tangible personal property. The handling charge represents the Taxpayer’s profit or markup, which are included in the definition of sales price.

7. **Equipment Leasing with Services**, PD 16-72 (May 6, 2016). The Taxpayer, a nonprofit organization, contracted with a vendor for the lease of two printers and on-site staffing services. The Department determined that the charges for the property and services were subject to sales tax prior to the effective date of the Taxpayer’s nonprofit exemption certificate letter. There is no statutory exemption for the services when furnished in connection with the lease of property.

8. **Delivery Charges**, PD 16-140 (June 27, 2016). Taxpayer operates an internet grocery delivery company that sells food and non-food items to customers. Customers have the option of purchasing prepaid delivery service or paying for delivery with each separate purchase. The Department ruled that sales of prepaid delivery service are exempt from sales tax because the purchases do not provide any tangible products to the Taxpayer’s customers. Similarly, separately stated charges for delivery with respect to individual transactions are also exempt from sales tax.

9. **Security Systems**, PD 16-49 (April 11, 2016). Taxpayer installs monitoring equipment at hospitals and nursing homes. The equipment allows for two-way communication between medical staff and patients. The equipment is owned by the Taxpayer, but the video tape is owned by the hospital or nursing home and can be viewed by medical staff using over-the-counter software. Even though the Taxpayer continuously monitors its equipment, the true object of the equipment is to allow the hospital or nursing home to monitor its patients from a single location. Accordingly, the equipment is considered a non-monitored system and is therefore subject to tax (see PD 13-108). *See also* PD 16-93 (May 20, 2016) (sale of a video security system in which customers can review the digital images captured on the system’s cameras is a taxable sale of tangible property).

10. **Ice Cream Trucks**, PD 16-50 (April 11, 2016). Ice cream sold by ice cream trucks is for immediate consumption by the consumer.
Accordingly, those sales are not eligible for the reduced rate of tax for food products sold for home consumption; rather, they are subject to the full sales tax. See Virginia Tax Bulletin 05-7 (May 31, 2005).

11. **Use Tax Calculation.** PD 16-74 (May 10, 2016). The Taxpayer, a construction contractor located outside of Virginia, proposes an allocation formula to allocate material costs to Virginia. Under this formula, the cost of all inventory consumed is multiplied by a fraction, the numerator of which is revenue generated from Virginia projects and the denominator of which is total revenue. The Department rejects this formula. First, the use tax is based on the cost price of materials purchased by the taxpayer each month, not the value of inventory consumed each month. Second, the formula does not ensure that the 1% local tax gets distributed to the appropriate locality. The Department proposes a new methodology.

12. **Intercompany Transactions.** PD 16-84 (May 17, 2016). The Taxpayer is a holding company for subsidiary operating companies that perform electrical and telecommunications contract work. The Taxpayer purchases equipment for use by its subsidiaries. It pays sales tax at the time of purchase. The costs for the use of the equipment are allocated to the subsidiaries without markup. On audit, the allocated cost amounts were treated as rental charges. The Department upheld the auditor’s view that the Taxpayer is a lessor. For future purchases, it should issue a resale exemption certificate to the vendor. As lessor, the Taxpayer should report and remit to the Department the sale tax based on the intercompany accounting entries recorded each month.

13. **Display Case Advertising.** PD 16-92 (May 20, 2016). Taxpayer provides display advertising services at Virginia hospitals. It installs display cases and LCD boards under 5 or 10 year contracts with hospitals, and sells space in these cases to local businesses. The display cases are owned by the Taxpayer; the local businesses own the advertising material displayed in the display cases. The Department ruled that the Taxpayer does not operate an advertising business and is not a real property contractor. Rather, it is in the business of leases space. It is the user and consumer of the display cases and must pay tax at the point of purchase. Additionally, the sale of space in the display cases to local businesses is not subject to sales tax.

14. **Photography Packages.** PD 16-69 (May 3, 2016). A typical package offered by the Taxpayer, a photography business, includes a service fee for the photographer’s time, a removable flash drive device containing the images, and the provision of an online service in which the customer can view and print selected images. When an image is selected for printing, it is printed by a third party who collects sales tax on the printing charge. The Department determined that the true object of the taxpayer’s services is the sale of tangible personal property and, as such, the entire transaction is subject to sales tax.
15. **No Taxable Use.** PD 16-102 (May 25, 2016). Taxpayer purchased equipment that broadcasters needed in order to comply with FCC rules requiring that they operate in different channel frequencies. Taxpayer purchased this equipment pursuant to an agreement with the FCC under which the Taxpayer could use the vacated telecommunications channels for its own purposes in exchange for purchasing the new equipment. The broadcasters identified the equipment it wanted the Taxpayer to purchase and the equipment was shipped directly to the broadcasters. The Taxpayer reviewed the purchase orders and paid the invoices. The Department ruled that the Taxpayer owed no use tax on the equipment purchases because it made no taxable use of that equipment in Virginia. **Comment:** Beware any invoice that shows a Virginia billing address.

