What's Hot in Virginia Taxation?

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WHAT'S HOT IN VIRGINIA TAXATION?

A Discussion of recent tax legislation, court cases, Tax Commissioner rulings, and Attorney General opinions

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I. TAX LEGISLATION INCLUDED WITHIN THE BUDGET BILL ("Budget Induced Legislation")

It took the General Assembly the full 60-day session, plus a 3-day extension, followed by a Special Session lasting another 47 days before the legislature reached agreement on a number of compromises to pass a two-year budget for Fiscal Years 2005 and 2006. Included within the budget are a number of tax law changes including the following:

- 27.5 cents-a-pack increase in the cigarette tax (currently 2.5 cent-per-pack – lowest in the nation). 30 cents-a-pack by FY2006.

- A 10 percent excise tax at the wholesale level on tobacco products other than cigarettes.

- A 10 cents/$100 increase in Recordation and Real Estate Transfer Taxes.

- Increase in state sales taxes from 3.5 percent to 4.0 percent (local sales tax rate of 1 percent remains unchanged).

- Reduction in sales tax rate on food to 1.5 percent by FY2008 and elimination of the trigger on implementation.

- Repeal of marriage penalty on filing status.

- Personal exemption increase from $800 to $900.

- Standard deduction for singles remains at $3,000; joint returns increased from $5,000 to 6,000 (double the single deduction of $3,000).

- People aged 62 to 64 can subtract $6,000 of income and those over age 65 can subtract $12,000 of income for tax purposes, but the $6,000 benefit will no longer be available for those who turned 62 after January 1, 2004.
• Eliminate sales tax exemption on property purchases and leases for selected public service corporations (except fuel used in power generating activities). The increase in sales taxes from this change may be passed on to consumers in their utility bills.

• Virtually end the corporate tax deduction for payments to Delaware Holding Companies.

• Raise the state income tax filing threshold from $5,000 to $7,000 for single filers and from $8,000 to $14,000 for couples.

• Provide low-income filers a choice between the current credit of $300 per family member for families with income below the poverty level and a nonrefundable credit of 20 percent of the federal earned income tax credit; families would not lose their eligibility for the credit if their income was $1 above the poverty level.

• Imposes a reporting requirement on “pass-through” entities; and permits such entities to file composite returns on behalf of all its non-resident partners/members.

The legislature also approved capping the amount the state pays for “car tax” relief at $950 million, which represents the final piece of a tax plan expected to raise more than $1 billion over the biennium.

II. CORPORATE INCOME E TAX

A. 2004 Legislation

1. Delaware Holding Company/Anti-Passive Investment Company. SB 5018 (Enrolled) amends Va. Code §58.1-402 to greatly restrict the use of Delaware Holding Companies/Passive Investment Companies by requiring that companies “add back” to federal taxable income royalty payments/interest expenses paid to affiliates. There are some limited safe-harbor exceptions from the add-back based largely on whether the recipient of the payment is taxable elsewhere or has significant business activity outside of the affiliated group of corporations. If no safe harbors are available, a taxpayer may petition the Tax Commissioner for elimination of the add-back. In that petition, the Taxpayer must first pay the tax; must then pay the Department a “fee” of unspecified amount; must pay the Department’s outside expenses for experts and the like; and ultimately, must demonstrate that the transaction is not one of tax avoidance, but has valid business purposes. Whether or not the taxpayer has met its burden rests in the Commissioner’s sole unfettered and unqualified discretion, and taxpayers may not appeal the Commissioner’s exercise of discretion in ruling on such petitions to the judicial courts. A copy of the relevant portions of this bill are located at Appendix A.
2. **Fixed Date Conformity.** SB 526 (Chapter 512) amends 58.1-301 to advance Virginia's date of conformity to the Internal Revenue Code from December 31, 2002 to December 31, 2003. The bill continues the disallowance of any bonus depreciation allowed for certain assets under federal income taxation to flow through to the Virginia income tax (I.R.C. §168(k)) and any 5-year carry-back of net operating losses ("NOL") allowed for NOL's generated in either tax year 2001 or 2002. The new conformity date legislation does permit the flow-through to Virginia income the increase in the I.R.C. §179 expensing (from $25,000 to $100,000) for qualifying property placed into service in tax years beginning on or after January 1, 2003 and before January 1, 2006; includes software as property that may be expensed under §179, and permits the benefits of The Military Family Tax Relief Act of 2003 (broader application of I.R.C. §121; above the line deduction of up to $1,500 for overnight travel expenses of National Guard and Reserve Service members traveling more than 100 miles from home while on reserve duties; and the expanded income tax exclusion for military death benefits).

3. **Qualified Equity and Subordinated Debt Investment Tax Credit ("QESDITC").** HB 282 (Chapter 614) amends Va. Code §58.1-339.4 to reduce the annual revenue level required for a company to qualify for the credit from $5 million to $3 million; exclude companies that have already successfully raised more than $3 million in total investment capital; eliminates the availability of the credit to professional/institutional investors such as larger venture capital funds; and adjusts the penalties under the credit so they do not create disincentives to investments. These changes take effect on January 1, 2005.

The QESDITC grants an income tax credit to individuals, trusts and estates in an amount equal to 50% of qualified investments made in a qualified Virginia small business venture. The aggregate amount of credit available to a taxpayer in a tax year is limited to the lesser of the tax imposed for such tax year or $50,000. Unused credits can be carried forward to offset future income tax liability for up to 15 taxable years.

4. **Major Business Facility Job Tax Credit.** SB 231 (Chapter 170) amends Va Code §58.1-439 to extend the sunset date for the major business facility job tax credit from January 1, 2005 to January 1, 2010.

5. **Major Business Facility Job Tax Credit.** HB 615 (Chapter 619) amends Va. Code §58.1-439 to lower the threshold amount of jobs from 100 to 25 that must be created in order to take advantage of the major business facility job tax credit in severely economically distressed areas that have an unemployment rate of at least twice the average statewide unemployment rate (anticipated qualifying localities include three cities (Danville, Galax, and Martinsville) and nine counties (Appomattox, Carroll, Dickenson, Grayson, Halifax, Henry, Mecklenburg, Patrick and Smyth)). The credit will be available for 2004 and 2005 and would be limited to $100,000 per year for all taxpayers. Taxpayers who create more than 50 jobs would still be eligible for the credit for creating jobs in economically distressed areas or enterprise zones.
6. Land Preservation Tax Credit. HB 1185 (Chapter 635) amends Va. Code §58.1-513 to permit any pass-through entity that allocates or transfers land preservation income tax credits among taxpayers to designate with the Tax Commissioner a general partner, member-manager, or shareholder of the entity as the individual that the Tax Commission must first proceed against for the collection of taxes in the event any portion of the credit is disallowed in the future.

7. Minimum Tax on Electric Suppliers. SB 681 (Chapter 716) enacts Va. Code §58.1-400.3 (a new section) and creates an alternative minimum tax for certain electric suppliers. The minimum tax applies when it exceeds the general corporation income tax and is equal to 1.45 percent of the electric supplier’s gross receipts minus the state’s portion of the electric utility consumption tax billed to consumers.

Electric cooperatives that are exempt from federal taxation under I.R.C. §501 are subject to this new minimum tax, although the tax is imposed at the 1.45 percent rate only against gross receipts from sales to nonmembers minus the consumption tax collected from nonmembers. This legislation also amends Va. Codes §58.1-2628 and 58.1-2674.1 pertaining to electric suppliers that file consolidated or combined returns; and includes the minimum tax in those regimes as well. The legislation is effective for tax years beginning on or after January 1, 2004.

8. Recyclable Materials Tax Credit. SB 690 (Chapter 611) amends Va. Code §58.1-439.7 to extend to sunset date from December 31, 2003 to December 31, 2006 for a corporate income tax credit for machinery and equipment used to produce personal property from recyclable materials.

B. Recent Court Decisions

1. General Motors Corp. v. Virginia Dept. of Taxation, 2003 Va. Cir. LEXIS 79 (Case No. L 192277, Fairfax Co. Cir. Ct., April 8, 2003), affirmed ___ Va. ___ (No. 032533 September 17, 2004). The Trial Court held that interest income earned on funds in a single account maintained in New York was not part of its unitary operations conducted in Virginia, but was instead a separate investment/business from that in Virginia. As a result, the interest income was not subject to formulary apportionment and could not be taxed by Virginia. See, e.g., Allied-Signal (US Sup. Ct. 1992). The taxpayer proved the non-operational character of the interest income by demonstrating that the account balance far exceeded working capital needs, was not used as security to borrow working capital, or as security to acquire stock in other companies, or to support bond issues.

The Trial Court also upheld the Department’s regulation excluding from the single-factor “costs of performance” ratio used to apportion income recognized by financial corporations the cost of activities performed by unrelated third parties.

Finally, the Trial Court rejected the Department’s assertion that IRC §6621(c) (the 2 % “hot interest” rate for large corporate underpayments) applied in Virginia; and
instead reduced interest to the regular statutory rate (which in Virginia, is the federal deficiency rate plus 2%).

General Motors appealed the Trial Court's decision as it relates to the court's holding that the Department's "cost of performance" regulations are a valid and consistent interpretation of the use of that term in Virginia Code §58.1-418 for purposes of determining the Virginia taxable income of a financial corporation.

Under Code §58.1-418, a financial corporation is required to determine its Virginia taxable income by calculating the cost of performance attributable to its business operations within Virginia, dividing that figure by the total cost of performance of its operations everywhere, and then using that ratio to determine what portion of its total income is taxable as Virginia income. The Department has promulgated a regulation, 23 VAC §10-120-250, defining "cost of performance" as used in Code §58.1-418 as "the cost of all activities directly performed by the taxpayer for the ultimate purpose of obtaining gains or profit." The regulation further provides that cost of performance does not "include activities performed on behalf of a taxpayer, such as those performed on its behalf by an independent contractor."

On appeal, GM asserts that 23 VAC §12-120-250 contravenes the plain meaning of Code §58.1-418 in that it improperly narrows the scope of the statute to include only direct costs of performance in the ratio calculation. The Department defends the regulation as a practical interpretation of Code §58.1-418, saying that while apportionment of a taxpayer's direct cost of performance between its Virginia operations and those elsewhere "can be readily ascertained," the Department cannot effectively monitor third parties to determine what part of their performance, if any, occurs within Virginia.

Holding: The Virginia Supreme Court held that the Trial Court erred in ruling that 23 VAC §10-120-250 was not plainly inconsistent with Virginia Code §58.1-418. Nothing in the language of the statute limits costs of performance to direct costs or suggests that the Tax Department may exclude costs incurred for activities performed on behalf of a taxpayer by a third party. The Supreme Court held that the Department erred in excluding amounts paid by GMAC (a financial corporation) to third parties from the cost of performance ratio.
C. Recent Virginia Tax Commissioner Rulings


   Virginia remains decoupled from the Internal Revenue Code in two areas: it does not allow bonus depreciation or the 5-year carry-back of NOL's generated in either tax year 2001 or 2002.

2. **Delaware Investment Holding Company.** P.D. 03-56 (August 8, 2003). The Tax Department consolidated a parent company with two of its subsidiaries (an operating subsidiary and a financing subsidiary) under Virginia Code §58.1-446 on the grounds that separate returns did not “properly reflect” Virginia taxable income. Parent performed merchandising, warehousing, and administrative functions for the group and was a Virginia taxpayer. It’s two subsidiaries - the operating subsidiary (OS) and the financing subsidiary (FS) were non-Virginia domiciled corporations with no nexus in Virginia. FS purchased receivables from OS and parent taxpayer as part of an intercompany financing arrangement in transactions documented as book entries. The Department consolidated the group on a finding that the taxpayer had failed to prove that the discount applied to the factoring arrangement - i.e. the purchase of receivables - was at industry rates and that the transactions were the result of true arm’s length negotiations on price.

3. **Delaware Investment Holding Company.** P.D. 03-57 (August 8, 2003). The Tax Commissioner reached the same result as in item 2 above, under substantially similar facts.

4. **Delaware Investment Holding Company.** P.D. 03-60 (August 8, 2003). Taxpayer had two subsidiaries domiciled in Delaware and which had no Virginia nexus. One subsidiary owned the stock of a foreign sales corporation (“FSC”) and the other subsidiary owned intellectual property that had been purchased from a third party. Neither subsidiary had any physical location in Delaware, any employees, or any significant expenses. Loans were not evidenced by written agreements. Payments on the loans were not made so that the annual loan balance simply increased with the interest payable. Finally, there were indications that the parent corporation was taking certain tax benefits associated with the patents. The Tax Department held that the subsidiaries “lack[ed] economic substance”; the transactions themselves “lack substance”; and there was no proof the intercompany transactions were conducted at arm’s length prices. As a result, the group was combined.

   The Tax Department also denied the taxpayer’s claim that some items of income were not apportionable to Virginia under Allied Signal. See, the GM case above. Those claims were denied for lack of proof. It appears, however, that the Department continues
its questionable practice of looking to the use of income to determine if the asset producing that income serves an operational function.

5. **Delaware Investment Holding Company.** P.D. 03-73 (October 15, 2003). Taxpayer transferred all of its trademarks and trade names into a wholly-owned subsidiary in a tax-free I.R.C. §351 exchange to insulate the trademarks and names in the event of a lawsuit, hostile takeover attempt, and to coordinate centralized management of the trademarks on a worldwide basis. A license agreement between the parent and subsidiary giving rise to a royalty in favor of the subsidiary was entered into, and the parent deducted the royalty payment on its Virginia tax return.

