Recent Tax Developments in Virginia: 2006-2007

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I. CORPORATE INCOME TAX

A. Legislation

1. Road Fix. After years of wrangling, the legislature and Governor have agreed on funding for Virginia’s transportation problem. The solution relies on a number of miscellaneous revenue sources, including increases in fines for traffic offenses and bonded indebtedness and a new sales tax on motor vehicle repair services in designated parts of the state. There is no “general” tax increase. It is most noteworthy that this legislation establishes the precedent of permitting designated areas of the state (in Tidewater and Northern Virginia) to approve a separate classification of business owned real estate from individual owned real estate and to impose a higher additional real estate tax on such property: Northern Virginia 25¢ and Tidewater 10¢.

2. Pass Through Withholding. No surprise, Virginia follows up its recent requirement that pass through entities file “information returns” with a requirement (SB 1238) that these entities withhold 5% of the allocable Virginia taxable income of all non-resident owners, to be claimed by them as a credit on returns filed by those non-resident owners.

3. Fixed Dated Conformity. HB 1696 moves Virginia’s conformity date to December 31, 2006.

4. Listed Transactions. HB 2920 now permits the Department of Taxation to create its version of a “listed transaction” by publishing a list of “abusive tax avoidance transactions.” If such a transaction is on the list, it extends the statute of limitations for assessment from 3 years to 6 years.

B. Rulings of the State Tax Commissioner

1. Telecommunications Company. P.D. 07-147 (September 12, 2007). During corporate income tax audit, telecommunications company discovered that its gross receipts as reported to the SCC had been overstated. Because statute of limitations for correcting errors by the SCC had expired, corporate income tax must be assessed on gross receipts as certified by the SCC, without adjustment.

2. Nexus/Internet Retailer. P.D. 07-24 (March 27, 2007). Retailer with no stores in Virginia sells tangible personal property via the internet. When orders are placed, they are fulfilled by an affiliated distribution center, one of which may be located in Virginia (if there is a favorable ruling). Risk
of loss and title pass from the distribution center to the customer upon delivery of the goods to a common carrier. Product returns are made to a distribution center outside Virginia.

With respect to income tax nexus, the Commissioner holds that the distribution center’s activities occur before the retailer has title to the property. This apparently permits the conclusion that the distribution center is not an “affiliated representative or an independent contractor acting on behalf of the retailer in Virginia.” As a result, the retailer owns no inventory in Virginia other than when it is in the process of being shipped. Accordingly, it has no property or payroll in Virginia, and therefore is not subject to Virginia income tax. The Commissioner also holds that all the actions do not go beyond “mere solicitation” and are protected by P.L. 86-272.

Similarly, the Commissioner holds that the distribution center is not an agent or subsidiary of the retailer. The work performed by the distribution center is for the benefit of the retailer, but the retailer does not control how the work is done. NOTE. The implication of this ruling is that the Commissioner would have held the retailer taxable in Virginia if the distribution center were its subsidiary versus its affiliate. Is the control of a subsidiary greater than the control of an affiliated entity? Or is this just adherence of the strict wording of Virginia’s statute that specifically refers to a subsidiary?

Observation. It looks like Virginia will get the economic benefit of having a distribution center for this affiliated group locate in the Commonwealth.

3. Pass Through Entity. P.D. 06-85 (August 25, 2006). Income received from an LLC which conducted all of its business in Virginia and was organized under Virginia law is Virginia source income. That income passes through to its members who then have liability for Virginia income taxes. The fact that income related to a lawsuit brought in another state does not mean that income was not from Virginia sources.

4. Pass Through Entity. PD 07-50 (April 26, 2007). A partnership in State A has two 50% equity partners. The general partner is an individual who resides in State B. The limited partner is a State B corporation. The partnership purchased commercial property in Virginia under a triple net lease. Neither the partnership nor the partners conduct any other business in Virginia other than the ownership of the Virginia commercial property. The income generated by the commercial property will retain its character as Virginia source income and pass through to both the general and limited partners, which are taxable entities. As such, the general partner will need to file a nonresident Virginia individual income tax return and the limited partner will need to file a Virginia corporate income tax return.

5. **Nexus/Va Corp.** P.D. 06-75 (August 23, 2006). Even though qualified to do business in Virginia and registered with the Department of Taxation, corporation was not subject to Virginia income tax. It is required to file a Virginia return (a separate return, not as part of a consolidated group because it has no nexus) but that does not make it subject to Virginia tax because, under the facts presented, it had no positive apportion factors in Virginia.

   Virginia’s payroll factor is determined based on compensation reported to the VEC. The procedures of the VEC do not provide for a “common paymaster” system. It is the taxpayer’s burden to prove that amounts reported to the VEC are incorrect.

6. **Nexus.** P.D. 06-76 (August 23, 2006). Officer of subsidiary was located in Virginia, but his salary was paid by parent corporation. The Department refused to treat this subsidiary as having income from Virginia sources because it did not have a positive payroll factor. It even refused to accept amended VEC payroll returns because “they had not been accepted by the VEC.”

7. **Nexus/Holding Co.** PD. 06-111 (October 10, 2006). Taxpayer had a subsidiary holding company which had no offices or employees anywhere. All of its books, records, and affairs were managed by the parent in Virginia. Taxpayer took inconsistent filing positions, including this holding company in the Virginia combined return in a year when it had a loss, but not otherwise. After taxpayer agrees to file its returns consistently, Commissioner holds that holding company has its “commercial domicile” in Virginia where its affairs are managed. Thus, it is properly included in the combined return for all years.

8. **Nexus/Collection Agency.** P.D. 06-114 (October 11, 2006). Out-of-state collection agency conducted its business on behalf of Virginia based customers by telephone and letter. When these collection efforts did not produce results, it retained local counsel. As long as the local help retained by the out-of-state company is an independent contractor, Commissioner rules that company does not have nexus with Virginia. (1) Virginia applies PL 86-272 to service businesses. (2) Company has no positive apportionment factors in Virginia.

9. **Lottery/Nexus & Withholding.** P.D. 07-119 (July 19, 2007). Corporation with no employees or property in Virginia purchased lottery annuities. Commissioner confirms that corporation has no nexus with Virginia and no liability for Virginia income tax on this Virginia source income. Nevertheless, the Lottery Commission is required to withhold from
payments unless corporation files an appropriate exemption certificate annually.

10. **Nexus PL 86-272.** PD 07-51 (April 26, 2007). Taxpayer is incorporated in Maryland and acts as a commission-based sales service. It has elected to be taxed as an S corporation. The Taxpayer employs one sales representative who resides in Virginia and solicits sales of tangible personal property on behalf of the Taxpayer's third-party clients. The employee receives a salary for the first six months of employment and commissions thereafter. Taxpayer does not have an office in Virginia, nor does it own or lease any real or tangible personal property in Virginia. It does not advertise within Virginia and does not maintain bank accounts, telephone directory listings or building directory listings in Virginia. The employee solicits sales orders from the third-party client's customers and remits the order forms back to the client's office. The Taxpayer does not take or hold title to any products for which it solicits sales. The Taxpayer does not approve sales orders and does not provide any financing services or collection of accounts receivable. The Taxpayer does not accept customer deposits on the sales of tangible personal property.

Some of the Taxpayer's clients offer product service agreements that are sold as an add-on. If a client's customer is interested in purchasing an agreement, the Taxpayer's employee relays the request to the client. The Taxpayer receives a commission on the sale of the service agreement. In addition, some of the Taxpayer's clients offer vendor financing. In these situations, the Taxpayer's employee serves as a conduit by relaying information about financing terms between the vendor and the customer. The employee earns an additional commission for providing this service.

The Taxpayer's employee is selling tangible personal property on behalf of third party clients, not for his employer. As such, this activity for purposes of the Taxpayer constitutes a business service, not the mere solicitation of sales. If the employee were selling tangible personal property on behalf of his employer, then that activity would constitute the solicitation of sales protected by P.L. 86-272. Moreover, these services do not qualify for the de minimis exception in Wrigley, as the employee performs this service on a regular basis. As such, the Taxpayer has nexus with Virginia and is subject to Virginia income tax.

11. **Nexus/Income Reallocation.** P.D. 06-107 (October 5, 2006). The stock of Corporation A, a manufacturer operating wholly outside Virginia, was owned by Corporation B, a holding company operating wholly outside Virginia. Even though the ultimate parent provided some small services for Corporation B, the Commissioner holds that combining the incomes of the taxpayer and Corporations A and B was improper because there was no distortion of Virginia taxable income possible when the two corporations in question did not operate in Virginia.
12. **Corporate Group/Guarantees.** P.D. 07-116 (July 19, 2007). Corporate affiliates provided lease guarantees for related retail stores located in Virginia. Commissioner holds that these lease guarantee activities are *de minimis* under PL 86-272 also applied by Virginia to sales of services. No nexus of the out of state entities with Virginia. To the extent that guarantees are provided by entities with Virginia nexus, all services related to the guarantees provided outside Virginia so the services are included in the denominator of the sales factor but not the numerator. Commissioner notes Department’s ability to reallocate income if there is a determination that fee arrangements are not based on fair market value, etc.

13. **Add back/Subject to Tax.** P.D. 07-153 (October 2, 2007). This is the first ruling of the Department concerning the “add back” legislation enacted in 2004. One statutory exception to the add back requirement provides:

   This addition shall not be required for any portion of the intangible expenses and costs if ... the corresponding item of income received by the related member is subject to a tax based on or measured by net income or capital imposed by Virginia, another state ...

   Tax practitioners who lobbied this legislation thought that it provided a simple exception to add back whenever the royalty payment would be subject to tax in another state. The Department, however, reads the exception as if the statute provided “no add back shall be required to the extent that the payment is actually taxed in another state.” Thus, the ruling holds that a taxpayer is allowed a deduction (no mention of deduction in the statute) equal to the royalty payments multiplied by the total of the apportionment factors in the states where the recipient is subject to an income tax. For example, if the recipient pays income tax in two states, and has a 2% and 3% apportionment factors in those states, it can deduct 5% of the royalty payment on its Virginia return. **Comment:** How does the Department conclude that statutory language stating that there shall not be any add back for “any portion” of an expense really means that there is a deduction only for the portion of the expense that is taxed by another state? Can Virginia make its tax depend on actions by another state?

14. **Interstate Destination.** P.D. 06-86 (August 30, 2006). The Department has long recognized that goods delivered to a customer for immediate transportation out of state are not “Virginia sales” for purposes of the sales factor. In this ruling, a Virginia manufacturer leased space at its refrigerated loading dock where its primary customer accumulated purchases which it then transported out of state. The fact that the
customer leased space at the loading dock made these deliveries “Virginia sales.”