**Exemptions: Industrial**

16. **Fuel for Concrete Mixers.** PD 16-48 (April 11, 2016). Taxpayer is a manufacturer of ready mix concrete. It owns and operates ready mix concrete trucks, and received a 35% refund of motor vehicle fuels tax on the diesel fuel it purchases to operate the trucks. The Department held that the diesel fuel is also exempt from the retail sales tax because it is used directly in the manufacturing process.

17. **Manufacturing Exemption.** PD 16-88 (May 19, 2016). Taxpayer, a lumber manufacturer, successfully argued that the strapping materials and parts are exempt from tax as an integral part of the production process. Strapping is used throughout the production process to prevent damage to the lumber as it moves from one step of production to another. The last stage of strapping occurs before the finished lumber is conveyed to storage. Accordingly, the Department agreed that the strapping plays an essential and immediate role in the production of the Taxpayer’s lumber. **See also** PD 16-89 (May 19, 2016) and PD 16-90 (May 19, 2016) (purchases of strapping materials and a strapping machine for use in strapping flooring products to prepare them for sale to wholesalers are exempt).

18. **Research and Development Exemption.** PD 16-71 (May 6, 2016). The Taxpayer operates a research and development facility, which produces an unusable waste product. A scrap recycler wants to purchase the waste product and transport it by common carrier out of Virginia to the recycling center. The Department ruled that the taxpayer’s sale of the waste product would not vitiate its research and development exemption. It is not the intended purpose of the facility to produce a product for sale; the waste is merely a by-product of the taxpayer’s exempt research activities.

19. **Manufacturing Exemption/AC units.** PD 16-103 (May 25, 2016). Taxpayer, a manufacturer, replaced the air conditioning units on its cranes. It uses the cranes to move material through the manufacturing process, which qualify the cranes as exempt equipment under the manufacturing
exemption. The Department ruled that the air conditioning units were an integral part of the cranes when the cranes were originally purchased. Accordingly, the Taxpayer may purchase replacement AC units exempt of the sales tax.

Exemptions: General

20. Purchases of Food: Nonprofit and Governmental Exemptions. PD 16-64 (April 22, 2016). The Department clarified its policy with respect to purchases of meals, food and catering by nonprofits and governmental entities. The confusion stemmed from 23 VAC 10-210-1071, which provides that the sale of meals is deemed to be the sale of a taxable service, and Va Code 58.1-609.11.B., which provides that purchases of tangible personal property for use or consumption by a qualifying nonprofit is exempt from sales tax. Going forward, the Department will not deny an exemption from the tax on the purchase of meals, food and catering on the basis that the meals, food and catering are taxable services. Rather, exemption is based on whether furnishing the food is an official function or purpose of the exempt entity and the level of dominion or control the exempt entity exercises over the food.

21. Durable Medical Equipment. PD 16-70 (May 6, 2016). The Taxpayer sells prosthetic devices, which it purchases on behalf of specific individuals, and related consulting, fitting and measuring services. It also makes bulk purchases of adaptors, pylons and other components, some of which will be physically attached to the prosthetic device. The Department determined that all of the bulk purchases are subject to sales tax even though some of them will be physically attached to the prosthetic device.

22. Durable Medical Equipment. PD 16-81 (May 16, 2016). The Taxpayer sells natural latex mattresses. It orders each mattress for a specific individual, based on a prescription that individual obtains from her doctor or chiropractor. The latex mattress is for use by people that may suffer from fibromyalgia, lupus or similar ailments, or for people that prefer a soft mattress. Because people without ailments may find the mattress useful, it is not exempt durable medical equipment.