The subsidiary was not a Virginia taxpayer. The subsidiary had no office space or employees, all of the subsidiary’s directors, officers and employees were officers, directors and employees of the taxpayer, and all transactions between the two entities were entirely accounting entries.

The Tax Department disallowed the royalty deduction claimed by the taxpayer-parent based on the taxpayer’s failure to prove that the royalty rate was at arm’s-length (there was no independent appraisal of the trademarks); the failure to prove that the transaction had economic substance (it consisted entirely of accounting entries); and the failure to demonstrate some substance to the subsidiary itself (no employees, office, etc).

6. **Partnership Apportionment.** P.D. 03-76 (October 30, 2003). A third-tier partnership sold a Virginia based business. The third-tier partnership had a 100% Virginia apportionment factor. The income passed-through to a second-tier partnership that had other sources of income and other property, payroll and sales factor characteristics in addition to the pass-through from the third-tier partnership. That second-tier partnership passed through the income (along with other income) to a first-tier partnership, which in turn passed it through to the taxpayer. The taxpayer allocated the income that passed-through from the third-tier partnership 100% to Virginia (employing a de facto tracing approach). The Department modified this approach, ruling not only that income passes through each partnership, but also the factors. As a result, each partnership must distribute the combined factors and income from all sources as items move through the tiers. There is no tracing.

7. **Sale of Intangible Assets no Virginia Sale.** P.D. 03-78 (November 3, 2003). A corporation headquartered in Virginia sold a manufacturing division located outside of Virginia. The sale included intangible assets (manufacturing contracts, certain loans and some intellectual property). The taxpayer included the proceeds from the sale of the contracts together with some of the interest and royalties in the denominator of its sales factor, but not the numerator. The Commissioner upheld the taxpayer’s position that these receipts were non-Virginia source on a finding that the income-producing activity occurred outside Virginia.

8. **LLCs May File a Composite Return.** P.D. 03-83 (November 3, 2003). The Virginia Tax Commissioner has issued a letter ruling stating that two limited liability
companies may submit a request to file a unified income tax return on behalf of their nonresident members. This year’s budget bill codifies this ruling, and in addition to imposing reporting requirements on all pass-through entities doing business in Virginia, permits the filing of composite returns on behalf of non-resident partners/members.

9. **Foreign Source Income Subtractions:**

   P.D. 04-10 (April 1, 2004). The Department held that 3 months of an affiliate’s foreign source income included on the taxpayer’s federal Form 1118, filed on a consolidated basis, was eligible for the foreign source income subtraction in Virginia.

   P.D. 03-65 (August 19, 2003). The Department held that royalty income generated by contracts with promoters in foreign countries to stage concerts could be subtracted as “foreign-source” income (i.e. foreign royalties) received. However, the Department also held that income from the sale of sponsorship rights to overseas tours (i.e. signage and the like) constituted advertising service income ineligible for the foreign-source subtraction; concession income passed-through from a joint-venture making sales at overseas tours was income from the sale of **tangible personal property** and thus, ineligible for the foreign-source subtraction; and certain other overhead costs were ineligible for subtraction.

10. **Tax Offsets/Merger.** P.D. 03-63 (August 19, 2003). The Department confirmed that the surviving corporation in a merger is liable for the debts of the corporation that merged into it; and thus, the Department may offset post-merger refunds against pre-merger assessments.

11. **Pass-Through Enterprise Zone Credits may Exceed Statutory Limitation to Single Taxpayer.** P.D. 04-32 (July 14, 2004). The Tax Commissioner held that a single partner, member, or shareholder of a qualified zone resident can claim, through several pass-through entities, more than $125,000 worth of the real property investment tax credit against Virginia bank franchise tax and corporate and personal income tax. The statutory limitation of $125,000 worth of credits for a five-year period for each “small qualified zone resident” applies to the entity that is the qualified zone resident. Therefore, a taxpayer receiving credits for more than one qualified zone resident pass-through entity may claim more than $125,000 worth of credits in a five-year period. For Virginia bank franchise tax purposes, the historic rehabilitation tax credit applies only to the state portion of the tax and not to the local portion. Because localities impose a local bank franchise tax by local ordinance, such taxes are not imposed by Chapter 12 of the Virginia Code and the credit is not available to these charges.

12. **Gain from Sale of Stock Not Allocated to Virginia.** P.D. 04-51 (August 16, 2004). A capital gain from a taxpayer’s sale of stock in a company in which the taxpayer had a ten percent ownership interest was allocable to the taxpayer’s state of commercial domicile, rather than included in the taxpayer’s income subject to Virginia corporate income tax, because the taxpayer’s investment in the stock did not serve an operational purpose. Although the original intent of the stock transaction was to enhance
the taxpayer’s operations, the taxpayer did not pursue the operational aspects of its relationship with the company. The taxpayer demonstrated to the Tax Commissioner that an alternative method of allocation and apportionment was appropriate, and the capital gain was allocated out of Virginia apportionable income.

13. **Parent Corporation’s Wage Payments are Excluded in Subsidiary’s Payroll Factor.** P.D. 04-58 (August 20, 2004). The Tax Commissioner held that wages paid by a parent corporation to the employees of its subsidiaries are to be excluded in the payroll factor of the subsidiary, despite bookkeeping allocations by the parent corporation to the subsidiary for a portion of the expense. This is a position of long-standing policy by the Department of Taxation, even where the parent corporation reports such total wage figures to the Virginia Employment Commission as the result of a common paymaster arrangement. The Tax Department’s policy is for each employer to be separately liable for taxes on its wages.

14. **Public Law 86-272 Protection Upheld.** P.D. 04-85 (August 27, 2004). A corporation which is registered to do business in Virginia had its corporate income tax assessment abated because its activities within Virginia fell within the protections of Public Law 86-272. The taxpayer demonstrated that all of its income had been apportioned to another state where the activities occurred.

15. **Consolidated Income Tax Return Required Despite Affiliate’s Lack of Nexus.** P.D. 04-88 (August 31, 2004). The Tax Commissioner held that Virginia may require the consolidation of an out-of-state affiliate’s income with an in-state parent company even when the affiliate lacks Nexus. The Commissioner determined that such action was warranted because the parent company failed to show that inter-company transactions with its affiliate did not improperly distort its Virginia taxable income. The taxpayer was a technology services company based in Illinois but also did business in Virginia. The taxpayer had a wholly-owned mail order supply company subsidiary based in Illinois. When reporting Virginia corporate income tax, the taxpayer filed a return, but did not include its mail order supply company in that return. The Tax Department during its audit inquired about a large inter-company receivable reported by the mail order supply company. Taxpayer failed to respond to two written inquiries regarding its affiliate. The Tax Department consolidated the taxable income of the taxpayer and its mail order supply company relying upon Va. Code §58.1-446. The Commissioner also opined that the burden of proof is on the taxpayer to show that its transactions with its affiliates did not improperly reflect its taxable income in Virginia. The taxpayer refused to provide information or documentation in response to the Department’s inquiries regarding its affiliates.

16. **S Corporation not Permitted to Add Back Salaries and Wages Paid to Shareholders for Purposes of Enterprise Zone Tax Credit Calculation.** P.D. 04-153 (September 17, 2004). The Tax Commissioner held that salaries and wages received by an S Corporation shareholder would be classified as compensation for services performed for the S Corporation pursuant to IRC §61 and Virginia’s conformity statute, Va. Code §58.1-301. The Commissioner noted that the salary would have the same character on
the shareholder's Virginia individual income tax return as it does on the federal income tax return. Accordingly, Virginia statutes do not allow S Corporations to add back salaries and wages paid to its shareholders in determining its income attributable to an enterprise zone.

17. Royalty Payments to PIC Disallowed. P.D. 04-159 (September 30, 2004). The Tax Commissioner upheld its assessment of Virginia corporate income taxes as a result of disallowing royalty payments paid by the taxpayer to its wholly-owned subsidiary that owned taxpayer's intangible property (trademarks and trade names). During audit, the Department determined that the royalty payments distorted Virginia income. Taxpayer protested claiming due process rights violations and also asserted a defense of laches. Taxpayer provided no additional information or documentation. The Commissioner found that the payments did not meet the "safe harbor" transactions relating to the transfer of patents or similar transactions under 23 VAC §10-120-361(E). The Department stated that it will look beyond fair market "price" of the transaction and into the structure and nature of a transaction in comparison with transactions between unrelated parties when determining if an improper reflection of Virginia taxable income occurred. The taxpayer provided no evidence at the time of its appeal to support its assertion that the Tax Department’s adjustments were invalid. Taxpayer also contended that the Department’s delay in issuing a determination violated the taxpayer’s right to due process. The Commissioner noted that the assessments were issued within the statute of limitations applicable for assessments and noted that the Department may collect any tax properly assessed within 20 years of the date of the assessment. All of the activities at issue in this protest occurred within those twenty years. The Commissioner held that the taxpayer’s defense of laches lacked merit and is not a valid defense for the taxpayer in this case.

III. INDIVIDUAL INCOME TAX

A. 2004 Legislation

1. Neighborhood Assistance Act – Health Care Professional Expanded. HB 285 (Chapter 725) amends Va. Code §63.2-2004 to make Neighborhood Assistance Tax Credits available to eligible health professionals who provide health care services within the scope of their licensure, without charge, regardless of where the services are delivered. Prior to this legislation the health care services had to be provided at the free or not-for-profit clinic in order for these health care professionals to be eligible for the tax credit. Health care professionals covered by this legislation includes physicians, dentists, nurses, nurse practitioners, physician assistants, optometrists, dental hygienists, professional counselors, clinical social workers, clinical psychologists, marriage and family therapists, physical therapists, and pharmacists.

2. Neighborhood Assistance Act – Chiropractors. SB 81 (Chapter 657) adds chiropractors to the list of health care professionals eligible to participate in the Neighborhood Assistance Act tax credit program by amending Va. Code §63.2-2004(c).
3. Neighborhood Assistance Act – Sunset Extended. HB 237 (Chapter 216) and SB 436 (Chapter 699) amended Va. Code §63.2-2002(D) to extend the sunset date for tax credits allowed under the Neighborhood Assistance Act from the close of fiscal year 2004 to the close of fiscal year 2009.

4. Individual and Fiduciary Income Tax Returns – Clarifies Filing Locations. HB 902 (Chapter 544) amends sections 58.1-305 and 58.1-306 to permit taxpayers to file their individual and fiduciary income tax returns with the Department of Taxation as well as the local commissioners of the revenue. Prior to this legislation, individual income taxpayers were required to file their income tax returns with their local Commissioner of the Revenue, unless the locality had opted to have its residents file directly with the Department of Taxation.

5. Voluntary Check-Off Contributions on Tax Returns. HB 1486 (Chapter 649) adopts Va. Code §30-19.1:10 and amends Va. Code §58.1-344.3 to limit the number or organizations eligible to receive check-off contributions from individual income tax refunds to 25. Each check-off would be required to receive contributions of at least $10,000 annually for three consecutive years to remain on the individual income tax return. The list of organizations will be reviewed annually by the House and Senate Finance Committees of the Virginia General Assembly. Note: Virginia, by far, offers the most check-offs (27), the next highest state is Oregon with 18 check-offs, followed by Illinois with 12 check-offs. The average number of check-offs per state is 6.

B. Recent Virginia Tax Commissioner Rulings.

1. Virginia Land Preservation Tax Credit/Historic Rehabilitation Tax Credit. P.D. 02-158 (December 10, 2002). Taxpayer proposed to purchase and rehabilitate an historic structure located on undeveloped land, and then to establish a preservation or conservation easement to prevent development of the property. The taxpayer asked about the availability of the land preservation credit and historic rehabilitation credit. Va. Code §58.1-513A precludes the claiming of the historic rehabilitation tax credit for costs related to the project for which the land preservation credit is claimed. If the taxpayer rehabilitated the structure before conveying the property to the conservation agency, then the taxpayer could claim only the land preservation credit. However, if the rehabilitation expenses do not increase the value of the preservation or conversation easement, then the taxpayer could claim both credits.

2. Virginia Land Preservation Tax Credit. P. D. 03-12 (February 27, 2003). This credit is equal to 50% of the fair market value of Virginia land or an interest in Virginia land that is for certain uses related to land preservation. The credit can be transferred from one taxpayer to another; there is no limit on the number of transfers. However, a transferee taxpayer may not use the credit for any taxable year prior to that in which he acquired the credit, even if he acquired the credit prior to the due date of the prior year return (e.g., a credit transferred after 12/31/02 but prior to the deadline for filing the 2002 return may not be used against the 2002 tax liability). See also P.D. 03-13 (March 4, 2003).
3. **Virginia Land Preservation Tax Credit.** P.D. 03-55 (August 7, 2003). The Tax Commissioner corrected erroneous dictum in previous Department rulings (P.D. 99-293 and P.D. 02-97) that incorrectly suggested that only “private foundations” could receive donations for which tax benefits are allowed under the Virginia Land Conservation Incentive Act of 1999.