15. **Apportionment/Gain.** P.D. 06-130 (October 25, 2006). Capital gain from the sale of stock was properly included in numerator and denominator of Virginia apportionment factor. Even though corporate headquarters was outside Virginia, evidence showed that all the income producing activity resulting in the capital gain occurred in Virginia.


17. **Sales Factor/Satellites.** P.D. 07-80 (May 19, 2007). Sale of satellites by joint venture resulted in an increase in the denominator of the Virginia sales factor, but not the numerator. The satellites were not located in Virginia.

18. **Franchisor/Sales Factors.** P.D. 07-121 (July 31, 2007). Income earned by out-of-state entity from Virginia franchisee was included by the auditor in the numerator of the sales factor on the theory that this income was from selling tangible personal property (e.g., training manuals and marketing catalogs). Wrong. Income was from services, not tangible personal property. Because services were performed primarily out-of-state, they are excluded from the Virginia numerator.

19. **Intercompany Transaction/Apportionment Factors.** P.D. 06-88 (September 19, 2006). Because intercompany rents and intercompany sales are eliminated in a consolidated return, those rents and sales must also be eliminated from the apportionment factors.

20. **Alternative Apportionment/Pass Through.** P.D. 07-75 (May 18, 2007). Taxpayer owned a partnership interest which held interests in various other pass through entities, one of which recognized gain on the sale of real estate in Virginia. Even though doing so would increase its Virginia income tax liability, taxpayer sought alternative apportionment method to separately account for the Virginia real estate gain. Permission denied because (i) Department’s method not unconstitutional and (ii) Department will not change apportionment method if the alternative method increases taxpayer’s liability in Virginia.

21. **Alternative Apportionment.** P.D. 07-117 (July 19, 2007). Procedure for applying for an alternative apportionment method requires the taxpayer to file its return using the statutory method and then file an amended return
proposing the alternative method. Taxpayer must show that the statutory method produces an unconstitutional result or, because of Virginia law, produces a double tax.

22. **Alternative Apportionment/Real Estate.** P.D. 07-118 (July 19, 2007). Hotel owned by a pass through entity in Virginia was managed by an unrelated company. Taxpayer asserts that hotel entity should pay Virginia tax on a separate accounting basis, i.e., that the income, losses and factors should not flow through to the LLC owners. Relying on conformity with federal law, Commissioner holds that LLC is treated as partnership and results flow through. **COMMENT:** This and other rulings suggest that taxpayers are lining up to challenge Virginia’s ability to tax entity income on a flow through basis to “shareholders.” Why should LLCs be treated differently than C corporations? Will tax withholding change these dynamics?

23. **NOL Carryovers.** P.D. 07-120 (July 31, 2007). Consolidated group plans to eliminate through liquidation or reorganization affiliates having NOLs. Some of these affiliates are not members of the Virginia consolidated group. Nevertheless, Department holds that these NOLs, to the extent they become part of the federal consolidated return, can be used in the Virginia consolidated return even though they were “earned” by entities having no nexus with Virginia.

24. **Agricultural Credit Associations.** P.D. 06-125 (October 3, 2006). Discusses the state taxability of agricultural credit associations and federal land bank associations. A limited exemption was acknowledged for the ACA based on how IRS had characterized its income. Otherwise, state tax immunity denied.

25. **Claim of Right.** P.D. 06-141 (December 4, 2006). Under IRC § 1341, a taxpayer can (i) reduce the tax for the year of the repayment by the amount of tax attributable to the inclusion of income in the previous year or (ii) deduct the amount repaid in the year of the repayment. The Commissioner agrees that Virginia will conform to these options so that a claim of right repayment will be considered a timely payment for Virginia income tax purposes.

26. **Land Credits/Transfer.** P.D. 07-1 (January 9, 2007). 2002 legislation authorizing transfer of land preservation tax credits was originally limited to transfers made after January 1, 2002. Exception allowed in 2005 for taxpayers who received erroneous advice from the Department. Commissioner holds that taxpayer cannot claim that instructions to tax returns were erroneous advice because those instructions clearly stated the January 1, 2002 date.

27. **Historic Tax Credits/Purchase.** P.D. 07-82 (May 25, 2007). GCAM 2007-002 addressed the treatment for federal tax purposes of partnership which
allocated credits to partners who promptly sold their partnership interests. IRS held that taxpayers would be deemed to have acquired their credits from the partnership by purchase. State Tax Commissioner rules that federal tax consequences will flow through to the Virginia return, but taxpayer would be allowed to claim any Virginia income tax credits “purchased” by them.

28. Land Preservation Credits/Queue Priority. P.D. 07-95 (May 25, 2007). The amount of land preservation tax credits that can be claimed is limited by statute. The Department of Taxation will apply a first come first served analysis to allocating these credits, but will not place an application in the queue until the DCR has verified the donation. **COMMENT:** The early bird gets the worm.

29. Land Preservation Tax Credits/Limitation. P.D. 07-131 (August 17, 2007). The $100,000 limitation on land preservation tax credits is a **per taxpayer** limitation, not a **per return** limitation. Thus, each member of an affiliated group filing a single consolidated return was entitled to claim a credit of up to $100,000. Note carefully that each member of the group had its own credit.

30. Underpayment Penalty. P.D. 07-54 (May 4, 2007). Underpayment penalty waived. An extension was filed after the weekend due date, but that filing deadline is automatically extended by statute to the next business day.

31. Officer Liability/Statute of Limitations. P.D. 07-90 (May 25, 2007). Tax Department “converted” corporate income tax assessments against corporate officer who then appealed those converted assessments over two years later. Commissioner holds that taxpayer missed his 90 day filing deadline for an administrative appeal. **COMMENT:** Note that this taxpayer still had, as of the date of this adverse ruling, time to file in court. Does it make any practical sense for the Commissioner to refuse to resolve these cases administratively?

32. Appeal/Statute of Limitations. P.D. 07-93 (June 1 2007). Taxpayer missed by one day the deadline for filing its 90 day administrative appeal. **COMMENT:** Keep in mind that taxpayers have a variety of other remedies available to them, though these may involve payment of the tax.

33. Withholding Ship Crews. P.D. 07-115 (July 19, 2007). Commissioner reviews federal statutes governing state income tax withholding on wages paid to crewmen of boats operating in navigable waters. Under these statutes, Commissioner concludes that the taxpayer should look to employees’ state of residence for withholding requirements. Commissioner goes on, however, to decline to rule concerning Virginia withholding requirements with respect to the taxpayers’ non-resident employees, saying that there is a conflict in the federal statutes when a
non-resident earns more than 50% of his pay in Virginia. **COMMENT:** Why did the Commissioner leave this taxpayer in a quandary? Who better to rule about Virginia income tax withholding than the Virginia State Tax Commissioner?

II. INDIVIDUAL INCOME TAX

A. Cases

*Di Belardino v. Commonwealth,* (Case No. CL06-5696) and *Dutton v. Commonwealth,* (Case. No. CL06-6291, Cir. Ct. City of Richmond (June 22, 2007). Di Belardino and Dutton were “investor members in a Delaware LLC doing business in Virginia. Neither is a Virginia resident. Dutton, however, owned certain rental real estate in Virginia. The LLC settled litigation relating to a patent, and this resulted in income to the LLC. The Department took the position that even though this income was from the settlement of litigation in another state, it is Virginia source income because the LLC is managed, directed and controlled from Virginia. The Department then took the position that this income flows through to its nonresident members.

The trial court is unclear in its opinion whether the income from settling the patent litigation is income from an intangible used in a trade or business in Virginia. Nevertheless, it focuses its opinion on whether Virginia, as a constitutional matter, has sufficient nexus with the two taxpayers. It holds that Dutton, who also owned real estate in Virginia, had sufficient nexus for Virginia to tax. But it holds that Di Belardino, who had no contacts with Virginia aside from owning the investment interest in the LLC, does not have sufficient nexus to be taxed. The taxpayers and the Commonwealth have noted possible appeals.

B. Rulings of the State Tax Commissioner

1. **Apportionment.** P.D. 07-106 (July 2, 2007). Taxpayer earned commissions representing real estate buyers, some of whom purchased real estate in Virginia. Commissioner rules that apportioning income to Virginia is not necessarily based on days spent working in Virginia. Truck drivers apportion based on the ratio of miles driven. Department believes the most equitable way for a sole proprietorship to apportion income is based on the location of sale to revenues, or a single sales factor. In the case of real estate sales, it is the location of the real estate.

2. **Apportionment.** P.D. 07-130 (August 18, 2007). Out-of-state S corp provides services in Virginia for an unrelated third party. Stockholder is sole employee of corporation. S corp’s Virginia source income is determined using standard three factor formula, and that portion of its income flows through to its S corp stockholder. Wages paid to that stockholder are prorated to Virginia based on days spent by that salesman/employee in Virginia.
3. **Domicile/Military.** P.D. 07-53 (May 4, 2007). Under the Soldiers and Sailors Civil Relief Act, military personnel do not abandon their legal domicile solely by complying with orders that take them to a new state or country. Thus, there will be no presumption of Virginia tax liability for a soldier or sailor posted here unless there is evidence of an intent to abandon the former domicile.

4. **Military/Civilian Employee.** P.D. 07-69 (May 10, 2007). Did husband and wife become Virginia residents when they were transferred here for eighteen months of training as “student/interns with the US Army”? No property, family, rented or owned home in Virginia. They did file Virginia income tax returns, but they also filed returns in their former home state. Problem was that they listed a Virginia address on their passport applications. Commissioner rules that this simple declaration of intent was not sufficient to make them Virginia residents.

5. **Domicile.** P.D. 07-78 (May 18, 2007). Taxpayer owned a car in Virginia, a home in Virginia and filed a resident income tax return. Commissioner holds that taxpayer has not proved that he had permanently abandoned his Virginia domicile since he retained both car and home in Virginia and overseas assignment did not appear to be “permanent.”

6. **Domicile/Hospital.** P.D. 07-105 (July 2, 2007). Taxpayer who spent three months a year in Virginia was hospitalized in Virginia. Commissioner holds that notwithstanding involuntary nature of hospitalization, that is a place of abode and he was an actual resident because he spent more than 183 days in the state. Showing a little compassion, however, Commissioner holds that he was not a domiciliary resident the following year because a previous audit had established his domicile in another state, no basic facts had changed, and holding a valid Virginia drivers license was consistent with his actual residence (in hospital) the previous year.

7. **Domicile/Proof.** P.D. 07-136 (September 4, 2007). State employee held to be a Virginia resident (i) because employees are supposed to work at their home office (for more than 183 days per year) and (ii) because employee failed to provide requested documentation.