23. Durable Medical Equipment. PD 16-85 (May 17, 2016). Taxpayer sells an implantable retractor system designed to replace the urinary function in patients. Products may be sold exempt from sales tax in the following scenarios: (1) hand delivered to a doctor pursuant to a prescription for a specific patient on the procedure date; (2) products ordered by and billed to a doctor in advance of a procedure date for a specific patient pursuant to a prescription; and (3) products shipped to a hospital on consignment, a sale is placed only when a prescription is issued by a doctor for a specific patient. Bulk purchases of the product by a medical facility to be held in inventory by that facility are not exempt from sales tax.
24. **Durable Medical Equipment.** PD 16-133 (June 24, 2016). Sales of a medical device that monitors and records a patient’s heart rhythms can be made exempt from tax provided the sale is to or on the behalf of a specific individual based on the prescription of a licensed medical practitioner. This monitor is predominantly used by persons who suffer fainting spells. The data collected by the monitor are used by the physician to determine the cause of the fainting spells.

25. **Nonprescription Drugs.** PD 16-106 (May 25, 2016). Sales of stretch marks therapy cream and anti-wrinkle cream with SPF 15 sunscreen may not be sold as an exempt nonprescription drug. These products promote attractiveness; the inclusion of the SPF protection serves a secondary function to the intended use of the product. The Ocean Protect sunscreen with SPF-50 is an exempt nonprescription drug and may be sold exempt of sales tax. Audit adjustments were made accordingly.

26. **Occasional Sale.** PD 16-58 (April 20, 2016). The Department was unable to rule on whether the taxpayer’s purchase of property related to the purchase of a division from another company qualified for the occasional sale exemption. In particular, more information was needed to determine if (i) the activities of the division required the seller to maintain a Virginia sales tax registration, (ii) the segment of the business sold to the taxpayer was a separate and distinct division of the seller, which continued to operate following the sale, or (iii) that segment was liquidated as part of the transaction.

27. **Burden of Proof/Grocery Store.** PD 16-1 (February 1, 2016). The Department ruled on three matters for the grocery store taxpayer: (1) Food items, all of which qualify for the reduced rate of tax, packaged together in a tin and sold for one price is subject to the reduced tax rate for food purchase for home consumption; (2) The auditor correctly denied numerous resale certificates because the purchaser was not registered to collect Virginia sales tax, or because the certificate date was after the transaction date and the resale was not otherwise proven; and (3) the taxpayer did not owe tax on the maintenance and repair parts installed by contractors on the taxpayer’s refrigeration coolers and cases. In doing so, it determined that the coolers and cases were real property fixtures, so the contractor was liable for the tax on the cost price of the repair parts.

28. **Medical Records.** PD 16-16 (March 8, 2016). Taxpayer enters into agreements with physicians and healthcare facilities that require it to provide patients’ medical records as requested by patients, insurance companies, employers and others. The Taxpayer also provides coding, training, education, converting and storage services in connection with these agreements. Applying the true object test, the Department ruled that the provision of medical records and related services are nontaxable professional services.
Audits & Procedure

29. **Corporate Officers/Personal Liability.** PD 16-105 (May 25, 2016). The exit agreement between the Taxpayers and Business, along with amended returns showing correct ownership percentages, establish that the Taxpayers were no longer associated with the Business and cannot be held as corporate officers of the Business for purposes of Virginia Code 58.1-1813.

30. **Responsible Officer.** PD 16-110 (May 31, 2016). The Taxpayer, a one-third owner of a corporation, was held liable for the corporation’s delinquent sales tax assessments because he had a duty to pay sales taxes, willfully did not pay and had knowledge the liabilities were not paid, and had the authority to prevent the failures. Taxpayer was responsible for preparing invoices, upon which sales tax was charged, and preparing payroll via use of Quickbooks software. Per the operating agreement, he was one of two managers authorized to conduct business of the corporation. He thought sales taxes were paid electronically via Quickbooks, but he should have known better because he regularly utilized the accounting software. In addition, he admitted to the tax liabilities when the company credit card was declined.

31. **Burden of Proof/Responsible Officer.** PD 16-123 (June 22, 2016). Withholding and sales and use tax assessments against four convenience stores were conveyed to the stores’ owner. The stores had not remitted all of the sales tax they had collected at the point of sales, as shown by the stores’ records. In addition, the stores had paid employees in cash and failed to withhold any amount for taxes. As the stores’ sole owner, the taxpayer is liable for the outstanding assessments.

32. **Responsible Officers.** PD 16-109 (May 31, 2016). The Taxpayer was determined to be a responsible officer of the corporation and responsible for the corporation’s outstanding sales tax liability. While he was not primarily responsible for filing sales tax returns, he did occasionally file them. He also signed an offer in compromise during the audit period. Pursuant to the operating agreement, he had the power to manage the business as a manager. In addition, he was aware of the sales tax liability when his company credit card was declined because the Department had placed a lien on the corporation’s account.