4. **Virginia Land Preservation Tax Credit.** P. D. 03-77 (October 31, 2003). The Tax Commissioner rules that the Land Preservation Tax Credit is not dependent upon the amount allowed as a federal itemized deduction for charitable donation on the taxpayer’s federal tax return. The Commissioner also rules that the tax credit can be adjusted at any time within the statute of limitations. Therefore, if the taxpayer’s credit is adjusted at any time within the statute of limitations, any transferees of the credit are subject to the credit amount and carry forward limitations provided under Va. Code §58.1-512(B)(1). If the Department timely adjusts the credit claimed by a taxpayer, such adjustment would flow through to any transferee of the credit.

5. **Virginia Land Preservation Credit Applies to Donation to County.** P.D. 04-96 (September 8, 2004). A donation of land to a county qualifies as a donation to an instrumentality of Virginia for purposes of the Land Preservation Credit against Virginia corporate income and personal income tax.

6. **Land Conservation Easement Tax Credit Transfer Guidance.** P.D. 04-119 (September 15, 2004). The Tax Commissioner provides guidance pertaining to the transfer of unusable but otherwise allowable land conservation easement tax credits to third parties. The Tax Commissioner notes that the limitations regarding the amount of the credit that may be used in a given year are not intended to restrict taxpayers of using the full amount of the credit earned. Such taxpayer holding an unused amount of credit may transfer portions of such credit to more than one taxpayer. Transferees of the tax credit are subject to the same credit amount and carry forward limitations as provided for by Va. Code §58.1-512(B)(1). When a transferee receives a credit resulting from a transfer, the transferee becomes a taxpayer for purposes of claiming the credit. As such, the amount of the credit that may be claimed by a transferee cannot exceed $100,000 for a given taxable year. As to when the carryforward period begins, the tax credit is deemed to be “originated” in the taxable year in which the credit is earned. In other words, the carryforward period begins with the taxable year following the taxable year in which a qualified donation is made. As such, the transferee will inherit the carryforward period remaining as if the transferee had made the qualified donation.

7. **No Cancellation of Indebtedness Subtraction.** P.D. 03-72 (October 15, 2003). Husband and wife’s receipt of cancellation of indebtedness income arising out of the bankruptcy of a partnership in which they were partners is subject to Virginia taxation to the extent such income is included in federal adjusted gross income. There is no provision in Va. Code §58.1-322 for a subtraction of COD.
8. **Domiciliary Resident.** P. D. 03-90 (November 14, 2003). Taxpayer was a resident of another state (not Virginia). In 1997 the taxpayer was transferred overseas to work in another country. Taxpayer sold his U.S. house. Several years later taxpayer was transferred to another country to work. Taxpayer obtained a driver’s license in the first overseas country where he worked and subsequently obtained a Virginia driver’s license to use when he visited the U.S. so he could rent a car. The taxpayer also used a Virginia address to receive financial documents. The Virginia auditor assessed Virginia income taxes on the taxpayer’s income. On protest, the Tax Commissioner set aside the Virginia tax assessment holding that the taxpayer was neither an actual nor a domiciliary resident of Virginia. Evidence supported position taxpayer did not abandon his overseas domicile and obtain a Virginia domicile.

9. **Subtraction for Low Income Federal/State Employees.** P.D. 03-85 (November 4, 2003). Tax Commissioner holds that employees of the U.S. Postal Service are not defined as employees of the federal government pursuant to 5 U.S.C.A. § 2105(e) and the USPS is not defined as an independent establishment of the United States government by 5 U.S.C. § 104. Accordingly, the subtraction for the first $15,000 or less of income from the salary of each federal and state employee whose annual salary is $15,000 or less under Va. Code § 58.1-322(c)(24) does not apply to U.S. Postal Service employees.

10. **NOLs May Not Offset Capital Gain.** P.D. 03-66 (August 14, 2003). The Commissioner Virginia Department of Taxation has ruled that a net operating loss sustained by a business could not be used to offset capital gain and that the method for calculating nonresident taxable income is constitutional.

   The taxpayers in this ruling were not residents of Virginia during the tax years 1995 through 2001. During those years, they were the sole owners of a business in Virginia. For each year from 1995 through 2001, the business sustained a net operating loss, and the taxpayers filed Virginia nonresident returns reflecting those losses. In 2001, the taxpayers sold the business for a gain. On their 2001 nonresident income tax return, they offset the capital gain reported in the numerator of the nonresident apportionment ratio by the total of the net operating losses from 1995 through 2001. The Department of Taxation disallowed the offset for the net operating losses and assessed additional income tax and interest. The taxpayers challenged the disallowance, asserting that the state’s method of calculating the taxable income of nonresidents treats non-residents inconsistently and, therefore, is unconstitutional.

   The Tax Commissioner denied the NOL based on the following conclusions: the treatment of nonresident individuals is consistent with its treatment of Virginia residents with respect to NOLs; and the taxpayers were able to use the net operating losses to reduce income taxable in their state of residence for the years 1995 through 2000. In 2001, the income subject to Virginia tax was their state taxable income computed as residents multiplied by the ratio of the net operating loss of the business plus the gain from the sale of the interest divided by the taxpayer’s net income, gain, loss, and deductions from all sources.
11. **Non-Resident’s Income From S Corporation Subject to Tax.** P. D. 04-23 (June 2, 2004). A Virginia non-resident taxpayer who spent seventy percent of his working days performing consulting services in his state of residence for an S Corporation that he formed in that state, pursuant to an oral agreement with a Virginia S Corporation in which the taxpayer owned a forty-nine percent interest and for which he also performed services, was subject to Virginia personal income tax on the consulting fees he earned from the S Corporation in the other state because transactions between the two S Corporations improperly reduced the income from business performed in Virginia by the Virginia S Corporation. The Tax Commissioner held that the taxpayer's argument that he was an employee while in Virginia but an independent consultant while in the other state was an incompatible arrangement because the husband did not cease to be an officer of the Virginia S Corporation while he was in the other state. The Commissioner also questioned whether the oral agreement and the intercompany consulting fees reflected fair market intercompany transactions. The Commissioner held that the Tax Department's traditional position that an apportionment be based on the number of days that services were performed in Virginia did not apply to the taxpayer's income from S Corporations.

12. **Leased Property in Virginia by Non-Domiciliary LLC Included in Property Factor for Purposes of Apportionment.** P. D. 04-29 (June 24, 2004). Non-Virginia LLC has elected to be a disregarded entity for federal income tax purposes. Under Virginia’s conformity statute the LLC will be disregarded for Virginia income tax purposes. The LLC leases and uses all real and personal property from its Executive Director who resides in Virginia along with the property. The Tax Commissioner holds that this property should be reflected as a positive property factor for purposes of apportionment and each member receiving income from the LLC would be considered to have property in Virginia and required to file the appropriate income tax return based on their income from Virginia sources.

13. **Credit for Income Tax Paid to Connecticut.** P. D. 04-37 (July 27, 2004). A Virginia resident who was domiciled in Connecticut was entitled to a credit against Virginia personal income tax for tax paid to Connecticut on income earned during periods when the taxpayer worked outside Virginia. The credit could not exceed the income tax paid to Connecticut for the relevant period when the taxpayer worked outside both Virginia and Connecticut and could not exceed the Virginia income tax attributable to the same period.

14. **Gambling Winnings were not Business Income.** P. D. 04-59 (August 20, 2004). A Virginia resident was not entitled to a credit against Virginia personal income tax for taxes paid to another state on income from horse racing and pari-mutuel wagering because the gain was not earned or business income. The taxpayer was not engaged in a continuous and regular business of gambling because he reported the gambling income as "other income" on his federal return and reported gambling losses on his federal Schedule A. Business income must be reported on federal Schedules C, E, or F. Taxpayer indicated that he spent up to twenty-five hours per week researching,
planning, and gambling; but declined to obtain a professional gamblers license because he was not engaged in gambling full-time.

15. **Person Incarcerated Outside Virginia was Domiciled in Virginia.**

P.D. 04-60 (August 23, 2004). A Virginia resident who was incarcerated in another state was subject to Virginia personal income tax on income from the termination of retirement accounts because he did not prove that he intended to abandon his Virginia domicile. The taxpayer claimed that he established domicile in another state by involuntarily moving to the prison and receiving mail and telephone calls there. However, he indicated that he did not intend to establish residency in that state while he was incarcerated and did not obtain property, register with any governmental agency, seek employment, or file and income tax return with that state. Further, he was uncertain where he would live after being released. The Tax Commissioner held that the taxpayer failed to prove that he had abandoned his Virginia domicile and established domicile in the other state.

16. **Coalfield Employment Enhancement Tax Credit Disallowed.** P.D. 04-91 (August 31, 2004). Taxpayers who earned a Virginia Coalfield Employment Enhancement Credit through a pass-through entity but who had failed to attach Form 306 (Coalfield Employment Enhancement Tax Credit) to their Virginia personal income tax return could not claim the credit because the failure to properly attach Form 306 constituted a failure to not follow the procedure for claiming the credit. The Tax Commissioner stated that no relief may be given and that the tax credit claimed by the taxpayers was properly disallowed. The Commissioner noted that the Department of Taxation has given taxpayers and tax preparers adequate notice of the requirement by issuing a tax bulletin providing notice of the requirement and including the requirement in the instructions for Form 306.

17. **Tax Protester.** P. D. 04-106 (September 8, 2004), P.D. 04-117 (September 9, 2004), P.D. 04-139 (September 16, 2004), and P.D. 04-141 (September 16, 2004); P.D. 04-168 (October 1, 2004), and P.D. 04-169 (October 1, 2004). Assessments upheld. In six separate tax protests, various arguments were filed with the Department of Taxation contesting Virginia tax liability on a number of frivolous grounds. In each case the Tax Commissioner upheld the assessments issued by the Department and indicated that the 100% civil fraud penalty will apply if the taxpayers continue to not file income tax returns or file fraudulent tax returns.

18. **Employee Working Outside U.S. is Virginia Resident.** P.D. 04-123 (September 16, 2004). A corporation hired an employee for a position that requires the employee to travel for extended periods of time outside of the United States. The employee resided in a state that did not impose an income tax. In connection with this employment, the employee rented an apartment in Virginia where he intends to stay while working in the United States. The Tax Commissioner held that based on these facts, the employee should have wages withheld as a Virginia resident.

19. **Taxpayer Did Not Prove Abandonment of Virginia Domicile.** P.D. 04-124 (September 16, 2004). Taxpayer claims he abandoned Virginia permanently as
his Virginia domicile and reestablished himself in another state for domicile purposes. Evidence of his intent to abandon the Virginia domicile included moving into his son’s home in the new state and using a recreational vehicle registered in the new state under his son’s name as his primary source of transportation. Taxpayer admitted that he maintained a residence in Virginia but that such residence was not available for his use because his other son was residing in his former residence. The taxpayer also claimed that tax return information went to the Virginia home because his son residing in that house prepared the taxpayer’s tax papers and returns. None of taxpayer’s assertions were evidenced by any objective evidence. No lease agreements or moving receipts evidencing a move were produced. The taxpayer only provided a driver’s license in the new state along with a voter registration for the new state. The Tax Commissioner held such evidence insufficient to show that the taxpayer intended to change his domicile from Virginia to the new state during the tax year.

20. Credit for State Taxes Paid to Other State Restricted to Earned Income. P.D. 04-125 (September 16, 2004). Taxpayers, a husband and wife, are residents of Virginia and file a Virginia resident income tax return. The husband is a member of a professional limited liability company (“PLLC”) that operates offices in both Virginia and North Carolina. Partner receives a partnership tax schedule reporting his income from the PLLC. Husband claimed all of the income listed on the federal Schedule K-1 for purposes of claiming the credit for taxes paid to another state. The Tax Commissioner disallowed the credit for the portion allocated to income that was not earned income or business income.

IV. RETAIL SALES AND USE TAXES

A. 2004 Legislation

1. Declaratory Judgment to Adjudicate Constitutional Nexus. HB 1463 (Chapter 647) and SB 668 (Chapter 609) create Va. Code §8.01-184.1 to grant circuit courts jurisdiction over civil actions in which a Virginia business seeks a declaratory judgment against officials in other states to prevent such other states from forcing the Virginia business to collect and remit retail sales and use taxes to another state. In making the decision whether to grant a declaratory judgment, the circuit court must evaluate whether the demand from the other state constitutes an undue burden on interstate commerce within the meaning to the U.S. Constitution and decisions of the federal courts construing Article I, Section 8, Clause 3 of the U.S. Constitution (Commerce Clause). See Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

2. Exemption for Software, Data and Content Delivered Electronically via Internet. SB 632 (Chapter 607) amends Va. Code §58.1-609.5(1) to codify the Department of Taxation’s current policy that exempts software, data, content and other information services delivered electronically via the Internet as professional and personal service transactions.
3. **Telephone Calling Cards Subject to Sales and Use Tax; Exempt from all Other State and Local Utility Taxes.** HB 246 (Chapter 60) amends Va. Code §58.1-602 to define telephone calling cards as tangible personal property and make the initial purchase of telephone calling cards subject to Virginia sales and use tax and exempt such cards from all other state and local utility taxes.

4. **Exemption for Film and Audio Visual Works Extended.** HB 1262 (Chapter 101) and SB 571 (Chapter 606) amend Va. Code §58.1-609.6(6) to extend the sunset date from July 1, 2004 to July 1, 2009, for the sales and use tax exemption for certain tangible personal property used in the production of audio visual works (film, video, and audio).