8. **Domicile.** P.D. 07-144 (September 12, 2007). Inconsistent facts concerning residence in Virginia, where taxpayer was employed to work with a company that went bankrupt. Commissioner recounts Virginia residence, shared with girlfriend, which was subleased to girlfriend, who later moved in with taxpayer when he finally purchased a Virginia home. Held a Virginia resident.

9. **Domicile Change/Timing.** P.D. 07-99 (June 27, 2007). Even though taxpayer claimed he began the process of moving to a new state in August, the first affirmative act in that process was not reflected until December 1 when he signed a lease on a residence there. With respect to a lump sum
payment allegedly made by a related entity in Virginia for “future services” outside Virginia, the Commissioner finds that the payment distorted Virginia taxable income and did not reflect an arm’s length payment.

10. **Domicile/Refunds.** P.D. 07-89 (May 25, 2007). Commissioner agrees with holding of Tax Court in another state that taxpayer had never abandoned her domicile there. She retained home, husband, cars and boat in that state. Commissioner holds that effective July 1, 2006 the provisions of Virginia Code § 58.1-312A(4) allows a taxpayer to apply for a refund within one year “from the final determination of a change made by any other state … to request a refund resulting from credits for taxes paid to other states.” Until the other state’s Tax Court had ruled, there was no “final determination.” **Comment:** The Commissioner has appeared to reach a very fair result in this ruling even though the statute cited does not appear to provide for refunds.

11. **Refunds/Limitations.** P.D. 07-6 (January 15, 2007). Taxpayer who mistakenly paid income tax to Virginia instead of Maryland was barred by the statute of limitations from obtaining a refund of those overpayments. Maryland’s right to audit was longer than the Virginia Commissioner’s right to allow refunds.

12. **Statute of Limitations/Erroneous Refund.** P.D. 07-102 (June 27, 2007). Tax Department approved a refund in May, 2004 which was credited to taxpayer’s 2004 estimated payments. The Department determined on November 6, 2006 that this credit was incorrect. Although the error correction appears to be outside the usual two year statute of limitations, Commissioner asserts (i) that two year statute of limitations applies only when there has been a clerical or processing error and (ii) a five year limitation period applies when there has been a misrepresentation of fact by the taxpayer “including inadvertent taxpayer errors.” Because credit claimed was contrary to instructions, Commissioner holds that five year statute of limitations is applicable.

13. **Statute of Limitations.** P.D. 07-114 (July 19, 2007). Administrative appeal rejected because not filed with 90 days of the assessment.

14. **Statute of Limitations/Counting Days.** P.D. 07-133 (August 24, 2007). Taxpayer did not file a timely administrative appeal. Taxpayer’s appeal was timely dated, but its delivery service showed that delivery was made three weeks late.

15. **Domicile/Pass Through Entity.** P.D. 07-148 (September 12, 2007). Firm engaged in an insurance brokerage business claimed at the Virginia address shown on its returns was simply where its accountant was located. Department reviewed the facts and concluded that some of its business was conducted in Virginia, and it owned an automobile registered in
Virginia. Accordingly, corporation was required to apportion its income using its three-factor formula. Employees/members of the entity required to report their share of entity's Virginia source income.

16. **Virginia Source Income/Loans.** P.D. 07-101 (June 27, 2007). Loans to related entities provided for interest based on a percentage of net sales. This so-called “interest” was treated as a guaranteed payment by the IRS. Taxpayer failed to provide information showing to the contrary. Income from these “loans” held to be Virginia source income.

17. **Withholding/Professional Athlete.** P.D. 07-59 (May 10, 2007). How an athlete assigned to a minor league team in Virginia is taxed depends on (i) whether he is a resident or nonresident of Virginia and (ii) the type of income in question. The athlete may be an “actual resident” depending on the number of days spent in Virginia. Nonresidents pay tax based on the ratio of Virginia source income to total income. Signing bonuses are not deemed to be Virginia source income unless the bonus requires the player to perform services in Virginia. Salary is attributable to Virginia based on time working in Virginia versus outside Virginia.


19. **Nonresident Credits/LLPs & LLCs.** P.D. 07-70 (May 18, 2007). Only taxes paid to another state on earned or business income from sources outside Virginia qualifies for the out-of-state tax credit. This ruling sets forth the general rules for when income from an LLP or LLC engaged in real estate activities qualifies for the credit. As a general rule, income from an LLC will qualify. Income paid to general partners who do not materially participate in the conduct of business will not qualify. Note statutory change applicable to the sale of a capital asset occurring after 1999.

20. **Land Preservation Tax Credit/Park Service.** P.D. 07-132 (August 24, 2007). Notwithstanding vagaries in the statute, Commissioner accepts a bargain sale to the National Park Service as a conveyance that will qualify for the Land Preservation Tax Credit.

21. **Investment Partnership.** P.D. 07-77 (May 18, 2007). A pass through entity that invests solely in intangible property such as stocks and bonds and that has no employees and no real or tangible property is not carrying on a trade or business. This is so even if the general partner resides in Virginia and the investments are managed by a corporation with offices in Virginia. Although that general partner and corporation will be subject to Virginia income tax, the nonresident partners are not and the investment partnership need not file a Virginia income tax return.
III. RETAIL SALES & USE TAXES

A. Legislation

1. Sales Tax Holidays. Two new sales tax holidays were enacted in 2007. HB 1678 allows “energy efficient products” with a sales price of $2,500 or less to be made exempt on the first Friday, Saturday and Sunday in October in each year. SB 1167 allows “hurricane preparedness equipment” to be purchased during a seven day period beginning on May 25 of each year.

B. Court Decisions

1. Intersections Inc. v. Virginia Department of Taxation, 2006 Va. Cir. Lexis 213 (Cl 2005-4731, November 8, 2006). Taxpayer licensed certain software which was necessary to its credit reporting services. The software gave the taxpayer access to data and information and various services provided by the licensor of the software. Court holds that true object of the transaction was to gain access to the “seller’s data monitoring, analysis and delivery services.” Accordingly, contract was for the purchase of a service and not subject to use taxation.

2. Bloomingdale’s Inc. v. Department of Taxation, Cir. Ct. City of Richmond, Case No. CL-05T00891-00-1/07-3860 (August 7, 2007). This case reverses the Department of Taxation’s policy, unique in the United States, that sales are taxable in Virginia if they are delivered outside Virginia to anyone but the purchaser. In recent years, the Department has applied this position whenever an order is accepted and payment is processed at a location in Virginia even if the goods are never in Virginia. The policy affects primarily gift transactions shipped to donees out-of-state. The Circuit Court held that the transactions were not taxable in Virginia because title and risk of loss remained with the retail merchant until the goods were delivered out-of-state. The Circuit Court also held that the transactions qualified for the interstate sale exemption which contains no requirement that the goods be delivered “to the purchaser.”

3. Gibson v. Commonwealth, 649 S.E.2d 214 (Ct. Apps., August 28, 2007). Corporate officer filed truthful and appropriate returns reporting sales tax collections from customers and employee withholding taxes. He failed to remit those “trust fund” taxes. Court of Appeals upholds his conviction of three Class One misdemeanors. The statute makes it a crime for a corporate officer to fail to “account for and pay over” certain trust fund taxes. Failing either to account for the taxes accurately or pay them over is a crime. One cannot avoid conviction simply by filing an accurate return but not paying the taxes.
4. *GFT, Inc. v. Commonwealth*, Cir. Ct. City of Richmond, Case No. CL06-7245-00 (April 16, 2007). Taxpayer was assessed successor liability with respect to unpaid sales and use taxes of a business, the assets of which it bought at a foreclosure sale. Virginia Code § 58.1-629 requires the purchaser of a business’ assets to withhold from the purchase price sufficient funds to pay any unpaid taxes or to obtain a certificate of no taxes due from the Department. It is not the Department of Taxation’s burden to prove that such taxes were not withheld. It assessed the successor in interest for the unpaid taxes, and it is that person’s burden to prove that the assessment is incorrect.

C. Regulations

The Department has issued emergency regulations to implement the new policy enacted effective July 1, 2006 with respect to government contracts. Under the Department’s previous policy, a government contractor was not permitted to purchase tangible personal property for resale (and eventual exempt sale to the government) under a contract that the Department deemed to be for services. A hard fought amendment to the Budget Bill directed the Department to “cease and desist” in this interpretation and to make its analysis of taxability at the “order level,” not at the contract level. Effective on and after July 1 2006, separate orders issued by the government for purchases of tangible personal property can be purchased for resale (and eventual exempt sale to the government) even if the order is made under a contract for services. Note that this happy reversal in policy does have a dark side in that contracts primarily for the sale of property will also be analyzed at the “order level” with the result that no property can be purchased for resale under an order that is primarily for services.

D. Rulings of the State Tax Commissioner

**Taxable Transactions & Measure**

1. **First Use.** P.D. 07-17 (March 27, 2007). Manufacturer shipped tools to Virginia which were then used at locations throughout the United States. The tools were apparently used to service product, not directly in the manufacture of product. Commissioner holds that “first use” was in Virginia and that subsequent shipment out-of-state does not relieve taxpayer of imposition of the use tax.

2. **Barter Transactions.** P.D. 07-94 (June 1, 2007). Barter transactions are taxable. Tax is the ultimate responsibility of the buyer, not the seller.

3. **Intercompany IT Services.** P.D. 06-105 (October 5, 2006). Taxpayer provided IT services to affiliates. Because the taxpayer owned, managed and operated the equipment at issue, monthly charges for those services were deemed to be nontaxable.
4. Frequent Stayer Points. P.D. 07-12 (March 23, 2007). Chain hotel awards “guest loyalty points” to frequent stayers. Each hotel contributes to a segregated bank account a percentage of its gross receipts. When royalty points are redeemed, the hotel receives cash from the fund. The redemption of royalty points for a complimentary room is not subject to sales and use taxation. Moreover, the payments from the fund to the hotels are not subject to tax as the payments are not made in exchange for the use of a hotel room by the user and, more importantly, these funds were taxed on the original room rental transactions.

5. True Object. P.D. 06-119 (October 17, 2006). Taxpayer purchased expense management services that were accessed via the vendor’s website. At yearend, taxpayer was provided a CD with expense reports for the year. Commissioner concludes that the true object of the transaction was the acquisition of the professional services and expertise of the vendor to manage the taxpayer’s expense report and reimbursements. No sales tax applicable.

6. Government Contracts/True Object. P.D. 06-62 (August 7, 2006). Audit appeal covers full range of government contracts and Department’s position that personal property purchased under a contract for the rendition of services cannot be purchased as an exempt resale and is always taxable to the contractor. In one classified contract, contracting officer refused to let Department employees with appropriate security clearances review statement of work for contract. Unless such permission is granted during a 45 day extension, assessment of tax will be upheld.