33. **Double Taxation.** PD 16-36 (March 24, 2016). Untaxed sales to a customer were included in Taxpayer’s audit for the periods October 2008 through September 2014. Untaxed purchases from the Taxpayer were included in the customer’s audit for the periods August 2011 through July 2014. The Taxpayer asserted that double taxation occurred. The Department noted that in the Taxpayer’s sales sample extrapolation, no amounts were extrapolated for the periods from August 2011 through July
2014. All other periods, however, include sales tax on untaxed sale to the customer. As such, no double tax.

34. **Burden of Proof/Credit for Tax Erroneously Paid.** PD 16-75 (May 11, 2016). The Taxpayer requested that the Department reconsider its position that no credit be given in audit for sales tax erroneously paid to vendors on purchases for resale. While the Department does allow credit against the assessed tax in similar situations, the Taxpayer must verify that the tax has been paid. Because the Taxpayer did not prove sales tax was erroneously paid, no credit was given.

35. **Burden of Proof.** PD 16-80 (May 16, 2016). Taxpayer did not substantiate its claims that the separately stated installation charges are exempt because it stated on appeal that those amounts include a “significant markup for profit.” Profit is not an exempt labor charge. Taxpayer also did not provide adequate proof that its Virginia employment tax withholding was correct. Accordingly, the auditor’s assessment was upheld.

36. **Burden of Proof.** PD 16-108 (May 26, 2016). Taxpayer failed to meet its burden of proof with respect to certain untaxed sales, including sales of products shipped to addresses outside of Virginia. The report created by Taxpayer indicating destination zip codes was not supported by invoices or shipping records, and was not accepted as proof that no tax was owed on those sales.

37. **Burden of Proof.** PD 16-114 (June 8, 2016). Department’s audit revealed several untaxed purchases by the Taxpayer, a veterinary clinic. The Taxpayer did not have adequate records to support its position that the purchases were exempt. For example, the Taxpayer claimed that its payment for certain assets under a master lease agreement includes applicable taxes. In the Department’s view, the lease and supporting invoices imply that the Taxpayer needed to pay a certain amount plus applicable tax, but the tax was never calculated nor paid by Taxpayer.

38. **Burden of Proof.** PD 16-124 (June 22, 2016). Department issued three rulings to the Taxpayer, a wholesale distributor. First, it accepted an exemption certificate in good faith even though the registration number provided was the purchaser’s federal EIN. The Taxpayer could not have known that this registration number was invalid. Second, the Taxpayer failed to provide sufficient evidence that the purchase of software and related maintenance agreement was exempt. The Taxpayer supplied an email from the software seller stating that it delivers software to customers electronically, but that email did not reference the specific transaction. Third, the Taxpayer was unable to prove that certain of its customers paid use tax on their purchases. Accordingly, the Department was unwilling to give credit in the audit for those purchases (see PD 11-206).
39. **Use of ABC Records.** PD 16-43 (April 7, 2016). Taxpayer, a restaurant, contests an audit assessment that used sales information for January 2012 provided to the Department by the Department of Alcoholic Beverage Control to extrapolate liability over a 68 month audit period. The audit period was extended to 68 months because a deficiency greater than 50% was reported for January 2012. The Department acknowledged that the auditor’s method is inconsistent with its accepted methodologies, but upheld the assessment because the Taxpayer did not respond to the auditor’s repeated requests for information.

40. **Burden of Proof.** PD 16-95 (May 20, 2016). Taxpayer, a small independent grocery store, was issued non-filer assessments because it did not file sales and use tax returns for 14 months. It contests the assessments, but could not substantiate its claims that most of its transactions were food stamp transactions.

41. **Reliance on Department Advice.** PD 16-1369 (June 27, 2016). The Taxpayer, a seller of manufactured signs, disputes the auditor’s assessment that all of its sales were subject to sales tax. It claims that it was told by other sign contractors and by the Department that it did not have to charge tax on the sales of its signs provided it paid sales tax on the materials it purchased to make the signs. Because the advice from the Department was not in writing, the assessment stands.

42. **Refund Request/Statute of Limitations.** PD 15-116 (June 16, 2015). The taxpayer, which has performed work in Virginia since 2007, had been paying the special use tax on construction equipment that it brought into Virginia. It later learned that it was not required to pay the tax and, in April 2014, requested refunds of all taxes paid. The Department refunded taxes paid only from March 2011 because it does not have the authority to issue refunds outside of the 3 year statute of limitations.