5. **Exemption for Advertising Businesses Extended.** SB 533 (Chapter 821) amends Va. Code §58.1-609.6(4) to extend the sunset date from July 1, 2004 to July 1, 2008 for the retail sales and use tax exemption allowed for the purchase of printing materials by advertising businesses when the printed material is distributed outside Virginia.

6. **Nonprofit Exemption Modified.** HB 515 (Chapter 515) amends Va. Code §58.1-609.11 to modify the process for exempting nonprofit entities from sales and use tax as such process was designed by the 2003 General Assembly to go into effect on July 1, 2004, by (1) permitting churches to continue to use self-issued exemption certificates; (2) grandfathering the types of organizations that are exempt from collecting sales and use tax on fund-raising sales of tangible personal property; and (3) permitting nonprofit rescue or fire fighting organizations that do not hold a federal income tax exemption to be eligible for the sales and use tax exemption through June 30, 2006. The legislation also permits the Department of Taxation to refuse to grant the exemption certificates to organizations that fail to disclose their total taxable purchases for the preceding year.

7. **Sales and Use Tax Return Dealer Filing Option.** HB 1241 (Chapter 567) amends Va. Code §58.1-615 to allow dealers to file tax returns and remit payment to the local commissioner of the revenue or local treasurer instead of the Virginia Tax Commissioner. The local tax officials are required to certify the date the return is delivered to them by the dealer. The local tax official will then forward the return and tax payment to the Tax Commissioner for processing no later than the day following receipt of the return and payment by the dealer.

8. **Joint Committee to Study Collection of Remote Sales.** HJ Resolution No. 176 creates a joint subcommittee to study the impact of collecting remote sales taxes on Virginia's economy, including the impact on revenue on small businesses. In conducting its study, the joint subcommittee shall determine the amount of revenue Virginia would generate and the impact on small business located in Virginia if Virginia collected taxes on remote sales; and the ability to use the lack of a requirement to collect remote sales as a marketing tool. The joint committee shall be composed of 3 House Delegates, 2 Senators, 4 non-legislative citizen members with experience in e-commerce.
and Internet sales, 2 non-legislative citizen members with experience in accounting and collecting and remitting sales tax in multiple jurisdictions; and 3 non-voting ex officio members (Secretaries of Finance, Technology, and Commerce and Trade).

B. Recent Court Decisions

1. LZM, Inc. v. Virginia Department of Taxation. Case No. CL 01-0552, Montgomery County Cir. Ct., August 21, 2003) also reported by the Department of Taxation at P.D. 03-67 (Aug. 21, 2003). The Trial Court granted summary judgment to the Department of Taxation upholding the Department’s assessment of sales and use taxes on the total charges for the taxpayer’s lease and pumping service of portable toilets. In reaching this result the court applied the “true object” test in WTAR Radio-TV Corp. v. Commonwealth of Virginia, 217 Va. 877 (1977). LZM leased 445 toilets, all except 115 toilets, involved the providing of a pumping service in addition to the lease of the portable toilets. The remaining 115 toilets were leased without a pumping service, but simply picked up by LZM at the end of the agreed time period. These 115 toilets were subsequently pumped before subsequent releasing. LZM billed separately for the toilet leases and the pumping services. Negotiations for both the lease and pumping services occurred at the time of the lease as part of one transaction. The Trial Court held the “true object” of the transaction was the rental of the portable toilets, and the pumping services provided were maintenance necessary to ensure the proper operation of the leased toilet. The court also noted that the pumping service was not offered as a separate service to consumers, but was offered only to lessees of portable toilets.

C. Recent Virginia Tax Commissioner Rulings

1. Bad Debt/Gifts. P.D. 03-86 (November 12, 2003). Tax Commissioner holds that the deduction for bad debts is to be computed on each bad debt and not on the aggregate of all bad debts for a particular period. The Department also sustained the sales tax assessed on gifts that were shipped out of Virginia upholding regulation 23 VAC 10-210-680 and concluding there was no Commerce Clause, Equal Protection Clause or Due Process Clause violations of the U.S. Constitutions on “deemed” possession of gift items in Virginia.


3. Audit: Separately Stated Taxes. P.D. 03-82 (November 3, 2003). The Department held an automobile dealership liable for use taxes on its purchase of business assets despite claim by dealer that seller of the assets included the sales tax as a component of the total purchase price. The Department noted taxpayer could not demonstrate tax was charged and paid from transaction documents and the seller of the equipment was not registered to collect Virginia sales and use tax.

fixed assets due to poor documentation. Repair charges also fully taxed as no
documentation was provided to support claims of exempt labor and incidental parts.
Training services included with taxpayer's purchase of software were taxable as a
constituent part of the sale of the software – there was not separate contract for the
training services, although the price for training was separately stated on the invoice.

5. Dual Use Equipment – Telecommunications/Computer Cable
Installation. P.D. 03-87 (November 12, 2003). Taxpayer is in the business of installing
cable and telecommunications/computer systems. Taxpayer treated all sales and services
as retail sales. Cable was purchased without tax as a purchase for resale, and tax was
collected from the customer at the time of installation. The Department treated the
taxpayer as a real estate contractor when it installed cable in walls, ceilings and floors.
Accordingly, the tax was due on the cable when purchased, with no obligation to collect
from the customer when installed. The Department did allow the collected sales tax to be
credited against the use tax assessment.

Taxpayer operated a hardware store. During audit the Department challenged a number
of exemption certificates maintained for sales to certain organizations (Church,
Agricultural, Commercial Waterman, Resale, and Ships and Vessels) and assessed tax.
The assessment was upheld on the basis that the vendor could not rely on the certificates
in good faith due to their incompleteness, improper use by wrong entity, and similar
problems that in the Department’s view “should have been noticed” at time of
transactions.

pile-driving contractor, subcontracted with a general contractor on two real estate
construction projects. The general contractor contracted with the IDA for purchases of
tangible personal property. The Department assessed a use tax on taxpayer under the
general rule of Va. Code § 58.1-610(B), which imposes use tax on contractors who are
“provided” property ex-tax by exempt organizations.

8. Government Credit Cards. P.D. 03-94. The Tax Commissioner
amended its prior ruling in P.D. 02-105, concerning the federal government’s use of
government-issued credit cards to make purchases exempt from Virginia sales and use
taxes, and to clarify details concerning the four types of credit cards issued under the
GSA Smart Pay Program.

9. Hotel Room Rental. P.D. 03-93 (December 10, 2003). Taxpayer was
charged sales tax on an “attrition fee” collected as damages when a customer cancelled a
contract to rent a block of 20 rooms on short notice. While the charge for the rent for the
rooms would have been exempt (due to the duration of the rental), when the charge was
converted and classified as damages, it fell outside the exemption. The Tax
Commissioner did exclude golf green fees from the sales tax audit as those charges
reflected a payment for the use of real property. Charges for golf carts were subject to
sales tax.
10. **International Mail and Packaging Service.** P.D. 04-11 (April 2, 2004). Taxpayer is an Agency that operates an international mail and packaging system to deliver personal mail and packages sent to American staff and families assigned to diplomatic and consular missions throughout the world. The mail and packages are delivered to a special zip code located at a Virginia based U.S. postal facility. From there the mail and packages are delivered to the Agency’s mail facility located in Virginia where the mail/packages are staged, sorted, x-rayed for security, consolidated and placed in sealed pouches. The sealed pouches are then delivered to freight forwarders for air shipment to the various embassies throughout the world. The Agency sought a ruling that any packages including gifts or items for which sales or use taxes were not paid, would not subject the Agency to a sales tax on any mail order purchases. The Tax Commissioner ruled the Agency had no sales tax exposure.

11. **Business of Leasing.** P.D. 04-1 (January 13, 2004). A partnership that was created by a group of doctors to acquire office furniture and equipment to be leased by the medical practice was required to pay Virginia sales tax on monthly rental charges because the partnership was engaged in the business of leasing or renting tangible personal property. The partnership claimed that it was not engaged in a leasing or rental business because it was created solely to own the equipment used by the practice, it leased only to the practice, and it did not hold itself out to the public or others as being in the business of leasing. However, the fact that the partnership leased only to the medical practice did not negate the fact that the transfer of equipment between the partnership and the practice constituted a taxable transaction.

12. **Manufacturing.** P.D. 03-71 (October 15, 2003). Taxpayer owned a restaurant with an on-site micro-brewery. Taxpayer asserts its brewing equipment purchases should be exempt manufacturing equipment and that its process was industrial in nature (SIC Code 2082 brewing of beer). Auditor assessed tax and stated brewing activities off-site must exceed 50 percent of total beer sales and taxpayer’s beer sales were retail, not wholesale. The Tax Commissioner upheld the assessment because more than 50 percent of beer sales are for direct sale on the premises to customers (a nonindustrial, taxable activity).

13. **Manufacturing.** P.D. 04-2 (January 13, 2004). Several purchases made by a truck parts manufacturer are exempt from sales and use tax because they were used directly in production as either component parts of exempt production equipment or for production line quality control. The equipment at issue was:

- a bake oven;
- floor plates; steel and grout;
- paint booth components;
- data gathering software; and
Regarding the bake oven, the Commissioner said that the beams, posts and insulated panels purchased to build the shell of the bake oven are component parts and do not serve any other function. The oven encloses the heat needed to cure painted products and creates a special environment that is a necessary and immediate part of the production process. Accordingly, the beams, posts and panels are deemed used directly in production and will be removed from the audit, the Commissioner rules.

Considering the floor plates, the Commissioner determined that the plates rest on the floor and are not permanently attached to realty. Finding similarity the steel supports that were treated as part of exempt machinery in P.D. 91-183, the Commissioner ruled that the floor plates constituted component parts of exempt equipment and were not taxable. A similar conclusion was reached with respect to steel used in building frames for manufacturing processes. Finally, grout used to level the presses during installation was found exempt as a component part of the exempt presses because it acted as "mortar" holding the presses in place.

The paint booth components were found taxable. Although the booth was used in the taxpayer’s production process, it did not create a special environment necessary to the production process. Therefore, it was treated as if it were a "work area" and not equipment. This is consistent with prior Department rulings on paint booths. The Commissioner also upheld the assessment of tax on software used to gather data in the bar coding process for warranty purposes because it did not operate or control machines necessary to the production process. Under Virginia Regulations Section 10-210-920(C)(2), the industrial manufacturing exemption applies to "computer hardware and software used to direct or control production line and/or quality control operations."

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The mechanical desktop AutoCAD software, the Commissioner held that it was used intermittently for quality control and primarily to design molds based on drawings furnished by customers. In this capacity, the software would appear to be used in a taxable engineering capacity rather than an exempt research and development activity. As a result, it was taxable.

14. Manufacturer/Research and Development. P.D. 04-8 (March 19, 2004). Taxpayer is a manufacturer of fuel injectors and fuel rails for the automotive industry. Taxpayer also builds and sells prototypes of these items. The taxpayer manufactured the product in accordance with the prototype. At issue was the availability of the manufacturing exemption to equipment located in the prototype lab. The Commissioner held that equipment in the prototype lab did not qualify as exempt manufacturing equipment because the construction of prototypes was a "preproduction" activity. The Commissioner further held that the equipment was not eligible for the research and development equipment exemption because the equipment was used 60%-70% of the time in actually prototype production. The R and D exemption requires the equipment to be used exclusively for R and D activities.
15. **Manufacturing – On-Site Production.** P.D. 03-80 (November 3, 2003). Taxpayer operates an industrial laundry and rents linens, uniforms and various other items to customers. Taxpayer also provides commercial laundry services to large hotels and hospitals. At issue was the application of tax to boiler chemicals, a linen table, and the forklift trucks. The Tax Department held that the boiler chemicals did not qualify for the manufacturing exemption relying upon *Webster Brick Co., Inc. v. Department of Taxation*, 219 Va. 81, 87 (1978) and *B.I. Chemicals, Inc. v. Department of Taxation*, 34 Va. Cir. 502 (Richmond City 1994). The Tax Commissioner also held the linen table and forklift trucks were taxable because they were used away from the production site (not elsewhere on the same property where the exempt activities occurred).

16. **Maritime Port.** P.D. 03-70 (October 15, 2003). Taxpayer signed a contract with the Virginia Port Authority (Virginia government agency) to plan, integrate, and implement comprehensive maritime and port related security system projects. Taxpayer asked if its equipment purchases would qualify for the marine terminal exemption. The Tax Commissioner concluded the property purchases would be taxable because the property was not going to be used for handling cargo, merchandise, freight and equipment. The equipment was also not going to be used in the operation of the marine terminal.

17. **Packaging Materials.** P.D. 03-79 (November 3, 2003). Taxpayer manufactured concrete block and masonry products. Finished product was placed on pallets and subjected to shrink wrapped plastic bags that had been placed over the block product and pallets. Taxpayer challenged an assessment of tax on the pallets it used as part of the packaging of its product for shipment. The general rule is that pallets are taxable materials and not packaging materials, although they become exempt packaging materials when bound by shrink-wrapping or some other bonding material to the items they carry so as to restrain product movement in more than a single plan of direction. See P.D. 98-47 (March 11, 1998). The Tax Commissioner, however, upheld the assessment because its auditors observed most of the block product in the staging yard was not covered by plastic bags for subsequent shrink-wrapping.