7. True Object/Operate System. P.D. 07-98 (June 27, 2007). When true object of the contract is for services, contractor is the user and consumer of all tangible personal property provided. Note rule change as of July 1, 2006. Second contract in audit was unrelated to the first contract and should be analyzed individually. Services provided under that contract to operate equipment were “of incidental scope and duration.” Commissioner holds that subcontract was for the sale of tangible personal property. Comment: This could be an important ruling under the new regime in effect on and after July 1, 2006. Traditionally, the Department has considered sellers taxable when equipment sold was operated by them (e.g., computer centers). This ruling appears to establish a “incidental” test that will surely be applied in the future.

8. Federal Purchasing Agent/New Law. P.D. 07-139 (September 5, 2007). The new rules in effect July 1, 2006 with respect to the application of the “true object” test to government contractors do not change the way that duly authorized purchasing agents are taxed.

9. Services/Home Infusion Pharmacies. P.D. 07-14 (March 26, 2007). Home infusion companies held to be engaged in selling medicines, not providing services. Thus, exemptions not lost.
10. **Airline Food Service.** P.D. 07-143 (September 12, 2007). Reviews a long list of services provided by a catering company. Because majority of services were with respect to airline owned property and equipment (e.g., cleaning and servicing), were unrelated to the sale of food, and were separately stated on invoices, held not taxable.

11. **Equipment Rental with Operator.** P.D. 07-128 (August 17, 2007). Upon reconsideration, the Commissioner agrees that the rental of a mechanical bull and rock climbing wall, both with operators, are nontaxable services. The operators have sophisticated skills and computer knowledge and are not mere attendants as previously ruled.

12. **Government Contracts/ID/IQ.** P.D. 06-83 (August 25, 2006). It was unclear from the statement of work in this contract whether the taxpayer would be providing primarily services or tangible personal property. Under these circumstances, the Commissioner holds that it is appropriate to look at individual task orders and apply the true object test at that level. Commissioner confirms Department's previous position that amnesty penalties will apply even to taxpayer who did not know it had underpaid the tax. Assessment of interest at the “large corporate underpayment” rate was corrected.

13. **Government Contract.** P.D. 06-137 (October 30, 2006). Items purchased under a task order for various engineering services held to be used and consumed by the government contractor. This was so even though the items were delivered directly to an Army warehouse and were never used or consumed as part of the taxpayer’s services. The Commissioner asserts that taxing such items (i.e., denying a resale exemption) is consistent with the holding in *United States v. Forst* “in which the court held that the resale exemption was inapplicable to a government contractor, which was the final consumer of items provided in the performance of its contract with the US.” **Comment.** The Department should be careful in how it characterizes court holdings. A munitions manufacturer under contract with the government was in fact allowed to purchase all of its equipment and supplies used in the manufacturing process under what many would characterize as a traditional “resale” exemption. The manufacturer was, in fact, held taxable on administrative supplies, desks, chairs and other items for which it could be fairly characterized as the “user and consumer” even though title to those items vested immediately in the government.

14. **Modular Construction.** P.D. 06-104 (October 5, 2006). Taxation of “mobile offices” is administered by the DMV. Modular construction is taxed to a real estate contractor (i.e., one who installs the building) at 60% of the sales price times the tax rate.

15. **Direct Pay Permits/Contractor.** P.D. 07-20 and P.D. 07-21 (March 27, 2007). Person providing painting and sand blasting services is a contractor. The fact that the contractor provided a direct pay permit (e.g.,
by a manufacturer) does not obviate the fact that the contractor is taxable on all materials it uses in performing its contract.

16. **Contractor/Direct Pay Permit.** P.D. 06-92 (September 19, 2006). Real estate contractor performed work for entity authorized to provide direct pay permits, and purchase order provided permit number. Nevertheless, a contractor was the user and consumer of all construction materials. Only “dealers” can take a direct pay permit number.

17. **Real Estate Contractor/Direct Pay Permit.** P.D. 07-124 (August 17, 2007). Even though manufacturing customer gave real estate contractor a direct pay permit number, real estate contractor was required to accrue and pay tax on all of its purchases. If manufacturer did pay the tax, it is entitled to a refund; the contractor is not.

18. **Real Estate/Telecom Installations.** P.D. 06-131 (October 25, 2006). Taxpayer had contracts with both a public school system and the federal government to sell and install telecommunication systems, including cables and other structures in building crawl spaces. Commissioner recognizes that a sale of a telecommunication system is a sale of tangible personal property, but holds that seller must pay tax on all equipment and supplies used in the installation. Even the wiring and cabling, etc. are held to be “installation materials” that become part of the real estate and are not resold to the governmental entity. **Observation.** Note that the Commissioner has found a way to divide what appears to be single purpose contracts into multipurpose contracts and tax the alleged components separately. Is this consistent with the Department’s traditional application of its “true object” test?

19. **Contractors/Credits.** P.D. 07-135 (September 4, 2007). Taxpayer erroneously treated sale of cabling installed in buildings as a retail sales, charging tax to its customers. Commissioner refuses to allow a credit against the contractors use tax for the taxes erroneously collected. Previous ruling allowing such a credit reversed.

20. **Real Estate Fixture.** P.D. 07-81 (May 18, 2007). Racking system used in industrial warehouse was held not to be part of the real estate. Even though the system was anchored to the building with concrete and epoxy anchors which would have to be cut to remove the racks (and the holes filled in with concrete), the Commissioner holds that “racks are trade fixtures that come and go as the building’s use changes and its ownership changes.” Thus, the racking system was held not to be a permanent improvement to the real estate.

21. **Contractor/Retail Sales.** P.D. 07-111 (July 19, 2007). In a change of tactics, auditor tried to assess real estate contractor with sales tax with respect to (i) partitions installed in a government building and (ii) signage.
Commissioner holds that both items are integral parts of the real estate and not sales of tangible personal property that should have been taxed.

22. Contractor/Nurseryman. P.D. 07-67 (May 10, 2007). Contractor renovating golf course was deemed to be in two businesses: (i) retailer with respect to the sod, shrubbery, etc. that it sold as part of renovation and (ii) contractor/service provider with respect to other services. Sales tax should have been charged on cost of plant material. COMMENT: On what basis does the Department apply this rather unusual dual status to this form or real estate contractor? Why should other contractors be treated differently?

23. Retailer versus Contractor. P.D. 07-108 (July 6, 2007). Company that fabricates granite and marble countertops and installs those countertops will be classified as either a retailer or contractor based on a 50% of gross receipts test. The test is applied annually. Only if the taxpayer is principally a retailer can it obtain a direct pay permit to permit all material purchases to be made initially exempt. Commissioner declines to treat this company under the exception to the contractor’s sales tax for persons “selling and installing cabinets, kitchen equipment and other like items.” Comment: Why? This would seem to be exactly the sort of situation the General Assembly thought should be treated under the retailer rules to produce a fair result.

24. Real Estate Contractor. P.D. 07-84 (May 25, 2007). Taxpayer sold and installed bank equipment, some of which became part of the real estate after installation. Taxpayer was taxable consumer of the equipment that it installed as part of the real estate or furnished in connection with the provision of monitored services. It was also assessed consumer use tax with respect to items permanently installed for exempt banking customers such as federal credit unions. As a real estate contractor, taxpayer could not purchase items for resale exempt to a federal entity.

25. Software/Electronic Delivery. P.D. 07-22 (March 27, 2007). To qualify for the electronic delivery “exemption,” contracts and other sales documentation must specify a method of delivery. That delivery must be in electronic form and not permit the additional provision of any tangible medium. Failure to provide a delivery method will result in taxation.

26. Internet Software. P.D. 06-103 (October 5, 2006). Taxpayer provided software to customers via the internet. This included documents that were scanned by a third party and then stored on the taxpayer’s system where they were accessed by customers. Because the customers never received the data in hard copy, but only via the internet, the transactions with the customers were not taxable.

27. Software/Separate Contracts. P.D. 07-92 (June 1, 2007). Taxpayer executed separate contracts for the sale of computer software and services
related to the installation, testing and training with respect to that software. Commissioner's ruling appears to feel free to ignore the separate contract and tax labor components from the "services contract" that taxpayer cannot prove were unrelated to the sale of the computer software. For example, labor charges for "testing" could be attributable to either taxable or exempt software; therefore, they are taxable.

Subcontract. Even though signed on same day, contract between purchaser, prime contractor and subcontractor was recognized as separate and distinct billing arrangements. Accordingly, services provided to software purchaser held not taxable. Vendor of software was apparently subcontractor to services provider.

LOI. Taxpayer provided "gap analysis" under a Letter of Intent that eventually led to the sale of software. Because the LOI was clearly separate from any future license agreement, it stands on its own for sales and use tax purposes. Service is not taxable.

Foreign Sales. License fees charged to foreign affiliates not subject to Virginia tax. Both original licenses and second tier licenses were used on hardware outside the United States.

28. Software/Acquiescence. P.D. 07-74 (May 18, 2007). Department appears to acquiesce to the holding in Intersections, Inc. v. Department (Cir. Ct. Fairfax Co., November 8, 2006). Holds that true object of taxpayer in this ruling was to obtain a tax exempt service, not purchase software.

29. Interstate Sales/Bloomingsdale's. P.D. 07-134 (August 9, 2007). This document is a copy of the Final Order in Bloomingsdale's v. Department of Taxation. Note the specificity with which the Final Order details, as to each of five transactions, that risk of loss and title did not pass in Virginia.

30. New Business/Computer Services. P.D. 07-126 (August 17, 2007). Commissioner rules that corporation not previously doing business in Virginia can bring computer equipment into Virginia, free of any use tax, provided it can prove that the equipment was purchased more than six months before coming to Virginia. The service to be offered in Virginia allows customers, via the Internet, to access computing resources. The Commissioner holds that charges for this service are not subject to sales and use tax. The equipment used to provide the service, however, is taxable unless exempt under the six month rule noted above.

31. Hotel Booking Agent. P.D. 06-139 (October 24, 2006). Out-of-state company booked accommodations for customers, including an amount that covered both its fee for services and anticipated taxes. The full amounts were remitted to the hotel operator which thereafter paid the service fee to the out-of-state booking agent. Commissioner holds that the out-of-state booking agent, not being engaged in business in Virginia and
not being the entity that is providing the hotel room, is not required to collect the tax. This is the responsibility of the hotel operator.

32. Timeshares/Booking Agreement. P.D. 06-145 (December 8, 2006). Independent parties sold unused timeshare points for owners of those points. Because the company itself did not own an interest in any hotel, motel, etc. or act as agent for such an owner, it is not subject to tax as one who is in that business. Moreover, the purchase of such unused timeshare interests are not “transient” within the definition of the statute.