43. **Statute of Limitations.** PD 16-94 (May 20, 2016). Taxpayer’s request that the Department apply a 2010 accelerated sales tax overpayment to its June 2015 accelerated sales tax liability was denied. In general, if the accelerated payment creates an overpayment, the dealer is entitled to claim a credit on the following month’s return. Refunds will not be authorized unless the request is made within three years from the due date of the return.

44. **Exemption Certificates.** PD 16-104 (May 25, 2016). In audit, the auditor determined that the Taxpayer did not accept certain valid resale exemption certificates in good faith. The Taxpayer was allowed to obtain new certificates and other supporting documentation and most of those transactions were removed from audit. In one case, the Department determined that the resale certificate accepted by the Taxpayer at the moment sale was accepted in good faith, even though the registration number was incorrect.
VI. COMMUNICATIONS SALES AND USE TAX

A. Rulings of the State Tax Commissioner

1. **Bad Debts.** PD 16-113 (June 8, 2016). The provisions of the Retail Sales and Use Tax Act allowing for possible alternative methods for computing bad debts do not apply to the Communications Sales and Use Tax. The statutory method must be followed.

2. **Right of Way Fees.** PD 16-44 (April 7, 2016). The tax applicable to access lines and other services does not apply to charges made to local government entities.

VII. BUSINESS LICENSE TAX

A. Cases

1. **Out-of-State Deduction.** *Ford Motor Credit Company v. Chesterfield County,* No. CL07-418, 2015 Va. Cir. LEXIS 83 (June 19, 2015). On remand, the Supreme Court of Virginia tasked the circuit court with determining whether FMCC was entitled to an out-of-state deduction under Va. Code § 58.1-3732(B)(2). The court determined that in order to claim the deduction, FMCC had to show that (1) the gross receipts were attributable to business activity conducted in another state or foreign country, (2) FMCC was liable for income or other tax based on income in that jurisdiction, and (3) FMCC actually reported those receipts on the filed the out-of-state return. There was no dispute that FMCC could not trace taxable gross receipts attributable to business activity conducted out of state to any particular out-of-state return. Therefore, the court ruled that FMCC was not entitled to the out-of-state deduction. **COMMENT:** This holding appears to be contrary to the Supreme Court's holding in *Nielsen v. Arlington County* in which the locality's attempt to require direct tracing of receipts was rejected when payroll apportionment is required.

B. Attorney General Opinion

1. **Growlers.** 2016 WL 4708865 (Va. A.G. September 1, 2016). Does the City of Manassas' meals tax apply to beer sold in "growlers?" The Attorney General holds that under the Virginia ABC rules, the local meals tax does not apply to "factory sealed" containers of 64 ounces of less. A brewery is a factory, hence, if the growler is filled and sealed at the brewery, it is not subject to the local meals tax.
C. Rulings of the State Tax Commissioner

Classification

1. Manufacturer’s Warehouse. PD 16-87 (May 19, 2016). Bottling company manufactured in various Virginia localities and shipped its product to a finish goods warehouse where it was stored and then delivered to grocery stores and other retail customers. Consistent with modern merchandising practices, company’s drivers deliver the goods to the customer; other employees moved goods from the customer’s storage area to the store floor and set up product displays. All contracts were negotiated on a national basis from locations outside Virginia. Locality claimed that, because these contracts were essentially “requirements” contracts, and not definite quantity contracts, selling was occurring at the warehouse. Commissioner holds that the exclusion in Virginia Code §58.1-3703C4 is an “exemption” that must be strictly construed against the taxpayer. On this basis, any activity attributed to the warehouse other than the mere storage of goods causes all of the activities in the warehouse to be subject to gross receipts taxation. In this case, the activities of employees in stocking shelves exceeded mere storage. The fact that the company operated a separate vending machine business at the warehouse also caused the loss of the “exemption” for the entire warehouse. Comment. The Commissioner’s ruling is questionable for several reasons. First, Virginia Code §58.1-3703C4 is not an “exemption.” The statute makes it very clear that it is a restriction on the power of localities to tax. The Supreme Court of Virginia has held in several BPOL cases that the restrictions on localities’ powers to impose BPOL taxes are strictly construed against localities. Second, the taxpayer in this case had obtained a favorable ruling from the Department many years before this audit arose. The Department, however, claims that it was not aware of the shelf stocking and other activities which exceeded “mere storage.” Of interest, however, is that the ruling very clearly addressed the vending machine operations and treated them as a separate business which did not “infect” the other activities at the warehouse. The “mere storage” analysis in this ruling appears to be a new theory of taxation, and one that will certainly lead to more aggressive assessments by Virginia localities.