18. **Research and Development.** P.D. 03-91 (November 14, 2003). Taxpayer is engaged in basic laboratory research and it purchases supplies that it uses or consumes directly in the development of new products or the improvement of existing products for the pharmaceutical manufacturing industry. The Tax Commissioner agrees that taxpayer’s testing and analysis are part of the research and development of its customers’ products.

19. **Virginia Public Procurement Act – Prohibited Source.** P.D. 04-4 (January 23, 2004). A vendor was prohibited from doing business with Virginia as an approved vendor because one of the vendor’s affiliates failed to register to collect and remit Virginia sales and use tax on Virginia sales. The Virginia Public Procurement Act prohibits state agencies from contracting for goods or services with nongovernmental sources if a source or its affiliates is required to collect tax under Virginia’s sales and use tax nexus statute but fails or refuses to collect and remit tax on its sales delivered to
locations within Virginia. The affiliate met the definition of a “dealer” required to
register pursuant to the nexus statute because it was owned or controlled by the same
interests that owned or controlled a business located in Virginia.

20. **Voice and Data Communications.** P.D. 03-84 (November 4, 2003).
     Taxpayer provides voice and data communications from a Virginia location to overseas
     locations. The Department assessed tax on office and computer equipment purchases.
     Taxpayer claims its equipment is exempt because it has an FCC overseas common carrier
     license. The Tax Commissioner holds taxpayer is not a telecommunications company
     within the meaning of Va. Code § 58.1-609.3(3). When the definition of a
     telecommunications company was amended in 1999, it required a telecommunications
     company to hold a certificate of convenience issued by the SCC. Taxpayer does not hold
     a SCC certificate of convenience. The Tax Commissioner also ruled there was no
     Commerce Clause violation because substantial differences existed between international
     markets served by the taxpayer and local markets served by telecommunications
     companies.

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

22. **Taxable Sales Price Does not Include Buy-Down Discount.** P.D. 04-
     42 (August 11, 2004). A retailer that sold cigarettes to customers for a discounted price
     and was subsequently reimbursed by a tobacco manufacturer in connection with a buy-
     down program was required to collect and remit Virginia sales and use tax based on the
     discounted price. The buy-down incentive paid by the manufacturer to the retailer was
     separate and distinct from the retail sale transaction and was not subject to retail sales and
     use tax. The taxpayer’s books and records should reflect the tax due on the discounted
     selling price charged to customers.

23. **Software License to Virginia Stockbrokers Taxable when Transferred
     Via Tangible Medium.** P.D. 04-38 (July 28, 2004). The Tax Commissioner held that
     fees associated with the license of trading software are subject to sales and use tax if the
     software is delivered in tangible form. An out-of-state software developer asked the Tax
     Department whether stock-trading software licensed to brokers in Virginia would be
     subject to sales and use tax. The Tax Commissioner advised that the taxability of the
     software depends on the method of delivery. If the software is transmitted electronically,
     there would be no sales and use tax associated with the software licenses. However,
     should the software be delivered via CD-ROM then the fees associated with the software
     licenses would be taxable. The Commissioner did provide that the electronic information
     service charges would generally be exempt as they are separately stated exchange fees
     and installation labor. The Commissioner also advised that a broker’s sub-license to an
     end user is taxable unless the software is also delivered electronically. The resale
     exemption is not applicable because the broker is authorized to use the software.
24. **Exemption for Goods Stored in Virginia but Sold Outside of Virginia Granted.** P.D. 04-62 (August 23, 2004). Goods held in Virginia as part of storage arrangements and then subsequently sold to out-of-state customers are held not to be subject to Virginia sales tax because the transfer of title and possession of the goods occurred outside of Virginia. The Tax Department noted that the transactions qualified as exempt sales in interstate commerce under Va. Code §58.1-609.10(4). In this ruling the taxpayer, a manufacturer of printed business communications products, entered into storage agreements where forms were temporarily stored in its Virginia warehouse for subsequent delivery to its customers located outside of Virginia. Under the agreements, the taxpayer placed into storage a supply of printed forms. Title to the printed forms remained with the taxpayer until the customers were invoiced. At audit, the Department held that the goods held in the warehouse were completed sales. On appeal, the taxpayer asserted that the goods were being held in a resale inventory for sale in the ordinary course of business. The sale did not occur until the property was shipped to the customers and there was no taxable use of the property in Virginia. The Commissioner agreed.

25. **Hotel Reward Points not Included in Sales Price.** P.D. 04-68 (August 24, 2004). The value of reward points used in a hotel’s point redemption program was not included in the sales price of hotel rooms subject to Virginia sales tax because the points were analogous to retailer’s coupons. If a participant redeemed points for a complimentary room, the hotel was not required to charge or collect sales tax. If points were redeemed for a fifty-percent reduction in a charge of the room, the hotel was required to collect tax only on the portion of the room charge that was not subject to the discount. If points were redeemed for a free room upgrade the hotel was required to charge and collect tax only on the actual amount charged for the room.

26. **Safety Equipment Exemption Denied.** P.D. 04-76 (August 25, 2004). Reflective signs, strobe lights, and safety nets purchased by a mining company for use in its mining business were not eligible for the Virginia sales and use tax exemption for property used directly in mining because the property was not used directly in mining operations, even though the mining company was required by federal or state law to incorporate those items in its safety plan. However, purchases of reflective tags and hardhats qualify for the exemption as protective apparel.

27. **Audit Sample Excluded Use Tax Paid in Error.** P.D. 04-84 (August 27, 2004). Virginia use tax accrued and paid in error to the Tax Department was not included in the taxpayer’s Virginia sales and use tax audit sample because the taxpayer’s tax treatment of the vendors for which tax was accrued in error was not consistent throughout the audit. Therefore, including the use tax as a credit in the sample base would have skewed the sample and nullified its validity. Although use tax accrued and paid in error has been included in audit samples in the past, the Commissioner stated that it does not include it if inclusion would distort an audit sample.

28. **Broadcasting Exemption Denied to Internet Service Provider.** P.D. 04-89 (August 31, 2004). Purchases of equipment by an Internet Service Provider
(“ISP”) that directed customers to the homepage of another ISP that provided proprietary content, email, access to the Worldwide Web, and other features were not exempt from Virginia sales and use tax as purchases of broadcasting equipment used by a video programmer providing internet service because the exemption is only available only to ISPs that provide proprietary content and other specific services directly to end-user subscribers. In this case, the proprietary content and email were provided by the other ISP rather than the taxpayer. The Tax Commissioner disagrees with a prior Virginia Attorney General Opinion No. 00-005 which holds that the exemption applies to equipment used to enable other companies to provide Internet access service to end-users. The Commissioner stated that under the rule of strict construction, the statutory language makes it clear that the exemption is available only to ISPs that offer proprietary and other content and email as part of a package to end-user subscribers.

29. Occasional Sale Exemption. P.D. 04-14 (May 3, 2004). Taxpayer established a successor entity to assume ownership and operation of a multi-speciality medical clinic. The taxpayer caused this successor entity to purchase the tangible and intangible assets of a health management company that was responsible for providing management and administrative services regarding the operation of taxpayer’s clinic. The assets purchased include medical and office equipment, furnishings and fixtures, and phone and computer equipment. The accounts receivable of the management medical practice were also conveyed in the sale. An examination of the selling company indicated that greater than eighty-percent of the total assets were sold to the taxpayer’s successor entity. The Tax Commissioner concluded that this sale of assets constituted substantially all of the assets of the selling entity and the transaction qualified as an exempt occasional sale.

30. Steel Fabrication Status Denied. P.D. 04-22 (June 2, 2004). Taxpayers are out-of-state contractors that furnish and install structural steel, steel stairs and steel railings in the performance of real property construction contracts in Virginia. As a result of an audit the taxpayers were assessed use tax on labor charges to fabricate tangible personal property for use in their Virginia construction contracts. The Tax Commissioner denied the exclusion of labor charges to fabricators engaged in real property construction under 23 VAC § 10-210-410(D) because the Commissioner held the taxpayers do not perform fabrication services. The taxpayers in this dispute contract with third parties to fabricate the materials that are used by them in Virginia real property construction projects. The Virginia regulation applicable to contractors that perform the actual fabrication of tangible personal property for their own use in real property construction only applies to the actual construction contractors and therefore is not applicable to the activities of the taxpayer. Labor charges billed to the taxpayers for the fabrication of materials used in Virginia real property construction jobs by the taxpayer were properly assessed as use taxes.

31. Traffic Design Services are Non-Taxable. P.D. 04-24 (June 2, 2004). Taxpayer is a developer of Internet banking, bill payment and bill presentment software and services for banks and other financial institutions. The taxpayer purchased graphic design services from several vendors for use in its newsletter and product packaging.
The resulting products were newsletters and product packaging (tangible property). The Tax Commissioner held that the “true object” test required that the charges for graphic design services be subject to tax because the true object of the transaction was to secure a service and the tangible personal property (prints, film and other materials) that were used in the newsletter. These items were critical to the ultimate transaction thus rendering the entire charge for the artwork and copy work taxable.

32. **Public Service Corporation Exemption Denied for Multiple Items of Property and Equipment.** P.D. 04-25 (June 2, 2004). The taxpayer is a state-regulated public utility engaged in the business of providing electric power to Virginia customers. The utility contested a number of assessed items and asserts such items were used directly in the rendition of its public service pursuant to Va. Code §58.1-609.3(3) [recently repealed by the 2004 General Assembly]. The Tax Commissioner denied the exemption for all of the items asserted on the basis that they were not used directly in the rendition of electricity and therefore are taxable. Specifically, the Commissioner noted that testing rubber hoses and blankets used to test the integrity of exempt insulating hoses and blankets are taxable. The actual insulating hoses and blankets would qualify for the exemption, however, the property used to test these items are taxable. Guy assemblies used to brace wooden poles that support the electric distribution lines are also taxable, despite their role as essential to the operation of a utility service. Guy assemblies are not used immediately for the transmission and distribution of electricity. Furthermore, the Commissioner held that ground rods, truck grounds, and ground plates all used to ensure that the electric distribution system is fully ground were taxable. When utility services disconnected, disconnecting sleeves are placed on the back of a meter to provide an insulating barrier between the utility’s electric distribution system and the equipment of the property owner by stopping the flow of electricity to the customer. While these items are necessary, the Commissioner held that such disconnect sleeves are taxable.

33. **Car Wash System at Convenience Store/Service Station Taxable as Business Personal Property.** P.D. 04-27 (June 10, 2004). The Commissioner held that a car wash system installed at a convenience store with full service car wash and quick lube centers was subject to sales and use taxes and not exempt real property. At issue was whether the vendor who furnished the components and installed a fully-automated conveyor system that incorporates computer monitors and control consoles (a foam sprayer, curtains, brushes, wands, chemical and water applicators and blowers) should have been responsible as a consuming user and pay the use tax on these items because they were fixtures to the real property. The Tax Department held that the three-prong test to determine whether tangible personal property is a fixture was not met in this case. The Commissioner also noted that the taxpayer reported these items of the car wash as equipment and machinery and business personal property and not as improvements to real property, for local tax purposes.

34. **Conveyor Flooring and Supports Not-Exempt Manufacturing Equipment.** P.D. 04-43 (August 12, 2004). Taxpayer, a furniture manufacturer, constructed a new manufacturing facility. In this facility a new conveyor system that is used directly in the manufacturing of furniture was constructed. In connection with this
project certain conveyor flooring, floor supports and related items of property were used in part of the overall conveyor system. The Tax Commissioner held that such items were not exempt from tax as a result of the manufacturing exemption because such items, while essential to the operation of the business, did not become an immediate part of the actual production process. The Commissioner also upheld the sales tax assessment on the taxpayer’s purchase of canned software. However, training services provided in connection with pre-written computer software that was provided outside of the state of Virginia would not be subjected to Virginia tax as these purchasers of training were contracted for separately from the actual software purchases.

35. Utility's Purchase of Electronic Receiver Transmitters (ERT Units) Not-Exempt. P.D. 04-48 (August 13, 2004). Taxpayer, a public utility engaged in the transmission, distribution and sale of natural gas purchased ERT units for installation on new and used gas meters. The ERT unit read customer usage data and broadcast that data to a mobile or fixed automatic meter reading system. This latter system facilitates the quick and efficient rendition of gas consumption for customer billing purposes. The Tax Commissioner held that the purchase of ERT units is fully taxable and not exempt under the public utility exemption. The Commissioner held that ERT units are fully taxed because they were simply installed on exempt meters. The meter vendor did not sell the meter and an ERT unit to the utility. Had the meter and ERT unit been purchased a single unit, the transaction would have qualified for the public utility exemption. Furthermore, the Commissioner noted that the ERT units serve only a billing purpose function and are not, by themselves, used in an exempt distribution activity, but rather are used in a taxable administrative activity. The presence or absence of an ERT has no effect on the availability and delivery of gas to the customer. The gas flows with or without it.

36. Dental Equipment Leases Taxable. P.D. 04-52 (August 18, 2004). Professional corporation made up of individual dentists are required to pay sales tax on lease payments to themselves individually on equipment leased to the professional corporation. The payments compensated the dentist for equipment they owned prior to incorporating. The lease arrangement was created as a reimbursement mechanism because the individual dentist did not want to contribute equipment into the professional corporation for fear of not being able to retrieve such equipment should the practice be dissolved. The professional corporation argued that the payments to the dentist are merely reimbursements to compensate the dentist for what they were individually paying on the equipment. The Tax Commissioner held the agreement reflects that these were lease agreements. The documentation indicated that the professional corporation was referred to as the lessee and the individual dentist were the lessors. The arrangements would be respected and the leases are subject to sales tax on each monthly payment.