33. Games/Booking Agents. P.D. 06-87 (September 19, 2006). Rental of games to churches and schools held taxable. Six-year statute of limitations on audit applied because no returns were filed. (Note: The Commissioner continues to pay lip service to the position that failure to file a return for even one month opens the audit to six years; but those were not the facts of this appeal). Because taxpayer did not want the Commissioner to contact its customers, availability of any exemptions was not possible to confirm. Finally, Commissioner applied “true object” test to determine that purpose of transactions was the rental of property, not the skills of the operators or attendants with that property, so regulation applicable to rental of equipment with an operator did not apply.

34. Separately Stated Tax. P.D. 07-4 and P.D. 07-5. (January 15, 2007). Business making sales in “outdoor setting” permitted to use a tax inclusive pricing method. Tax determined by dividing total receipts by 1.05.

35. Vehicle Repair Parts. P.D. 06-120 (October 17, 2006). Repair parts for two motor vehicles were held to be taxable because the automobile dealer did not show that the vehicles were being held for sale. One vehicle was apparently used as a “show car” to demonstrate the dealer’s repair talents. The other vehicle was used as a personal vehicle by the dealer and his wife.

36. Repair Shop Charges. P.D. 07-25 (March 27, 2007). Automobile repair shop assessed customers with an “environmental disposal/supply charge”. Because supplies are used and consumed by the shop in the performance of its service, they are not taxable to the customer. Environmental charges, however, are charges made in connection with the sale of tangible personal property. In future audits, taxpayer will be assessed tax on the combined charges if they are not separately stated.

37. Auto Dealers. P.D. 06-115 (October 16, 2006). The cost of license plate frames was not part of the cost of a new motor vehicle; rather, this was an advertising expense of the dealership and subject to sales and use tax. Environmental fees were not non-taxable service fees because they were related to the sale of tangible property, e.g., shop supplies.
38. **Transportation Charges.** P.D. 07-55 (May 10, 2007). Manufacturer of small loads of concrete held taxable on all charges for delivering concrete, without regard to a separate statement for such charges.

39. **Transportation.** P.D. 07-73 (May 18, 2007). Freight from the manufacturer to the retailer is included in the sale price and taxable. Separately stated transportation charges from the retailer to the customer are exempt.

40. **Separately Stated Installation Charges.** P.D. 07-107 (July 2, 2007). Taxpayer separately stated charges on its invoices for “commissioning services” which involved testing equipment after installation. Commissioner rejects that such services are “installation charges” which can avoid tax if separately charged. These are services rendered in connection with the sale of tangible personal property and taxable.

41. **Leases/Delivery Charges.** P.D. 07-127 (August 17, 2007). Taxpayer leased cones, barricades and other traffic control property to construction companies. It separately stated charges for delivering the leased equipment, picking it up, setting up the equipment and remaining with it under certain circumstances. The separately stated charges for delivery and pick up are not taxable. The other charges are part of the taxable leased proceeds.

42. **Sale Leaseback/Resale.** P.D. 07-152 (September 27, 2007). Ruling confirms that a resale exemption is available for a sale for exempt leaseback notwithstanding statements to the contrary on the face of ST-10 (resale exemption certificate). Manufacturing company intended to sell its exempt production equipment to a company which would lease it back to the manufacturer. As production equipment used directly in manufacturing, the leaseback would be exempt. Held that the resale exemption is available even if the leaseback is exempt and not taxable.

**Exemptions: Industrial**

43. **Digital Film.** P.D. 07-18 (March 27, 2007). Amusement park commissioned film which was then incorporated into one of its rides. This was held to qualify for the statutory exemption for certain audio visual works.

44. **Manufacturing/Direct Use.** P.D. 06-126 (October 25, 2006). Chemical used to clean and maintain production equipment held not exempt from tax. Similarly, electric winch used to remove bailing wire and other contaminants from a paper pulping machine was not directly used in manufacturing. **Observation:** Function of winch sounds more like a repair tool than a production tool.
45. **Direct Use Manufacturing.** P.D. 07-112 (July 19, 2007). Filter cartridges filtered soluble oil used in machinery which formed beverage cans. Filtered oil is reused on the production line. Commissioner holds that filters were an indispensable part of actual production. **Comment:** Note that the oil actually touched the product and that the filter was necessary to quality control (but no mention was made of quality control).

46. **Manufacturing/Direct Use.** P.D. 06-121 (October 17, 2006). Although rebuilding of production equipment is a taxable maintenance activity, the components and parts that become part of that rebuilt machine are exempt. All capitalized costs associated with such components are exempt.

47. **Direct Use Manufacturing.** P.D. 07-113 (July 19, 2007). Biocide chemical used to prevent biological growth on the product was exempt. It was an indispensable part of quality control and it also protected the integrity of the product and became part of the product. The biocide was exempt. An electric wench used to remove jammed materials from a pulping machine was taxable. (Note: tool used to repair or maintain a machine is indirectly used).

48. **Manufacturer.** P.D. 07-61 (May 10, 2007). (1) Chart paper not certified by DEQ is not exempt pollution control facility; (2) casters installed onto machine to enable it to be rolled between locations is an integral part of the machine and exempt; (3) taxpayer paid for a maintenance contract that provided for both parts and services. Even though it no longer received subscription updates (i.e., tangible property) its continuing payments to enable it to receive product support are taxable. Exempt status is determined at time of sale, not at time of subsequent delivery of service/property.

49. **Manufacturing/Gas Transmission.** P.D. 07-63 (May 10, 2007). Natural gas pipeline argued that equipment used to compress, scrub, filter and cool gas in an interstate transmission pipeline should be exempt as used in industrial processing. Commissioner holds that transmission activity is part of the distribution function, occurring after the natural gas is a complete product ready for sale. Also holds that activity is not "industrial in nature" because it does not fall in the appropriate SIC codes.

50. **Drilling/Trucks.** P.D. 07-71 (May 18, 2007). Equipment used in gas drilling activities was mounted on trucks. Commissioner holds that the actual drilling equipment must be analyzed separately from the motor vehicles on which they are mounted. Repair parts for the equipment used in gas drilling was exempt, but not the motor vehicle itself.

51. **Poultry Processor.** P.D. 07-13 (March 26, 2007). Poultry processing plant entitled to exemption for packaging supplies used at the processing plant; however, the exemption is not available for similar supplies used at its distribution facility. The distribution facilities were not located at the
processing plant, and “transportation” is not part of “direct use in manufacturing.” To the extent that packaging materials were marketed with and sold to the purchasers of the chicken parts, however, they could be purchased exemption. Printing plates provided to manufacturer of shipping cartons held taxable. Even though they were used by the carton manufacturer directly in its manufacturing process, they were not used by the poultry processor in its manufacturing process.

52. Audio Visual Manufacturing. P.D. 06-102 (October 5, 2006). Taxpayer produced and distributed educational audio and video products. Commissioner holds that the production of master copies of audio and video products that are used to mass produce products for sale is exempt under the audio visual exemption of § 58.1-609.6(6). To the extent that the taxpayer mass produces certain products itself, that qualifies for the manufacturing exemption. To the extent that the taxpayer subcontracts the actual manufacturing, however, there is no manufacturing exemption available (but packaging materials for those products can be purchased for resale).

53. Manufacturing/Divisions. P.D. 06-90 (September 19, 2006). Taxpayer’s attempt to have its business taxed in three separate divisions, one of which was a manufacturer, was rejected. All three divisions were located at the same address, used the same taxpayer identification number, same accounting system, etc. Because the dominant business activity was a service activity, manufacturing exemption denied.

Exemptions: General

54. Occasional Sale/Division. P.D. 06-67 (August 16, 2006). In order for the sale of a separate division to qualify for occasional sale treatment, Department’s position is that the division must have a completely separate set of books, bank accounts, employees and offices. The sale of a wholesale division did not qualify as an occasional sale. Accounting, human resources and other services were provided centrally; the wholesale division shared bank accounts with other divisions; and the wholesale division did not have separate offices.

55. NASCAR On Occasion. P.D. 07-8 (March 8, 2007). Broker represented homeowners who rented their homes two weekends a year to fans attending NASCAR events. Broker not liable for any transient occupancy tax because it did not own the accommodations. Property owners held to be making “occasional sales” because sales occurred on three or fewer separate occasions each year. Broker referred to local commissioners of revenue for information about local transient occupancy tax. Comment. Although not bound the same statutory rules, local transient occupancy tax, as a practical matter, piggybacks on the state’s sales and use tax as applied to transient room rentals. Nevertheless, be aware of the different rules.
56. **Occasional Sale.** P.D. 06-96 (September 29, 2006). No occasional sale exemption was allowed when assets were transferred to a subsidiary, thereby consolidating all Virginia locations in one company. Commissioner notes that transferring company continued in the same business and the transfer of assets to subsidiary was not an exchange for stock. Department's policy permits occasional sale exemption only for transaction qualified under §351 of the Internal Revenue Code. **Query:** Where in the statute is the IRC §351 requirement found? Moreover, if the subsidiary is also a distributor of products, why does not the resale exemption apply?

Commissioner corrected the audit to eliminate sales obtained apparently from a consolidated income tax return. Separate identity of subsidiaries recognized.

57. **Occasional Sale/Church Bazaar.** P.D. 06-129 (October 25, 2006). A church fundraiser that lasts for three weeks is not an occasional sale. Taxpayer tried to argue that the three week event was one sale and therefore qualified for the “three or fewer sales a year” occasional sale exemption.

58. **Interstate/Printed Advertising.** P.D. 06-117 (October 16, 2006). Mortgage company purchased advertising materials from printers which were then distributed by mail houses both inside and outside Virginia. To the extent that these printed materials are stored for less than 12 months in Virginia before being distributed, they qualify for exemption to the extent distributed outside Virginia.

59. **Media Advertising.** P.D. 07-86 (May 25, 2007). Calendars designed by an advertising agency were not part of a media campaign. Therefore, the sale of those calendars was not exempt “advertising.”

60. **Direct Mail Advertising.** P.D. 07-110 (July 19, 2007). Out-of-state printer sold printing to Virginia franchisees who delivered those materials to households for their customers. Virginia franchisees are media advertisers. Their sales to customers are exempt, but they are taxable on all their purchases. Therefore, sales from out-of-state printer to Virginia franchisees are taxable.

61. **Advertising.** P.D. 07-135 (August 17, 2007). Manufacturer claimed an advertising exemption for video catalogue stands and room planner guide. The Commissioner agreed that the video was intended for the general public who came to view furniture at retail stores. This was accepted as “media advertising.” The catalogue stands and room planner guides were simply administrative tools and were taxable.