2. Government Contractors. PD 16-118 (June 13, 2016). Taxpayer had contracts with the US Navy to rebuild certain weapons systems. Metallic housing units containing the old systems were delivered to the company’s plant where the housings were gutted and the systems were completely rebuilt using new components either purchased from unrelated parties, affiliates or manufactured by the taxpayer. The completely rebuilt systems, in the original metal containers, were then returned to the Navy. In a very confusing analysis, the Department appears to acknowledge that the activities of the taxpayer constituted manufacturing, but it was taxable because it was not “selling at wholesale at the place of manufacture”
because title to many of the components passed to the Navy before they were used in the rebuilding process. These title provisions are standard Government contract provisions essentially providing a security device to the Government in its highly complex and top secret equipment. The Department also appears to hold that because the contracts provided that the taxpayer “shall provide all necessary personnel, materials … and services” necessary to overhaul and rebuild the systems, the taxpayer must be selling services and not property. The Department ignored its own “true object” test that has been approved by the Supreme Court of Virginia in multiple cases.

Comment. This appears to be another example of a ruling in which the Department tries hard not to issue a final ruling against a locality. The ruling ignores the fact that the Supreme Court of Virginia in County of Chesterfield v. BBC Brown Boveri, 238 Va. 64 (1989) held that the overhaul and rebuilding of electrical generators constituted manufacturing and not “repair services.” The question is not whether there are labor services involved, but whether those services produce a product that is substantially different from the original materials. Finally, the Department’s attempt to distinguish its own “true object” test as applying only in sales and use tax matters is weak. The Supreme Court of Virginia has approved that test as how Virginia law determines whether the purpose of a contract is to obtain services or property. This ruling will present serious problems for Virginia’s Defense industry and Government contractors.

Exclusions, Exemptions and Reductions

3. **Definite Place of Business.** PD 16-46 (March 7, 2016). Fuel distributor owned storage tanks, fuel pumps and signage in a facility operated by a retailer. When fuel was withdrawn from the distributor’s tanks for sale to a customer, the retailer was charged. Commissioner holds that even though this distributor did not have an office, phone, employee or conduct record keeping at the location, it did have a continuing presence and presumably maintained and operated the pumps and storage tanks. Accordingly, it had a taxable place of business in the locality.

Procedure

4. **Procedure.** PD 16-3 (February 2, 2016). The Department declined to rule on the taxpayer’s issue because the facts indicated an ongoing dispute between the taxpayer and the locality with respect to the issue. The Department rarely issues an advisory opinion when a taxpayer is actively engaged in disputing an assessment with a locality.

5. **Procedural Complaints.** PD 16-37 (March 24, 2016). Taxpayer sought a refund based on misclassification of its business. After much delay, the
City denied it had jurisdiction and concluded that the taxpayer was properly classified. On appeal to the Department, the City claimed that the taxpayer’s appeal had been filed with the wrong City Administrator; that the Department had no jurisdiction to review classification issues; that the City’s ordinance trumped the Virginia Code; and that the taxpayer’s appeals had not been timely filed. All of these complaints, set forth in over twenty pages of technical argument, notwithstanding the fact that the City actually received the taxpayer’s local appeal, acknowledged the local appeal, ruled on the local appeal, and advised the taxpayer of its rights to appeal to the State. The Department concluded that the City had in fact issued a final determination which was appealable. Comment. This is yet another example of a locality more interested in playing procedural games than in providing the reasonable administrative review intended by the General Assembly.

VIII. PROPERTY TAXES

A. Cases

1. Real Estate/Common Areas. Saddlebrook Estates Community Association v. City of Suffolk, 292 Va. 70, 786 S.E.2d 160 (June 2, 2016). Property owned by the Saddlebrook Estates Community Association, Inc. (the “Property Owners Association” or “POA”) was leased to a commercial riding school which sold its services to POA Members as well as members of the general public. Reversing the trial court, the Supreme Court of Virginia held that Virginia Code §58.1-3284.1(A) provides that property that is owned as part of a planned development and held in common to benefit all of the other properties in that development has no value in and of itself. That value is ascribed to the individually owned lots and property whose value is presumably increased by the value of the common space. The fact that the property is leased to a commercial enterprise in a manner that still benefits the individual lot owners does not change the statutory requirement.