37. Occasional Sale Exemption for Division. P.D. 04-55 (August 20, 2004). A multi-national manufacturer of automotive supplies, electrical products, household goods, and manufacturing equipment sold all of the assets of its DIED division. Taxpayer also sold all of the assets of its M&CD division ending that division’s operations. The Tax Commissioner held that these two sales both qualified for the
occasional sale exemption. The business divisions sold were engaged in totally separate and distinct activities, maintain separate books, separate bank accounts, had separate fixed assets, separate employees, and there was a separate and distinct flow of economic advantage from one division of the organization to another. Both division sales qualify for the occasional sale exemption.

38. Occasional Sale Exemption of Division. P.D. 04-56 (August 20, 2004). An information technology service and product company sold all or substantially (95%) all of the assets of a business and claimed the occasional sale exemption applied to the transaction. The Tax Commissioner noted that the business division engaged in totally separate and distinct activities based on such considerations as separate books that are separately maintained, separate bank accounts, separation of fixed asset, separation of employees, and the flow of economic advantage of one division of the organization to another. However, the division at issue in this protest did not maintain a separate bank account but did segregate its checking transactions by using a different check style and separate signature authorization list and separate deposit serial numbers. The Commissioner held that the transaction qualified for the occasional sale exemption.

39. Incoming Freight Charges Subject to Tax. P.D. 04-61 (August 23, 2004). The Tax Commissioner held that its assessment of sales taxes on incoming freight charges (freight-in) passed on to the taxpayer’s customers are properly subject to tax. The taxpayer passed the freight-in charge on to its customers as a separate charge on the sale invoice but did not collect the sales tax on the separately stated freight-in charge. The exemption for transportation or delivery charges added to a taxable sale only applies to outgoing or “transportation-out” charges for delivery from the seller to the purchaser. Exempt transportation and delivery charges do not include charges from a manufacturer to a retailer’s place of business relating to purchases for resale.

40. Government Contractor Deemed User of Tangible Personal Property in Connection with Government Service Contract. P.D. 04-65 (August 24, 2004). Taxpayer, a government contractor, operated and maintained hazardous waste accumulation facilities on a military installation. In connection with this contract, taxpayer purchased storage drums upon which hazardous waste was deposited in connection with the contract. The taxpayer was invoiced directly for the purchase of these drums. The government’s credit as not bound directly to the vendor for the drum purchases, rather, the government made payments to the taxpayer for all services incurred in relation to the contract and the drum purchases. The Tax Commissioner upheld the use tax on the contractor on its use of drums purchased in connection with the contract.

41. Portable Storage Silos for Mortar Not Exempt Manufacturing Property. P.D. 04-70 (August 24, 2004). Taxpayer is a manufacturer of dry masonry products. The taxpayer custom blends dry mortar ingredients, including sand and any color pigments or ad mixtures, and packages the dry mortar in 3,000-pound bags for sale. Taxpayer also has portable silos that can be delivered to a customer’s job-site for use in mixing the mortar. The Tax Department assessed use tax on the portable silos.
The Tax Commissioner held that the portable silos were not part of the integrated manufacturing process and did not qualify for the manufacturing exemption.

42. Rocket Motor Testing Equipment Taxable. P.D. 04-71 (August 24, 2004). Taxpayer, a federal government contractor, specialized in the development and manufacture of rocket motors used in stinger anti-aircraft missiles. Taxpayer was assessed tax on testing equipment on the rocket motors that powered the explosive missiles. Taxpayer contested the tax on the testing equipment asserting that it was exempt production line testing and quality control. The Tax Commissioner disagreed because the motors were not tested “on the production line”. Taxpayer had argued that its production line for the manufacture of these products was not located at a single facility on its campus, but rather occurred at several different facilities on its campus until the products are completed and conveyed to the on-site storage warehouse. The taxpayer also argued that the federal government regulations require testing to be performed at a specified distance away from workers in the surrounding community. The federal government regulations required testing of the products to occur at a location physically separate from the rest of the production line, although it was still on the same campus of taxpayer’s manufacturing facility. The Tax Commissioner upheld the tax assessment stating that the testing of the motors occurs after the product is off of the production line.

43. Ancillary Water Purification Business Not Industrial in Nature and is Incidental to Overall Business. P.D. 04-73 (August 24, 2004). The Tax Commissioner held that a water purification operation that removed chlorine and other impurities from municipal water, adds oxygen, and bottles the water in five-gallon bottles did not qualify for the manufacturing exemption. The taxpayer sold coffee, office products, cleaning supplies and other items at retail to business customers. The Tax Commissioner held that the water purification process was a manufacturing activity. However, the manufacturing activities relating to the water purification were an incidental part of the taxpayer’s retail business. Furthermore, the activities were not industrial in nature and therefore do not qualify for the industrial manufacturing exemption.

44. Training and Showing of Horses Exceeds Agricultural Exemption Requirements. P. D. 04-162 (October 1, 2004). Taxpayer operates a horse breeding and training facility. The Tax Commissioner held that horses purchased exclusively as breeding stock are exempt from the tax. Furthermore, feed and supplies used in connection with the breeding stock also qualify for the exemption from tax. However, horses which are both used for breeding as well as training do not qualify for the agricultural exemption. The feed and supplies used for the mixed breeding stock also does not qualify for the exemption. The Commissioner held that horses that are trained and/or showed in competition to enhance resale value goes beyond the intent of the resale exemption and becomes a taxable use by the taxpayer. The subsequent sale of such horses are subject to the sales tax unless the purchaser provides the taxpayer an exemption certificate. The Tax Commissioner also held that the training of horses represented a non-taxable service not subject to sales tax on fees for training services. Furthermore, taxpayer’s purchase of prescription medication that is dispensed by a veterinarian could also be purchased exempt of tax.
45. **Demonstration Computer Units, Refurbished, May be Reclassified as Resale Inventory.** P.D. 04-163 (October 1, 2004). Taxpayer, engaged in the research, development and commercialization of computer technology, hardware and related software, withdraws computer units from its resale inventory for use in product demonstration. These demonstration units are issued to taxpayer's sales personnel or directly to customers. Units issued to the sales personnel are returned after a two-year period and a new computer is issued. Units issued to its customers are provided on a trial basis. At the end of the trial period, the customer may opt to purchase the unit, purchase a new unit or make no purchase at all. Units returned by the sales personnel and the customers are returned to the demo-pool and are refurbished and are then sold to price-sensitive customers or sold to customers who wish to purchase the used units. Assuming convincing documentation of the above facts exist, the Tax Commissioner will permit the demonstration units to be reclassified as inventory and support a finding that the units do not lose their exempt status as resale inventory while in the possession of the taxpayer’s sales personnel and its customers.

46. **Hazardous Waste Removal and Disposal Subject to Tax.** P.D. 04-166 (October 2, 2004). Taxpayer operates an automotive paint and body shop. The Tax Commissioner upheld the sales tax assessment on charges for hazardous waste removal and disposal that was billed to customers in transactions involving the sale of tangible personal property.

**V. PROPERTY (AD VALOREM TAXES)**

A. 2004 Legislation

1. **Real Property Tax – Elderly/Disabled Exemption.** HB 94 (Chapter 77) amends Va. Code §58.1-3211 to modify the income and net worth limitations for determining whether persons 65 or older, or those who are permanently and totally disabled, qualify for the exemption or deferral of local real property taxes. This legislation increases the net worth limitation for determining whether these persons qualify from $100,000 to $200,000 and increases the amount of income that may be excluded in determining the combined income limitation from $7,500 to $10,000. This legislation also increases the amount of income of a non-spouse relative living in the residence that may be excluded in determining the total combined income limitation from $8,500 to $10,000. The new law also increases the total amount of assets from $5,000 to $10,000 that a taxpayer can transfer to a relative who lives with and provides care to the taxpayer without the relative’s income being counted towards the taxpayer’s income limit.

2. **Real Property Tax – Elderly/Disabled Exemption.** HB 97 (Chapter 78) amends Va. Code §58.1-3211 to increase from one to 10 the maximum number of acres a locality may exclude in calculating the maximum financial worth of the elderly or disabled for real estate tax exemptions.
3. Non-Judicial Sale of Tax Delinquent Property. HB 925 (Chapter 100) adopts Va. Code §58.1-3975 to permit the local treasurer to sell tax delinquent provided real estate in a non-judicial sale if it is assessed at less than $10,000 and it is less than 4,000 square feet or it is not a buildable lot. The new law provides that the owner may redeem the property at any time before the sale by paying the delinquent taxes, penalties, interest, and pro-rata cost of advertising the sale. The treasurer may enter into an installment agreement of up to 12 months to pay the full redemption amount. Purchasers at a non-judicial sale would be entitled to some of the same protections as purchasers at judicial sales.

4. Property Tax Exemptions (Classification and Designation). HB 76 (Chapter 557) provides clarification to the process localities must follow in determining whether real or personal property of certain charitable and other related organizations may be exempted from local property taxes by amending Va. Code §58.1-3651. The legislation is retroactive to January 1, 2003 and is declarative of existing law.

5. Electric Supplier Reporting. SB 120 (Chapter 661) amends Va. Code §58.1-2628 dealing with the annual report filed by utilities. This legislation provides that the real and tangible personal property located in Virginia that is leased and operated by each electric supplier and corporation in the business of furnishing heat, light and power by means of electricity includes only those assets directly associated with production facilities and shall not mean real estate or vehicles. This legislation is effective January 1, 2004.

6. Electric Suppliers’ Property Tax Rates. SB 366 (Chapter 504) amends Va. Code §58.1-2606 to clarify that localities may tax certain electric suppliers’ generating equipment at a rate less than the local real estate tax rate. This legislation addresses confusion many localities had over their ability to use a rate less than the real estate rate on generating equipment.

B. Recent Court Decisions.

1. Personal Property Tax – Newspaper’s Computers are not “Machinery and Tools.” In The Daily Press, Inc. v. City of Newport News, 265 Va. 304, 576 S.E. 2d 430 (2003) the Virginia Supreme Court, reversing the circuit court, held computers and equipment used in a newspaper publisher news-gathering, editing, wire-services, photo labs, camera/platemaking, composition, and production and advertising functions. The publisher had argued that this equipment, while supportive of its manufacturing functions, was not related to the actual production or manufacturing of its product or used in connection with any machinery actually used in the manufacturing process. Accordingly, the publisher argued that the property should not be taxed as “machinery and tools,” but should be classified as manufacturer’s capital not subject to taxation. The
Circuit Court disagreed, holding that the integrated nature of the taxpayer's manufacturing process precluded any artificial boundaries between the various stages of production. The court held that the equipment used in the preparatory stages of collecting and organizing the information to be printed was both necessary and used in connection with the manufacturing process. As a result, the court held that the property was properly subject to taxation as machinery and tools.

**Virginia Supreme Court Decision:** Reversed and held that the only place where "manufacturing" occurs is in the press room. There, a printing press, using ink, a water fountain solution mix, and the aluminum press plate, transforms a news print roll weighing approximately 2,000 pounds into a newspaper. The machines and equipment used to gather and store the news and advertisements, to determine the content of the newspaper and its physical layout, and to create the aluminum press plate, i.e., the machines and equipment utilized in the newsgathering and pre-press functions were not used in the "actual process of manufacturing" or "used" in connection with the operation of machinery which is actually and directly used in the manufacturing process.

The city equated news-gathering, writing, editing and layout functions with the design and engineering activities classified as manufacturing in *County of Chesterfield v. BBC Brown Boveri, Inc.*, 238 Va. 64 (1989). The Supreme Court held the city's approach and its reliance on that decision misconstrue the issue in the present case.

The Supreme Court concluded that the personal property taxes at issue were erroneously assessed and that the newspaper was entitled to a refund of the taxes paid pursuant to the erroneous assessments plus interest.

2. **Alderson v. County of Alleghany**, 266 Va. 333 (2003). The Supreme Court of Virginia rejected an attempt by residents of the Town (formerly City) of Clifton Forge to avoid personal property tax for 2001 as a consequence of Clifton Forge's conversion to town status. The County's tax day was January 1, 2001, but the reversion was not effective until July 1, 2001. The General Assembly enacted legislation which created two 6-month tax years and validated the County's assessment of tax at the City's rate for the first short year and at the County's rate for the second short year. The Court rejected the taxpayers' argument that the special legislation violated either the uniformity requirement or the *ex post facto* prohibition of the Virginia Constitution.