62. **Agriculture.** P.D. 06-7 (January 19, 2006). Agriculture exemption is available only for items used in agricultural production for market. It does
not extend to the ancillary activities that support such production. Hence, welding supplies used to repair farm equipment were not exempt.

63. **Agriculture/Tree Farm.** P.D. 07-58 (May 10, 2007). Commissioner holds that weed eaters used to control grass between rows of Christmas trees are not exempt because their only purpose is to allow access for customers cutting their own trees. Distinguishes weed eaters used to control grass between rows of grapes in a vineyard where grass serves an erosion control purpose. **COMMENT:** Doesn’t grass between rows of trees also serve an erosion control purpose?

64. **Chickens.** P.D. 06-73 (August 18, 2006). Cages used to transport mature, live chickens from farms to the processing plants were not used directly in the production of agricultural product for market. The agricultural exemption does not apply to transportation after production has ceased. Nor do the cages qualify for the processing exemption because they are used before the processing activity begins.

The taxpayer also asserted that charges by a fabricator for fabricating and installing catwalks and stairs on roof areas of the processing plant should not be taxable because they were real estate construction. Apparently, the taxpayer did not establish that the fabricator actually attached the stairs and catwalks to the building. Therefore, there was no proof there was real estate construction.

65. **Restaurants/Disposables.** P.D. 07-62 (May 10, 2007). Restaurant items that are disposed of after use by one customer are considered part of the meal and can be purchased under a resale exemption. This includes: foil wrap for baked potatoes; shish-kabob skewers; paper napkin rings; carryout containers.

66. **Dyed Diesel Fuel.** P.D. 07-26 (March 27, 2007). Country club purchased dyed diesel fuel for resale to its members. Dyed diesel fuel used in pleasure craft is not subject to the Virginia Fuels Tax. It is, however, subject to the retail sales and use tax. Purchases by the country club could be made exempt for resale, but sales to members were taxable.

67. **DME.** P.D. 06-135 (October 30, 2006). IUDs used for birth control and pessaries used for uterus and bladder support are not medicines or drugs but are devices. They do not qualify for the exemption for durable medical equipment because they are purchased in bulk and not on behalf of an individual patient.

68. **DME.** P.D. 06-101 (October 5, 2006). Sleep clinic purchased CPAP machines which it then dispensed to particular patients. Commissioner holds that exemption for durable medical equipment does not apply because the machines were not specifically bought for individuals. They were purchased on bulk and then dispensed to individual patients. **Query:**
Although this ruling is consistent with the regulation, why could the sleep clinic not purchase these machines in bulk and hold them in a resale inventory just like any other merchant? In such a case, they would be dispensed to specific patients.

69. **Cancer Center Drugs.** P.D. 06-110 (October 10, 2006). Taxpayer managed cancer treatment center and employed doctors that staffed those centers. Prescription drugs were ordered by taxpayer for use in the treatment of patients at the cancer centers. Drugs were purchased in the names of the taxpayer, the cancer center and the physician. Because the purchase invoices listed the name of the physician and a DEA number, exemption for drugs purchased for use by physician and his practice applied.

70. **DME/PillCams.** P.D. 06-113 (October 10, 2006). Miniature cameras swallowed by the patient transmit images and data that allow diagnosis of the gastrointestinal tract. These do not qualify for the exemption granted durable medical equipment. They are disposable and must be read by a trained professional, therefore are not suitable for use in the home.

71. **Nutraceuticals.** P.D. 06-144 (December 8, 2006). The exemption for non-prescription drugs and proprietary medicines does not apply to food products and supplements, vitamin and mineral concentrates. These items, however, may qualify for the reduced tax rate applicable to food for home consumption.

72. **Dietary Supplements.** P.D. 06-147 (December 8, 2006). Company sold dietary supplements and other products through independent dealers. Dietary supplements, vitamins, toothpaste, body lotion, etc. do not qualify for exemption for nonprescription drugs. Nor do they qualify for the reduced sales tax rate on food for human consumption. Charges for “shipping and handling” are fully taxable because not limited to “transportation.” Annual renewal fee, however, charged to distributor is not taxable.

73. **Energy Star/Tax Holiday.** P.D. 07-151 (September 20, 2007). Sets forth extensive rules implementing the energy star sales tax holiday during the second week of October annually until 2012.

74. **Food for Home Consumption.** P.D. 07-137 (September 5, 2007). Even though sold to nursing homes, hotels and other commercial entities, food that is packaged in a closed container and not for immediate consumption is eligible for the “food for home consumption” reduced tax rate.

75. **Food for Home Consumption.** P.D. 07-122 (July 31, 2007). Auditor incorrectly determined that 5% tax rate should apply to all sales of food by this taxpayer. Because 80% of its sales were not for immediate consumption, its sales of food sold in closed containers and not for
immediate consumption are eligible to the reduced rate applicable for “food for home consumption.”

Audits & Procedure

76. **Nexus.** P.D. 07-138 (September 5, 2007). Out-of-state manufacturer with a Virginia based sales rep held to have nexus for sales and use tax purposes but, because of PL 86-272, no nexus for corporate income tax purposes.

77. **Burden of Proof.** P.D. 06-146 (December 8, 2006). Hotel operator failed to provide invoices substantiating its claim that taxes had been paid. Because burden of proof is on taxpayer, hotel loses.

78. **Burden of Proof.** P.D. 07-88 (May 25, 2007). Taxpayer has the burden of proof. If supporting information is not provided during audit appeal, taxpayer loses.

79. **Exemption Certificates.** P.D. 06-100 (October 5, 2006). The Department continues its curious analysis of exemption certificates that are provided after the commencement of an audit. The Commissioner acknowledges that these certificates are not relied on by the seller at the time of the transaction, and it is for this reason that they should provide no protection to the retailer. Nevertheless, the Commissioner states that they are “more closely scrutinized” because they were not accepted “in good faith.” It would seem that the question is not “good faith” but whether they were accepted at a time that induced reliance.

80. **Exemption Certificate.** P.D. 06-123 (October 17, 2006). When an exemption certificate is obtained by the taxpayer during an audit, or after the sale has occurred, the taxpayer will effectively have the burden of proving that the sale in question was in fact exempt. Query If the Department is not going to accept these exemption certificates, why do auditors continue to require taxpayers to obtain them during the audit? The untaxed invoices should show the identity of the customer making the purchases. Is the Department essentially saying that exemption certificate forms are the only method of proof it will accept? This might be read as a “catch 22” game by auditors who know that many customers, even if otherwise exempt, will be reluctant to sign exemption certificates after the fact for fear that it will somehow put the audit spotlight on them.

81. **Exemption Certificate.** P.D. 06-134 (October 30, 2006). Exemption certificate provided during audit rejected. The certificate was not entitled to the “good faith” exception because it was not accepted at the time of the transaction. Furthermore, taxpayer did not exercise its due diligence obligation when it accepted an exemption certificate from a service provider. Observation. The due diligence comments in this ruling appear to be “dictum.” Would the results have been the same if the exemption
certificate had been accepted at the time of the sale? To what extent is a vendor required to be an expert in sales and use tax law with full knowledge of exactly what a tax-exempt entity can and cannot buy?

82. **Exemption Certificate.** P.D. 07-87 (May 25, 2007). Exemption certificates provided after the fact merely evidence facts that may support an exemption. Such certificates do not create a presumption in the taxpayer’s favor as they would if obtained before the sale is made.

83. **Incomplete Exemption Certificates.** P.D. 07-91 (June 1, 2007). Exemption certificates provided during audit are not entitled to presumption of correctness. Moreover, exemption certificates that are incomplete or contain incorrect information (e.g., registration numbers) are not acceptable.

84. **Exemption Certificates.** P.D. 06-89 (September 18, 2006). Taxpayer accepted exemption certificates for photocopiers leased to customers who were manufacturers and research businesses. Because taxpayer took exemption certificates in good faith at the time of the lease, no tax will be assessed. This is so notwithstanding the fact that photocopiers generally will not qualify for either the manufacturing or the research and development exemption.

**Comment.** This ruling appears to be a marked departure from the recent trend of the Department’s rulings on exemption certificates. Whether this reasonable approach will last is yet to be seen.

85. **Exemption Certificate/Advertising Agency.** P.D. 07-76 (May 18, 2007). Commissioner does not permit advertising agency to use its form of “blanket resale exemption certificate.” Form ST-10A must be used when purchasing for resale materials in media advertising. Form ST-10 should be used when purchasing items for resale and other than media advertising.

86. **Sample/Distortion.** P.D. 07-60 (May 10, 2007). Sample period spanned two fiscal years of the taxpayer and picked up similar annual expense for each fiscal year. Commissioner holds that this produced a distortion.

87. **Sample.** P.D. 07-83 (May 25, 2007). Taxpayer requested that a new sample period be utilized for the second half of the audit to affect its change in accounting personnel during that time. Commissioner rejects this request, noting that taxpayer had not proved (in fact showed to the contrary) that addition of new personnel improved compliance.

88. **Sampling/Double Taxation.** P.D. 06-122 (October 17, 2006). The Department’s policy is that a transaction that is not properly taxed by the seller is includable in the audit sample even if the customer pays use tax on that invoice. P.D. 06-122 reaffirms that policy asserting that the
purpose of the sample is to determine the seller's compliance, not the combined compliance of the seller and its customers. **Query.** Isn't the purpose of an audit to determine whether the correct amount has been paid, by whomever? It seems apparent that there is a double tax under the Department's approach.

89. **Sample.** P.D. 07-85 (May 25, 2007). Department will not remove transactions from a sample unless (i) the transaction is isolated and (ii) not a normal part of the taxpayer's operations. In this case, it is reasonable to expect the taxpayer to purchase software licenses on a regular basis.

90. **Sample/Customer Payments.** P.D. 07-68 (May 10, 2007). Department continues its position that when retailer shows customers paid use tax, retailer is allowed only a credit for that specific sale. The sale is not removed from the sample period, nor will the Department allow a credit for all sales to that same customer without specific proof that each sale was self-assessed by the customer. **COMMENT:** If the theory of sampling is that an error can be presumed to repeat throughout the audit period, then why should not the same theory apply to corrections of errors? Stated another way, if it is shown that a customer has self-assessed the use tax, then why should not that correction be spread across the entire audit in order to determine the correct amount of tax that has not been paid, one way or the other, to the Commonwealth?

91. **Samples and Penalties.** P.D. 06-127 (October 25, 2006). Audit sample contained one unusually large invoice which taxpayer contended skewed the sample. Commissioner holds that an invoice can be removed from the sample only if the sale is not one that is an integral part of the taxpayer's normal business operations. This was so notwithstanding the fact that the taxpayer proved that its customer self-assessed the use tax on the transaction. Thus, there was no underpayment of tax to the Commonwealth. Nevertheless, the large invoice was retained in the sample which produced an enormous tax assessment.