2. Consumer Utility Tax. City of Richmond v. Virginia Electric and Power Company, 292 Va. 70, 787 S.E.2d 106 (June 30, 2016). The issue was whether the City of Richmond could require Dominion Power to pay consumer utility tax on natural gas consumed in the generation of electricity at Dominion Power’s plant located in the City. Analogizing to the Sales and Use Tax Act, the City argued that it was entitled to tax any consumption of natural gas. Dominion argued that the statute, however, authorized the city to tax only gas distributed by a pipeline distribution company through a pipeline for purposes of furnishing heat or light. The State Tax Commissioner held that, notwithstanding the fact that the entity in question did not own a single pipe and that it was not regulated as a pipeline distribution company and did not sell the gas for the purpose of producing heat or light, Dominion owed the City $7.3 million. The
Supreme Court of Virginia reversed. There were three separate opinions. Justice Mims held that the Code distinguishes between companies that provide “heat, light and power,” and this statute applied only to “heat and light.” Accordingly, there was no legislative intention to tax gas used to generate power (which, in turn, is subject to a consumer utility tax). Justice Powell based her opinion in favor of the taxpayer on the trial court’s finding of fact that the natural gas was not consumed for the purposes of furnishing heat or light. Justices Lacy, McClanahan and Kelsey, also ruling for the taxpayer, held that the State Corporation Commission had never regulated the taxpayer as a pipeline distribution company and, therefore, it could not be taxed as such.

3. Cable Converter Boxes. Eugene H. Walter, Director of Finance of Henrico County v. Verizon Online LLC, Record No. CL13-3050 (Henrico County Cir. Ct., March 2, 2016). Locality contended that cable-set up boxes were machines under §58.1-1102 2a and tangible property subject to local taxation. The locality argued that the set up boxes’ advanced technological features distinguished them from converters because they were computers or machines. Locality acknowledged that converter was not subject to local taxation. The court found the term “machines” ambiguous. Looking to the statutory intent and Tax Commissioner’s Bulletins, ruling below and Fiscal Impact statement, the court concluded that the set up boxes were not computers or machines within intended meaning of statute. The court gave great weight to the Tax Commissioner’s interpretation of the statute. After hearing expert testimony from both sides, the court found that the set-up boxes had the same primary purpose as converters – to deliver programming content. Therefore, the court upheld the Tax Commissioner’s ruling and held the set-up boxes were intangible and not subject to local tax.

B. Legislation

1. Effective Date: Pollution Control Property. Virginia Code §58.1-3667 provides that property certified by the DEQ as pollution control equipment is exempt as of the date the property was placed in service. This legislation effectively overrules the State Tax Commissioner who held that if paperwork certifying property as pollution control equipment is not dated on or before January 1, the tax day, the exemption is not available until the following year.

2. Interest on Refunds. For many years Virginia localities have attempted to eliminate the payment of interest on refunds, for example, by denying interest whenever the taxpayer was “at fault,” which would effectively deny interest on refunds claimed in an amended return. This year’s effort, House Bill 92, would have denied interest on refunds caused by the taxpayer’s “failure to file a license application or tax return prior to the deadline for filing;” that is, whenever the locality makes a “jeopardy assessment” which it collects but later cannot support. The Bill was
defeated in House Finance by a coalition of business organizations which successfully argued “to keep it simple,” by recognizing that interest is “for the use of money.”

3. **Electronic Tax Bills.** Virginia Code §58.1-3912 would be amended to permit local officials to transmit a tax bill electronically to a consenting taxpayer.

C. **Rulings of State Tax Commissioner**

1. **M&T versus Real Estate.** PD 16-54 (April 11, 2016). Taxpayer sought to reclassify certain of its equipment as real estate instead of machinery and tools. The Department holds that the local assessing officer must apply the three part test in *Danville Holding Corp. v. Clement*, 178 Va. 223 (1941) to determine whether the equipment is so affixed to the real estate as to be taxable as a real estate fixture. That test considers: (1) actual or constructive annexation to the real estate; (2) adaptation of the property to the purposes for which the building or realty is used; and (3) the intention of the parties making the annexation (the primary test). The Department rejected the locality’s argument that assets which are in fact machinery and tools must be taxed as such regardless of whether they are affixed to the realty.

   **Comment.** This ruling is contrary to the traditional view that the classification of machinery and tools cuts across personal and real property. Unless this ruling is overturned by the courts, it has the potential for changing significantly the way machinery and tools have been reported for local property tax purposes in Virginia.