3. **Shenandoah Associates v. County of Shenandoah**, 2003 Va. Cir. LEXIS 89 (Shenandoah County Cir. Ct., Law Nos. CL 98-132 & CL 01-140; July 2, 2003). Trial Judge held that the County's failure to consider restrictions on certain property affecting marketability constituted the disregard of controlling evidence. He further held that the taxpayer overcame the presumption that the assessment was correct. Specifically, the property, a housing facility for the elderly and handicapped, was subject to a deed of trust which precluded conveyance or encumbrance of the property or assignment of the underlying loan - the loan was with HUD and contained a prohibition on pre-payment. The effect was to make the property incapable of being sold while the deed of trust remained in place. See also **Woodstock Assoc. v. Shenandoah County**, 2003
4. **Young Life, Inc. v. Rockbridge County**, (At Law No. CH 300048-00, Cir. Ct. Rockbridge County, October 30, 2003). The Rockbridge County Circuit Court overruled six demurrers filed by the County challenging the ability of Young Life, Inc. to maintain an action to establish itself as either a not-for-profit charitable organization like the YMCA under Va. Code §58.1-3606(A)(5) or a Religious Association within the meaning of Va. Code §§58.1-3609 and 58.1-3617. The Circuit Court specifically held that the Constitutional Amendment delegating to localities the right to grant exemptions by designation after January 1, 2003 (in place of the General Assembly) did not repeal the property tax exemptions set forth in Va. Code §§58.1-3606(A)(5), 58.1-3609, and 58.1-3617, and the Constitutional Amendment was not self-executing. The Circuit Court also concluded that an incorporated entity could be a “religious association”, and that an organization’s payment of taxes, erroneously or otherwise, does not extinguish claims for exemption under Va. Code §58.1-3651(1) (now 58.1-3651(E)).

5. **Shoosmith Brothers, Inc. v. County of Chesterfield** (Va.), Record No. 032572 (September 17, 2004). The Virginia Supreme Court affirmed the decision of the Chesterfield County Circuit Court upholding the County’s assessment of real property taxes on property operated as a landfill. At trial, the Circuit Court concluded that the County had used an appropriate assessment methodology and that the assessment was a reasonable assessment of the fair market value of the landfill property. In using the income capitalization method to determine the fair market value of landfill property for Virginia real property tax purposes, Chesterfield County was allowed to factor in the income generated by the owner's use of the land pursuant to nontransferable government permits. The owner claimed that permits that did not run with the land represented intangible assets that were not subject to assessment and taxation. The court determined that consideration of the use of the land in assessing the fair market value did not constitute the assessment of an intangible asset even if that use required nontransferable government permits. The owner also claimed that prior case law required the county to use economic rent to capitalize income for the determination of fair market value; however, those cases involved properties that were subject to lease. The landfill in this case was owner operated and there was no evidence of comparable leases.

C. Recent Virginia Tax Commissioner Rulings.

1. **Real Estate Appeals to Boards of Equalization (“BOE”).** P.D. 03-92 (November 18, 2003). The Tax Department released Tax Bulletin 03-10 providing guidance on 2003 legislation that made several changes to the local real estate appeals process. The Bulletin highlights changes to the burden of proof applicable in appeals to Boards of Equalization (“BOE”) and discusses the changes to the one-year statute of limitations in selected cities and counties under the County Manager Plan of government by extending the statute of limitations in these jurisdictions to three years by January 1, 2007. In those jurisdictions that require a taxpayer to first appeal a real estate assessment
to the BOE before filing an appeal in circuit court, such requirement will remain in effect if the locality had imposed such requirement prior to July 1, 2003. CAUTION: This is still a very tricky area and you must check the locality’s rules. Do not assume you can immediately proceed to court!

2. **Business TPP Tax Base Includes Excise Tax.** P.D. 03-96 (December 17, 2003). A lessor’s “original cost” of tanker trucks subject to a Virginia city’s local business tangible personal property tax included federal excise tax that was imposed on the first retail sale or short-term lease of the trucks because the city imposing the property tax used as its basis the price or cost that the lessor used in negotiating its sales or leases of the heavy trucks, and that cost included the federal excise tax paid. Although federal excise tax is excluded from the tax base in calculating the federal excise tax due, the basis of “original cost” for purposes of the valuation of local business tangible personal property is different from the base used in determining the amount of federal excise tax.

3. **MACRS Property Election for Federal Income Taxes Requires TPP Classification for Property Tax Purposes.** P.D. 04-9 (March 26, 2004) Taxpayer owns retirement homes and assisted living communities throughout the U.S., including Virginia. Taxpayer replaced six air handling units for one of its Virginia facilities and elected 7-year MACRS depreciation on the air handling units. Taxpayer appealed the County’s determination that the 6 air handling units must be classified as business tangible personal property, as opposed to real property. The Tax Commissioner overruled the locality and held the air handling units should be treated as realty for purposes of local taxation. Classification of an asset on the federal income tax return does not determine its taxation as business tangible personal property.

4. **Percentage of Cost Method of Valuation for M&T Upheld.** P.D. 04-16 (May 14, 2004). Locality assessed machinery and tools ("M&T") at 25% of original cost. Taxpayer asserts the assessed value exceeds the fair market value of the M&T and therefore is unconstitutional. The Tax Commissioner holds the City's valuation methodology meets the uniformity requirements imposed by the Virginia Constitution and does not violate its fair market value requirements. The Commissioner stated the Virginia Constitution does not establish what valuation methodology is to be used for M&T, and that taxpayer's depreciated cost method of valuation as used for SFAS reporting requirements with NYSE and SEC is not preferable in this case.

5. **Time-Share Furniture Not Exempt Household Goods.** P.D. 04-19 (June 1, 2004). A local Virginia personal property tax exemption for household goods and personal effects owned by an individual, family, or household did not apply to furniture in time-share condominiums because the governing documents for the condominiums provided that the furniture was owned by the owner's association. The furniture falls under the classification of tangible personal property employed in a trade or business pursuant to Virginia Code §58.1-3503(A)(17) and is subject to the business TPP tax.
6. **Conversion of Lye Soap Stock to Feed Grain is Manufacturing.** P.D. 04-21 (June 2, 2004). Taxpayer is in the business of converting lye soap stock into edible feed stock oil and glycerin. The resulting products are then sold at wholesale. The process of conversion involves combining the original product with sulfuric acid and heat. The resulting endothermic chemical reaction produces an edible fatty acid and glycerin. These products are then dried, filtered and sold as animal feed fat. The Tax Commissioner held that the taxpayer should be classified as a manufacturer.

7. **Contracts were not subject to M&T Tax.** P.D. 04-54 (August 18, 2004). A city's use of original cost as the basis for Virginia local machinery and tools tax valuation was a valid method of valuing the property because the city's tax on machinery and tools were less than that imposed on the general class of tangible personal property. However, the value of contracts acquired by a taxpayer when it purchased an electric generating facility should not have been included in the "original cost" for purposes of reporting the machinery and tools tax because contracts are considered intangible property not subject to the tax.

D. **Recent Opinions of the Attorney General**

1. **Exemption from Tax.** Op. No. 03-49 (August 5, 2003). The Attorney General opined that the local property tax exemptions granted by the 2003 General Assembly 2003, either by designation or by classification, prior to January 1, 2003, were not repealed by the amendment of Va. Const., Art. X, § 6(a)(6) or by the enactment of Va. Code § 58.1-3651. He further opined that the localities lack any authority to repeal an exemption enacted by the General Assembly. Rather, the General Assembly has the authority to repeal any law that it has passed.

2. **Exemption from Tax.** Op. No. 03-043 (August 5, 2003). The Attorney General opined that the Va. Code § 58.1-3221 partial real estate tax exemption for rehabilitated property is available when a registered historic structure has been demolished so long as the property owner claiming the exemption is not the person responsible for the demolition.

3. **Property Date of Assessment Determination.** Op. No. 03-113 (February 4, 2004). In determining the date of assessment for purposes of correction of a Virginia property tax assessment, the date of assessment was the date that a written notice of assessment was mailed to the taxpayer's last known address. The taxpayer had one year from the date of the final determination to apply to the circuit court for judicial correction of the assessment. A commissioner of the revenue has a duty to initiate judicial correction if the commissioner determines that an assessment was improper or was an obvious error.

4. **Car Tax Repeal – Mixed Use Vehicle.** Op. No. 03-114 (February 4, 2004). The display of a commercial advertising sign on a passenger vehicle for more than 50% of the time does not, alone, disqualify the vehicle from relief under the Virginia Personal Property Tax Relief Act of 1988, under which the state pays a percentage of the
local personal property tax for qualifying vehicles. However, such a display is one of the
deciding whether a vehicle is a “qualifying vehicle” under the Act. A commissioner’s presumption that a vehicle is
being used for business purposes may be refuted by the taxpayer’s evidence of the
vehicle’s actual usage.

VI. BUSINESS LICENSE (BPOL) TAX

A. Recent Virginia Tax Commissioner Rulings

1. Untaxed BPOL Receipts Could Not Be Deducted. P.D. 04-5 (February 17, 2004). A contractor with a principal place of business in one city could not reduce
his Virginia local business, professional, and occupational license (BPOL) tax receipts
reported to the city by the amount that was earned in a town that did not impose a BPOL
tax. Although a statute allows contractors to reduce gross receipts in the locality in which
they maintain a definite place of business if they earn gross receipts in excess of $25,000
in one year in a locality in which they do not maintain a definite place of business, the
deduction applies only if a contractor pays a license tax to the secondary jurisdiction.

2. Classification of Cellular Telephone Services Resellers. P.D. 04-6
   (February 20, 2004). For the purpose of classifying cellular telephone service resellers
subject to Virginia local business, professional and occupational license (BPOL) tax, a
reseller would be taxed at the business services rate, rather than the higher public service
corporation rate, if the reseller is not subject to the regulatory authority of the State
Corporation Commission and does not qualify for the special tax status conferred on
Commission-regulated public service companies. A taxpayer that is not operating as a
telephone company but is merely reselling services with no obligation to construct,
maintain, or operate a telephone system would be regarded as providing a business
service for BPOL tax purposes.

   for a BPOL tax depends on whether a person is engaged in a course of dealing such that
he is “engaged in business.” Thus, a person who conducts an occasional yard sale on an
irregular basis is not “engaged in business” and is not subject to the BPOL tax; but
someone who does this on most weekends in the spring, summer and fall is licensable as
an itinerant merchant.

   Commissioner overruled local tax authority regarding classification of taxpayer where
evidence demonstrated 98% of sales were wholesale in nature. Commissioner also ruled
on apportionment of BPOL receipts where taxpayer demonstrated sales occurred in other
states where taxpayer filed an income tax return. Upon proof to be provided to local tax
jurisdiction, taxpayer is also entitled to a credit attributable to prompt payment discounts
5. Cellular Telephone Service Provider is Telephone Company. P.D. 04-17 (May 21, 2004). Tax Commissioner overruled locality that classified a cellular telephone service provider as a telephone company. While taxpayer would be classified as a telephone company under Va. Code §58.1-2600, the locality adopted a more stringent definition of a telephone company. As taxpayer does not meet the conditions of the more restrictive definition (e.g., requires operation of a telephone exchange, use and occupy streets, etc.), taxpayer was classified as a business service provider.

6. Information Technology Service Provider may Qualify as R&D Services. P.D. 04-20 (June 1, 2004). An information technology service provider sought a refund of BPOL taxes because it failed to claim the deduction for computer hardware and software sold to federal and state agencies. Taxpayer's documentation included a Blanket Purchase Agreement (BPA) with the GSA, but little documentation as to specific individual specified orders. Taxpayer's attempt to segregate revenues by percentage was not compelling to Tax Commissioner without either supporting invoices documenting receipts attributable to computer hardware and software or "identifiable appropriations" for such items.

7. Situs-Apportionment Determination. P.D. 04-26 (June 2, 2004). A multinational company engaged in computer information retrieval services from a number of locations worldwide, and had no office in the County dedicated to developing sales strategies and soliciting sales. Taxpayers receipts were based on both an annual fee and a database usage charge. The County used a worldwide payroll apportionment to determine the taxpayer's BPOL tax assessment. The Tax Commissioner stated that payroll apportionment is a method of last resort where a company has multiple offices and is impractical or impossible to determine which definite place of business gross receipts should be attributed to under the general rule. In this case, taxpayer could attribute training and seminar services to its office in the County. These fees are separate from the charges it makes for information retrieval services. Commissioner sent case back to locality directing taxpayer to "unbundle" charges. If this is not or cannot be done, the County may rely on the worldwide payroll apportionment to the entire gross receipts of the taxpayer.

8. No Definite Place of Business in County. P.D. 04-41 (August 10, 2004). Tax Commissioner orders refund of BPOL taxes after finding that the taxpayer's services provided were performed at definite places of business outside of the County and these activities were directed and controlled from the taxpayer's corporate offices located outside of Virginia. Taxpayer did have an office in the County, but its activities at this location were ancillary to its primary business.

9. BPOL Exemptions Not Applicable to Separate Business. P.D. 04-44 (August 13, 2004). The BPOL exemption for insurance companies subject to the state license tax did not apply to an insurance agent's gross receipts from his separate financial planning business because the exemption applies only to receipts received as an agent of an insurance company.
10. **BPOL Exclusion Not Retroactive.** P.D. 04-47 (August 13, 2004). Legislation that allowed BPOL tax exclusion from gross receipts for desk fees and other overhead costs paid by a real estate agent to a broker was not a clarification of existing law to be applied retroactively. The 2002 legislation did not contain a retroactive enactment clause, and it authorized an exclusion that did not exist prior to amendment of the statute.