Adding insult to injury, the Commissioner then holds that this unfairly large amount of tax is subject to an amnesty penalty on the theory that the taxpayer had sufficient time, and a duty, to review its records during the amnesty period to determine if there were any untaxed sales.

**Observation:** Rulings of this sort provide the business community with plenty of legislative fodder. If the Commissioner is unable to temper rigid adherence to the law with fairness, the Department should not be surprised when there is eventually a legislative backlash. In the meantime, taxpayers should consider two strategies in these situations. First, an offer in compromise, because it generally does not produce a published opinion, this often permits the Commissioner to exhibit some milk of human kindness. Second, in fashioning such a compromise, if there is an
unusually large invoice, produce an analysis of the entire audit period demonstrating that fact - that is, a sale of this size is not normal.

92. **Sample/Burden of Proof.** P.D. 07-56 (May 10, 2007). Because taxpayer failed to file returns, sampling methodology was utilized. Taxpayer failed to prove that this method was inaccurate. Lack of records (because federal government had seized them) was no excuse, though the Commissioner held that those records would be considered if they could be presented within the three year court filing limitation.

93. **Protective Claim.** P.D. 07-19 (March 27, 2007). Taxpayer apparently filed an informal refund request with the auditor which was not acted on for lack of information. Commissioner returns to the audit staff to obtain documentation.

94. **Successor Liability.** P.D. 06-112 (October 11, 2006). Taxpayer purchased the assets of a tavern business, part from the owner and part from a third party “debtor in possession.” Taxpayer/purchaser was liable for the unpaid sales taxes of the tavern business. There is a statutory obligation to withhold such taxes. Although equities do not appear to be a defense, Commissioner notes that these unpaid liabilities were in fact shown on the sales agreement and were ignored by the purchaser.

95. **Sale of Business.** P.D. 07-64 (May 10, 2007). Purchaser of a business is liable for unpaid sales and use taxes of that business. Statutory procedure allows purchaser to obtain certification from Department that all sales and use taxes have been paid.

96. **Fraud.** P.D. 06-128 (October 25, 2006). Taxpayer was nailed in audit for underreporting both sales and use tax gross receipts and, using the same data, personal income tax returns. Underreporting sales by 50% produces an automatic fraud penalty for both sales and use tax purposes and income tax purposes. Moreover, the fraudulent returns result in extended statutes of limitation (six years for sales and use tax and potentially unlimited for income tax). Just to make sure the Commissioner had the taxpayer’s attention, an amnesty period was added on top.

97. **Written Advice.** P.D. 06-116 (October 16, 2006). Only when a taxpayer asks a specific question and that question is answered in writing will the Commissioner uphold a taxpayer’s reliance on erroneous advice. The Department is not required to answer questions that are not asked.

98. **Advice/Prospective Application.** P.D. 07-79 (May 18, 2007). Landscaper failed to separately state installation charges, but had relied on advice of Local District Office that such separate statements were not necessary if labor charges were supported by internal documentation. In what appears to be a refreshing change from some of the hard line rulings in past years,
the Commissioner allows the taxpayer to rely on this erroneous advice and requires compliance with separate statement rules prospectively.

99. **Absorption Tax.** PD 07-32 (April 9, 2007). Virginia Tax Bulletin 07-5: specifically overturns all prior rulings and advice given by the Department on this subject. Virginia Code § 58.1-626 prohibits any person from advertising indirectly an intention to absorb all or any part of the sales or use tax. Any promotion that offers to reduce the sales price of an item and mentions the sales tax in connection with that reduction will be deemed an indirect attempt to circumvent Virginia Code § 58.1-626. Accordingly, such an advertisement will be deemed to violate the provisions against dealer absorption. Provides examples and explains the tax holiday exception.

100. **Sales Tax Absorption.** P.D. 07-123 (August 3, 2007). Tax Bulletin 07-5 concluded that any advertisement that mentions the sales tax in connection with the price reduction will be deemed an attempt to circumvent Virginia Code § 58.1-626 prohibiting absorption of the tax. Commissioner agrees that the language in the Bulletin is overly broad. Thus, advertisement of a 5% discount on the sale of goods but stating that the sale is still subject to sales tax will not be treated as an illegal absorption.

101. **Audit Appeals/Statute of Limitations.** P.D. 07-97 (June 27, 2007). Taxpayer’s request to reopen its audit not filed within 90 day appeal (and well after even the court filing limitation had passed).

102. **QSSS.** P.D. 07-72 (May 18, 2007). A Qualified Subchapter S Subsidiary is a separate legal entity for sales and use tax purposes. Each QSSS should be separately registered for sales and use tax purposes. Transactions made by one subsidiary corporation cannot be assessed to the owner.

IV. BUSINESS LICENSE TAX

A. Rulings of the State Tax Commissioner

**Classification**

1. **Water Purification.** P.D. 06-133 (October 31, 2006). Taxpayer sells, installs and services water purification equipment including the design of systems, the repair and maintenance of those systems, and the provision of chemicals used in the systems. The Commissioner holds that this is a business service because customers are purchasing the water deionization process, not just the chemicals.

Query. To say that customers are buying the deionization process is like saying that customers of Maytag are buying the process of washing their
clothes. Perhaps the underlying contract terms, not cited in the ruling, would shed more light on this issue.

2. **Petroleum Marketer.** P.D. 06-143 (December 8, 2006). Taxpayer maintained an office in a Town but sold most of its fuel at third party retail locations in surrounding jurisdictions. Each of the retailers operated as a commissioned merchant. Title to the fuel passed to customers at the time they pumped the gas. Commissioner holds that sales made at the retail locations are retail sales, and the petroleum marketer is taxable as a retail merchant at each of those retail locations. The Town cannot impose a wholesale merchants tax on these transactions.

3. **Manufacturing/Rebuilt Components.** P.D. 07-52 (April 26, 2007). Following *Chesterfield v. BBC Brown Boveri*, 238 Va. 64 (1989), the Commissioner holds that a corporation engaged in rebuilding alternators for sale is entitled to the manufacturing deduction from the BPOL tax. **COMMENT:** It is remarkable that the locality put the taxpayer to the expense of this appeal. The precedent of *BBC Brown Boveri* is clear. Even the locality classified the taxpayer as a manufacturer for property tax purposes. Finally, the State Tax Commissioner had given the taxpayer an advisory ruling that it is a manufacturer for BPOL tax purposes. On what good faith basis did the locality appeal?

**Exclusions, Exemptions and Reductions**

4. **Agency Receipts/Customs Broker.** P.D. 06-94 (September 28, 2006). Customers broker advanced funds to clients for payment of taxes and other charges. Commissioner holds that because company commingled client funds with its own receipts and claimed those receipts as an ordinary and necessary business expense, it is not entitled to exclude these amounts as “agency receipts.” In a remarkable show of fairness, however, the Commissioner returns the audit to the locality to review amended federal income tax returns filed by the taxpayer to see if, in this fashion, it can meet the deduction.

5. **Agent/Media Buyer.** P.D. 07-140 (September 5, 2007). Company that purchased advertising media for its clients, keeping a percentage of the media as its fee, was fully taxable on that fee. These do not meet the definition of “agency receipt.” Moreover, the taxpayer did not provide information during the audit to support its agency theory.

6. **Definite Place of Business.** P.D. 06-97 (September 29, 2006). Taxpayer used a terminal facility in the City of Richmond to store certain petroleum products which were picked up at the terminal by its customers. Taxpayer did not have an office at the terminal nor did it have any employees or tangible personal property other than fuel at the terminal. The Commissioner rules that it does not have a definite place of business at the terminal and, therefore, is not subject to local business license taxation.
7. **Interstate Deduction/Professionals.** P.D. 07-66 (May 10, 2007). Reversing an earlier ruling (P.D. 05-58), the Commissioner acknowledges that a professional partnerships’ deduction for interstate receipts under Va. Code § 58.1-3732(B)(2) is not limited to hours worked by partners. The deduction is not one that is given to each partner. Rather, it is a deduction for the firm as a whole so that hours worked by all billing personnel should be included in the deduction calculation.

8. **Interstate Receipts/Pass-Through Entity.** P.D. 07-142 (September 5, 2007). Revenues earned by a single member LLC, which was a disregarded entity, flowed through to other affiliated entities and were included in a consolidated return. Even though the single member LLC itself did not file tax returns in other state, revenues earned by it from business in other states are excludable under § 58.1-3732B(2) to the extent it can be demonstrated that such revenues are included in some type of income tax return (combined, separate, consolidated or otherwise) filed in another state.

9. **Title Insurance Agent.** P.D. 07-146 (September 12, 2007). Title insurance agent is subject to local BPOL taxation based on revenues from real estate settlement services. The Commissioner deems this to be a separate licensable business which is not covered by the exclusion provided by Virginia Code § 58.1-2508B for insurance companies. **Comment:** Note that the Commissioner treats this exclusion as an exemption to be strictly construed against the taxpayer. Is a restriction on a locality’s power to tax an exemption in a Dillon Rule state?

10. **Real Estate Rentals/Private Home.** P.D. 07-141 (September 5, 2007). Gross receipts from renting second home during portions of the year are not subject to local business license taxation. Private residences are exempt from this local taxing authority.

**Procedure**

11. **Bottled Water/Food.** P.D. 06-98 (September 29, 2006). Sale of purified water qualifies for the reduced tax on food for human consumption. The fact that water was sold in large coolers does not cause loss of the reduced rate. If retailer wants a refund, it must pass refund along to its customers.

V. **PROPERTY TAXES**

A. **Legislation**

1. **Idle Equipment.** HB 2181 provides a statewide test for determining when machinery and tools are “idle” for property tax purposes. Option 1: the equipment is idle on tax day, has been idle the entire preceding year and is expected to be idle for the entire current year. Option 2: the company
advises the locality in writing not later than April 1 that it expects the equipment to be idle as of the following January 1 and for the entire year following. Machinery and tools that meet one of these definitions of "idle" are deemed to be nontaxable capital.

2. **Recycling Equipment.** HB 3044 extends the sunset date for the recycling income tax credit to January 1, 2015 and makes the credit available to individual income tax filers, including the owners of a pass-through entity.