2. **Mobile Property Tax.** PD 16-65 (April 29, 2016). The Department asserts that it has jurisdiction to review only the assessment of tax with respect to mobile personal property, in this case a trailer. Accordingly, it had no jurisdiction to review a locality’s refusal to abate penalties and interest when the taxpayer failed to file a return. **Comment.** Once penalties and interest have been assessed, there are several statutes that treat them as part of the tax in question. The Department, yet again, strains to find an excuse not to review local assessments whenever possible, notwithstanding statutes intended to provide taxpayers with a reasonable appeal procedure.

3. **Real Estate Appeal.** PD 16-13 (March 1, 2016). The Department of Taxation does not have jurisdiction to review matters involving the assessment of real property tax, in this case the valuation of a leasehold interest. Real estate taxes are not “local business taxes” appealable under Virginia Code §58.1-3983.1. The taxpayer’s remedy is an administrative appeal to the local assessing officer, to the Board of Equalization, or to the Circuit Court.
4. **Real Estate Appeals.** PD 16-25 (March 8, 2016). To the same effect as PD 16-13 above, the Department does not have jurisdiction to hear appeals involving the assessment of local real estate tax.

5. **Boat Taxation.** PD 16-42 (March 31, 2016). The Department does not have jurisdiction under Virginia Code §58.1-3983.1 (local business taxes) to review methods of valuation used for “mobile property taxes.” It does have jurisdiction, however, to review the situs for taxation of a boat. In this case, although the boat was in the locality for more than six months (as required by various Attorney General opinions) and was taxable as of January 1 unless a different situs can be proved. The taxpayer claimed situs in another Virginia locality, but did not pay personal property tax there. The boat was held taxable in the assessing locality.

IX. MISCELLANEOUS TAX

A. Rulings of the State Tax Commissioner

1. **Recordation Tax/Value.** PD 16-32 (March 18, 2016). Recordation tax is based on the greater of (i) consideration paid or (ii) actual value of property conveyed. The value of the property is a factual matter for the Clerk of Court to consider and ascertain. Case is returned to the Clerk to consider both the actual consideration paid for the property as well as an appraisal provided by the taxpayer.

X. TRENDS

**Addback Litigation.** The Virginia Department of Taxation’s interpretation of the addback legislation enacted in 2004 has been controversial, to say the least. At least three cases have been filed in Virginia trial courts. One case for Kohl’s (see IB above) has been tried, and the taxpayer has a petition for appeal that will be argued in October. The taxpayer’s position in each case is that the “subject to tax in another state” safe harbor is unambiguous and not subject to the distorted interpretation made by the Department of Taxation.

**Norfolk/Manufacturing.** The City of Norfolk has taken very aggressive audit positions aimed at taxing manufacturers. Distribution centers are deemed taxable if any sales activity arguably occurs there. Manufacturing plants are treated as taxable if, as is typical under federal regulations, title to materials passes before manufacturing is concluded. Several appeals are pending with the State contesting this interpretation.

PD 16-118 discussed in section VII (Business License Tax) above is a very important ruling for the entire defense industry in Virginia.

**Procedural Games.** Local tax authorities are increasingly trying to create procedural traps for businesses that seek to appeal local tax assessments to the State. Although
the State Tax Commissioner appears not to support these procedural games, it is vital for businesses to dot their procedural “i’s” in their appeals.

**State Appeals.** Although the State appeal process continues to provide a good way to challenge local audits of business taxes, the Virginia Department of Taxation is showing continued reluctance to provide taxpayers with the practical relief they need and deserve. Appeals are not decided but are “remanded” to the biased local officials. Rulings on issues deemed sensitive local tax issues are not issued but are referred to the local officials.

**Machinery & Tools Valuation.** Manufacturing and mining companies should expect to see litigation soon about how localities value machinery and tools. Although the Constitution of Virginia requires property to be taxed at fair market value, Virginia Code §58.1-3507(B) provides the basis for the machinery and tools tax as “depreciated cost or a percentage or percentages of original total capitalized cost excluding capitalized interest.” As reported above, the Attorney General opined that, “the term ‘original cost’ means the amount paid by the original purchaser of the equipment. Op. Va. Atty. Gen. No. 08-109 (February 25, 2009). This opinion was reaffirmed by the Attorney General in Opinion of the Attorney General of Virginia No. 14-018 (June 26, 2014). The problem arises when there is a current arm’s length sale of the property for a price substantially below the locality’s depreciated “original cost,” as defined by the Attorney General. Assessing based on what some purchaser paid decades before and ignoring a current sale price flies in the face of the constitutional mandate of assessments at fair market value.