### B. Court Decisions

1. **Botetourt County v. Virginia Baptist Homes, Inc.,** Case No. CL06000061-00, Cir. Ct. Botetourt County (June 6, 2007). Notwithstanding that Virginia Baptist Homes has been designated as exempt by the General Assembly as a religious and benevolent organization, the Circuit Court held that its retirement facility in Botetourt County was subject to property taxation. Even though this retirement home is operated on a not for profit basis, the trial court held that the dominant purpose of the facility was neither religious nor benevolent. The trial court's opinion equates "religious purposes" to "religious services" and further equates "benevolence" to "charity". Because this start up entity charged residents, at cost, for services (in order to pay the bond financing), the Court held that it had not established a sufficient record of "charitable care." The record was nevertheless clear that the facility is operated on a not for profit basis (indeed at a loss for the first two years) and will provide increasing levels of subsidized care for financially needed residents as the facility matures. VBH has noted its appeal.

2. **Chesterfield County v. Palace Laundry, Inc. d/b/a Linens of the Week.** CL06-1982 (Cir. Ct., June 14, 2007)(Chesterfield County). The Circuit Court applied a presumption of validity to a decision of the County Tax Commissioner after the State Tax Commissioner had already determined that the County Tax Commissioner's decision to be in error. Chesterfield County assessed Linens of the Week ("LOW") with unpaid business tangible personal property tax. LOW argued that it was either a laundry business and exempt from the business tangible personal property tax or, in the alternative, an exempt processing business. Upon administrative appeal, the State Tax Commissioner determined that LOW was an exempt processing business. Chesterfield County filed a successful lawsuit challenging the State Tax Commissioner's decision. The Circuit Court chose to apply the applicable presumption of validity in favor of the County Tax Commissioner's local determination and not to the State Tax Commissioner's decision on the administrative appeal. LOW believes the Circuit Court should have applied its presumption of validity in favor of the decision of the appellate authority, the State Tax Commissioner, and not the County Tax Commissioner. LOW filed a petition for appeal with the Virginia Supreme Court. If the Virginia Supreme Court grants the petition the Court will be given the opportunity to address this issue for
the first time since administrative appeals of certain business property
taxes were authorized by the General Assembly in 1999.

   (January 12, 2007). County Assessor paid lip service to having considered
all three approaches to value, but advised the taxpayer that he had chosen
the cost approach as the most appropriate method of valuing “special use
property.” Reviewing the evidence at trial, the Supreme Court concluded
that the Assessor had not tried to obtain sufficient information about
comparable sales nor even requested data that would have allowed
application of the income approach. Under these circumstances, the Court
held that the proper standard of review was a showing by the taxpayer that
the assessment was erroneous, not that the Assessor had committed
“manifest error.”

C. Attorney General Opinions

1. **Merchant’s Capital/Car Dealer.** OAG No. 06-036, Aug. 11, 2006.
   Vehicles titled to a car dealership and available for sale constitute
inventory stock on hand and must be taxed as merchants’ capital when a
car dealer moved the cars off the dealership site to avoid merchants' tax
and relocated the cars titled to the dealership to private property.

D. Opinions of State Tax Commissioner

1. **Manufacturer’s Capital/Videos.** P.D. 06-79 (August 23, 2006). Taxpayer
   was engaged in the business of producing educational materials which
were then converted into audio-visual and audio course materials for sale.
The Commissioner holds that the production of VHS tapes, audio
cassettes, DVDs and compact discs was a substantial transformation of
raw materials into a new product. Hence, it was manufacturing. As to
whether the business was a “manufacturing business,” however, the
Commissioner rules that the manufacturing activities, as contrasted with
the production of the educational programs, must be a substantial part of
the business. The appeal was returned to the locality for further findings
of fact.

   **Comment.** Notwithstanding a complete factual record, the
Commissioner appears reluctant to accept her responsibility to give a
final ruling in administrative appeals from local decisions. “Remanding”
these cases to the locality often does nothing but subject the taxpayer to
further harassment. That was not legislature’s purpose in enacting these
appeal procedures.

   **Comment.** The Commissioner’s position that the actual manufacturing
activity itself must be substantial, apparently in contrast to the
nonmanufacturing activity, is questionable. The Supreme Court of Virginia has held that the substantiality test looks to whether the manufacturing activity is a substantial, not inconsequential, important part of the business. When the product that is designed and developed by the taxpayer ultimately is responsible for producing 100% of its gross receipts when sold in a manufactured form, is manufacturing not a substantial part of that business? Does it matter what percentage of an automobile maker's workers are engaged in research and development and design or what percentage of a shipyard's workers are engaged in research and development of warships?

2. **Valuation.** P.D. 07-2 (January 10, 2007). Stock in a manufacturing corporation was sold, and both new owner and locality agreed that valuation made at the time of sale reflected fair market value. The question was how to fit this valuation into the locality's depreciation guidelines that reduced taxable value by 10% per year to a minimum value of 50%. The locality wanted to start the depreciation process over using the appraised value as "100% good." The company wanted to plug the appraised value into the appropriate age-life bracket (50% given the average age of the plant and equipment was more than six years). The Commissioner disagreed with both. She essentially backed into a new "original cost" by dividing the appraised value of each asset by the age-depreciation factor for that asset. For example, assume a four year old asset with an appraised value of $6,000 and a local depreciation factor of 70%. The original cost of $10,000 would be adjusted to $8,571 ($8,571 x 0.70 = $6,000).

**Comment:** This ruling will be especially important now that recent legislation requires local assessing officers to consider fair market valuation appraisals. Assuming the locality and the taxpayer can agree on a new appraised value, this ruling indicates how the Department would recommend that the locality adjust reported original cost to reflect that valuation.

3. **FMV/Appraisal Standards.** P.D. 07-103 and 07-104 (June 27, 2007). Acknowledging the constitutional mandate that assessments be made at fair market value, both the taxpayer and local assessor retained professional appraisal firms. Those firms differed on the treatment of costs to be capitalized (e.g., sales taxes, installation costs and freight) and functional obsolescence. Concluding that the local assessor has exercised his "due diligence" by hiring an outside appraisal firm, the State Tax Commissioner holds, based on the presumption of correctness of local assessments, that there is no basis for overturning the local assessor's opinion of value as based on its outside appraiser's work. **COMMENT:** It is remarkable that the Commissioner recites not once, but twice, that "fair market value is a subjective judgment."
4. **Real Estate versus M&T.** P.D. 06-106 (October 5, 2006). Restaurant operator installed a microbrewery in its leased premises. Commissioner holds that locality appropriately classified this property as real estate instead of M&T. In close cases, the intention to annex personal property to the land must “affirmatively and plainly appear.”

**Query:** Why does the Commissioner treat the micro brewing assets as M&T? Beer brewing is clearly manufacturing, but the Commissioner for years has not considered equipment that is used in an activity that is ancillary to a restaurant, grocery store or other retailer to be used in a manufacturing business. The concern here is that localities may misread this ruling to say that a manufacturer’s equipment that is affixed to the real estate does not have to be assessed as M&T but can be taxed at what may be a higher real estate rate.

5. **Fixtures/Restaurants.** P.D. 06-142 (December 8, 2006). Issue was whether certain assets used in the kitchen area of a restaurant were properly classified by the locality as business personal property instead of real estate. Following the rule that the intention to annexed property permanently to the real estate must appear “affirmatively and plainly,” Commissioner holds that local assessing officer’s determination was not unreasonable. Consideration of MACRS is not improper as long as that is not deemed to be dispositive.

6. **Church Property/Musical Instruments.** P.D. 07-65 (May 10, 2007). Instruments used by the music director of a church for both church purposes and other business purposes not exempt because not used exclusively for charitable purposes. Instruments were depreciated on music director’s individual returns.

VI. **MISCELLANEOUS TAX**

A. Rulings of the State Tax Commissioner

1. **Recordation Tax/Bail Bondsman.** P.D. 07-23 (March 27, 2007). Virginia law requires a bail bondsman, in some circumstances, to place a deed of trust on real estate that is used to secure his bonded indebtedness to the Commonwealth. The exemption for deeds to the Commonwealth does not apply to deeds of trust.

2. **90 Days.** P.D. 06-78 (August 23, 2006). The Commissioner holds that the Department has no discretion to extend the 90 day period for filing an administrative appeal.

3. **Appeal Guidelines.** P.D. 06-140 (November 29, 2006). Provides a comprehensive statement of the procedures to be followed when appealing an assessment by the Virginia Department of Taxation.

5. **Communications Tax.** PD 07-42 (March 26, 2007). Purchases of communications services by a communications services provider for use in specific administrative support qualify for exclusion from the communications sales and use tax under Code of Virginia § 58.1-648 B vi because the communications services are purchased by a communications services provider for its internal use in connection with its business of providing communications services. Purchases of communications services by the corporation created to provide administrative support services to related communications services providers would not qualify for exclusion from the communications sales and use tax under Code of Virginia § 58.1-648 B vi because the communications services are not purchased by a communications services provider.

VII. Trends & Outlooks

**General Assembly.** The driving forces in Virginia tax legislation will be (i) a significant budget shortfall caused when tax collections did not meet expectations and (ii) Virginia’s continuing need to fund significant road improvements. The 2007 Session of the General Assembly addressed the road improvements with a hodge podge of measures including hugely increased fines for problem drivers. Because these fines were limited, for practical reasons, to Virginia residents only, the entire program received a significant backlash that was played up in the media this summer. Some candidates running for re-election this Fall are sufficiently frightened by that backlash to be talking about a common sense gasoline tax increase. Time will tell.

**New Commissioner.** With 18 months under her belt, the new State Tax Commissioner, Janie E. Bowen, appears to be implementing some important changes at the Department. Some of the more extreme positions taken by her predecessor, a former tax litigator with the Attorney General’s Office, have been settled. Rulings issued by Commissioner Bowen appear to reflect a less aggressive approach as well.

**Income Taxes.** The Department of Taxation has under consideration a number of changes in corporate income tax regulations, the most significant of which will deal with Virginia’s new “add back” legislation. The fact that this regulation effort has now been delayed for over 8 months indicates that the Department is struggling with the fact that the legislation adopted in 2004 does not provide them with as strong a position as they want. For example, the Virginia statute contains an exception to the add-back of royalties and other inter-company intangible payments whenever “the corresponding item of income received by the related member is subject to a tax based on or measured by net income” imposed by another state. The Department is reported to be considering any number of ways to read what appears to be an unambiguous exception out of the statutes.
Sales Taxes. Efforts to close the budget gap and fund Governor Kaine’s pre-school educational initiatives will invariably raise questions about the non-taxability of various services under Virginia’s Retail Sales and Use Tax Act.

Property Tax. Perhaps the most disturbing trend appears to be efforts to permit local governments to classify real property owned by businesses separately from such property owned by individuals (voters). Such a distinction was part of the transportation “fix” enacted in 2007 (applicable in Northern Virginia and Tidewater). Governor Kaine is now pushing for a 20% homestead exemption for individuals, the logical effect of which will be to shift that 20% on to other taxpayers (i.e., the business community).

Dated: 10/11/2007
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