11. **Agency Relationship Not Established.** P.D. 04-66 (August 23, 2004). Taxpayer, a mailing list broker, sold mailing lists to mass marketers on a one-time basis. Taxpayer claims it is acting as an agent on behalf of the mailer and mailer is solely responsible for full payment. Taxpayer received payments, disbursed amounts due mailers, and retained its commissions. Tax Commissioner held taxpayer failed to meet the three-part test to establish a true “agency relationship” for purposes of the BPOL tax exclusion. These three criteria are: (1) there must be a contractual relationship between the taxpayer and both the client and the contracted third party; (2) the taxpayer cannot commingle its funds with all other sources, rather it must have a separate accounting system or a fiduciary account where the pass-through receipts are recorded; and (3) the taxpayer cannot report these “pass-through costs” on its federal income tax return. Tax Commissioner held the second criterion was not met. The total receipts are subject to the BPOL tax.

12. **Custom Printer is a Manufacturer.** P.D. 04-67 (August 20, 2004). Taxpayer prints custom pocket folders, binders, and folios on a custom order basis. These products are sold at wholesale from the place of manufacture. Taxpayer’s mistake in properly characterizing its business on local business tax schedules does not preclude proper classification where evidence demonstrates qualification for BPOL exemption for manufacturer.

13. **Payroll Apportionment Method of Receipts Proper for Interstate Multiple Location Taxpayer.** P.D. 04-80 (August 25, 2004). Taxpayer is a multi-state information technology consulting services firm that performs defense related contract services for the federal government. Taxpayer performs its services under thousands of contracts from numerous locations both within the County and from other states. Furthermore, taxpayer has numerous subsidiaries that also perform services both within and without the County. Tax Commissioner holds that to avoid violating the Commerce Clause in the case of this particular taxpayer, use of interstate apportionment is necessary. Accordingly, payroll apportionment is the correct method to be utilized in determining the taxpayer’s BPOL liability. Only the gross receipts of the four subsidiaries that have a definite place of business in the County can be included in the tax base. Payroll apportionment must be based upon national gross receipts, not the Virginia income tax sales factor denominators.

14. **Residential Property Manager held to be Agent for BPOL Tax Purposes.** P.D. 04-81 (August 25, 2004). Taxpayer is a residential property manager who manages five residential projects in the City. Document produced by the taxpayer demonstrated that it engaged in a true agency relationship with its property owning
clients. The taxpayer met the three part test for establishing an agency relationship and accordingly is entitled to exclude client’s funds from the taxpayer’s gross receipts for purposes of the BPOL tax.

15. **Computer Hardware and Software Sold to Government Entities Excluded from BPOL Gross Receipts.** P.D. 04-90 (August 31, 2004). Taxpayer is a provider of information technology services that specializes in meeting requirements for government budget software, education technology infrastructure, systems management and document management. Taxpayer had a definite place of business in the County, along with other places of business within Virginia. Taxpayer was unable to provide the County with a clear accounting of gross receipts directly attributable to the County. Accordingly, taxpayer is required to use the general rule that apportions gross receipts of the business between definite places of business on the basis of payroll. Taxpayer did demonstrate an ability to segregate the monies it receives from federal agencies for the provision of certain exempt services and will receive the benefit of such deduction upon verification of these amounts.

16. **Money Lender and Leasing Activity are Two Lines of Business.** P.D. 04-98 (September 8, 2004). Taxpayer provides financing and leasing activities that generally fall into two categories: direct financing and operating leases. Tax Commissioner holds that a separate license shall be required for each definite place of business and for each type of business. Where taxpayer provides two separately licensable activities at the same location, it may be taxed at one rate, provided that rate is the highest rate. In this case, that appropriate rate is that of the money lender.

17. **Affiliated Group Exemption from BPOL Tax Explained.** P.D. 04-112 (September 14, 2004). Taxpayer was part of a chain of corporations with a common parent corporation. Taxpayer claimed to be a member of an affiliated group that qualifies for an exemption from the BPOL tax because it met the four criteria outlined in Va. Code §58.1-3700.1(1). Specifically, the taxpayer met the eighty-percent control of voting power for all classes of stock ownership rule, eighty-percent control of the non-voting ownership classes of stock rule, and that the parent corporation directly owned at least eighty-percent of the voting and non-voting classes of stock of at least one other of the corporations subject to inclusion in the BPOL tax rate base. The Tax Commissioner held that the taxpayer met all four parts of this test and granted a refund of BPOL taxes paid on gross receipts earned through transactions with another member of the affiliated group. These receipts are not subject to the BPOL tax pursuant to Va. Code §58.1-3703(C)(10).

18. **Integrated Business Service Provider.** P.D. 04-114 (September 14, 2004). Taxpayer provided a variety of business services accompanying engineering and design work, technical and non-technical services in the area of combat systems, hull maintenance and electrical work, command and control, communications, computers and intelligence systems, and an array of logistic services. In connection with providing these services, the taxpayer also has a number of licensed engineers in its employ to assist in the delivery of these services. Tax Commissioner held it in error for the City to require
the taxpayer to hold separate licenses for providing professional services (engineering), commercial service, and repair service in the integrated delivery of the services provided to its customers. The Tax Commissioner held that the taxpayer held itself out as an engineering and support services company and would therefore be subjected to a single license at the highest rate for the line of business that taxpayer conducts in a substantial portion of its overall business. The Commissioner further opined that the taxpayer’s business is so integrated that they must be assessed as a single business at the rate appropriate to the substantial part of the business. No vivisection of integrated business permitted by locality. See City of Winchester v. American Woodmark Corp., 252 Va. 98 (1996).

19. **Author is a Licensable Business Activity.** P.D. 04-137 (September 7, 2004). Taxpayer holds himself out as an author and conducts his primary business from his home, where he writes manuscripts. The author is subject to licensure and payment of BPOL tax as a writer.

20. **Classification as Telephone Company Includes all Services Provided Except Long-Distance Service.** P.D. 04-138 (September 16, 2004). Taxpayer is a competitive local exchange carrier offering full-service, telecommunication services within the City. Taxpayer holds licenses from the State Corporation Commission as a Public Service Corporation. Taxpayer was engaged in additional activities including basic local telephone service, selling or leasing telephones, and providing enhanced services such as call waiting, etc. Tax Commissioner held that all of these services are subject to the grandfathered BPOL tax rate of 3% on PSC’s.

21. **General Commercial and Direct Mail Printer is a Manufacturer.** P.D. 04-142 (September 17, 2004). Taxpayer is a general commercial and direct mail printer that handles medium to large printing orders ranging from 5,000 to more than 1,000,000 pieces. Taxpayer’s customers are direct mail house agencies and governmental or non-profit organizations, government agencies and commercial enterprises. Taxpayer does not engage in direct mail services. Rather, it prepares materials for direct mailing companies that, in turn, resell the materials to their clients. Taxpayer prints large volumes of envelopes using offset presses designed specifically for envelope printing. The Company also uses offset web and sheet fed presses enabling it to expand the types of printed products it produces. The Tax Commissioner held that the taxpayer’s activities constitute manufacturing and the Company should be treated as a manufacturer for purposes of the BPOL tax. The Tax Commissioner further held that its sales occurred at the place of manufacture and were to be excluded from the BPOL tax base.

22. **Receipts by Fiduciary not Subject to Local License Taxation.** P.D. 04-143 (September 17, 2004). Taxpayer acts as a bankruptcy fiduciary trustee for the operating expenses of debtors. These funds ultimately belong to the Office of U.S. Trustee. As such, the funds received by the fiduciary are not subject to local license taxation. However, the taxpayer’s compensation is separate and distinct from the other monies in the operating expense trust account and the taxpayer is responsible for a local license tax based on his compensation.
23. Jurisdiction Where Taxpayer Directs and Controls Vending Machines is Proper Taxing Authority. P.D. 04-154 (September 17, 2004). The Tax Commissioner was requested to reconsider a prior opinion issued as P.D. 02-150 regarding the appropriate jurisdiction for BPOL tax liability of a full-service vending machine operator. The Tax Commissioner held that the appropriate jurisdiction to tax the receipts generated by the vending machines is where the taxpayer controls and directs these machines, as opposed to the physical location of each vending machine. It is the operator who is subject to the BPOL tax on the gross receipts obtained from the machines in the jurisdiction from which he controls the business of operating the machines.

B. Opinions of the Attorney General

1. Untaxed Foreign Receipts Excluded from BPOL. Op. No. 03-123 (January 13, 2004). The local Virginia BPOL tax deduction for gross receipts attributable to business conducted in a state or foreign country in which the taxpayer is liable for an income tax or other tax based on income is available even if the gross receipts were not taxed by the state or county. The deduction applies if a licensee “is liable for” an income or income-like tax measured by gross receipts.

VII. PROCEDURAL AND MISCELLANEOUS TAX MATTERS

A. 2004 Legislation

1. Tax Secrecy of Information – Unpaid Wages. SB 165 (Chapter 166) amends Va. Code § 58.1-3(c) to authorize the Department of Taxation, upon entering into a written agreement, to provide tax information about employers and employees to the Commissioner of Labor and Industry to facilitate the collection of unpaid wages.

2. Tax Secrecy of Information – Worker’s Compensation Indemnity Benefits. SB 403 (Chapter 594) amends Va. Code § 58.1-3(c) to authorize the Department of Taxation, upon entering into a written agreement with the Department of Human Resource Management, to provide confidential tax information to DHRM to facilitate the identification of persons receiving worker’s compensation indemnity benefits who have failed to report earnings as required by law (assist in collection of overpayments resulting from the failure of injured workers to report income).

3. Tax Secrecy of Information – Unclaimed Property. SB 166 (Chapter 582) amends Va. Code § 58.1-3(c) to allow the Tax Commissioner to provide to the Department of the Treasury for its confidential use the tax information needed to locate the holders of unclaimed property.

4. Local Tax Offers in Compromise. HB 293 (Chapter 526) creates new Va. Code § 58.1-3994 to authorize the commissioner of the revenue to compromise and settle any assessment of BPOL taxes and business personal property, merchants’ capital, and machinery and tools taxes (“Local Business Taxes”) prior to the exhaustion of all
administrative or judicial reviews upon a determination that there is substantial doubt as to the taxpayer's liability. This new legislation also authorizes the treasurer to compromise and settle the amount of BPOL and Local Business Taxes due and payable upon a determination that collection of the entire amount due is in substantial doubt, and the best interests of the locality will be served by such compromise. This legislation is similar in effect to Va. Code § 58.1-105 that authorized the Virginia Tax Commissioner to accept offers in compromise of doubtful or disputed claims for state taxes or state tax liability of claims that are doubtful as to their collectibility.

5. **Local Business Taxes – Advisory Opinions by State Tax Commissioner**. HB 295 (Chapter 527) amends Va. Code § 58.1-3983.1 by authorizing the Virginia Tax Commissioner to issue advisory opinions in specific cases regarding business tangible personal property tax, the machinery and tools tax, and the merchants' capital tax. This legislation makes this new avenue available to both taxpayers and local tax officials. Such advisory opinions may be sought prior to the filing of a Local Business Tax appeal.

6. **Mobile Property Tax Appeals Authorized**. HB 464 (Chapter 534) amends Va. Codes §§ 58.1-3193 and 58.1-3983.1 to expand the Department of Taxation's authority to hear local tax appeals to include assessments of the tangible personal property tax on airplanes, boats, campers, recreational vehicles and trailers (the "local mobile property tax"). The Department of Taxation would not be required to make a determination regarding the valuation or method of valuation for local mobile property tax assessments. The determination of value and valuation methodology would remain subject to local determinations.

7. **Collection of Delinquent State Taxes by Localities**. HB 294 (Chapter 546) amends Va. Code § 58.1-1803 to allow the Department of Taxation to appoint local government treasurers to collect delinquent state taxes in the same manner as they collect delinquent local taxes.

B. Recent Court Decisions

1. **Circuit City Stores, Inc. v. Department of Taxation** (Rich. Cir. Ct., July 29, 2004. The Court held that the Department had the burden of proving that it mailed a Notice of Assessment within the meaning of section 58.1-1820 of the Virginia Code, that it had not carried that burden, and that as a result, the statute of limitations had expired. The Department was unable to introduce a copy of a Notice of Assessment, or any evidence that it printed or mailed. The Department's internal computer records indicating an assessment date within the applicable statute of limitations was insufficient proof of mailing. Furthermore, the taxpayer's administrative protest was not an admission of the receipt of the Notice of Assessment and had no bearing on the date of mailing in any event.
C. Recent Virginia Tax Commissioner Rulings.

1. Ninety Day Administrative Appeal Requirement. P.D. 03-53 (July 15, 2003). The Tax Department announced a POLICY CHANGE when it released Tax Bulletin 03-8. The Tax Department announced that a complete administrative appeal must be filed within 90 days of the date of an assessment. A form, available on the Department’s website, is also provided for use in all appeals. The remainder of the Bulletin addresses 2003 legislation removing the “pay to play” requirement and related issues.

2. Notice of Assessment – Proof of Mailing. P.D. 03-88 (November 13, 2003). Substantive tax issues addressed in item 2 above. However, the issue of whether the Department timely mailed the notice of assessment was raised. Taxpayer stated it received the assessment notice on May 7, 2002, without an official post mark to indicate the date it was mailed. The document bore a “date” on the top of April 25, 2002, and the statute of limitations expired on April 30, 2002. The Tax Commissioner held the assessment was timely mailed (no surprise) and relied upon its normal business routines (print assessment notice 5 days prior to mailing of assessment). The Commissioner did acknowledge that the postage and mailing machine may have malfunctioned. However, Commissioner concluded U.S. Postal Service must have accepted the mailing as the taxpayer did receive the assessment, despite failure of USPS to write/stamp date received on envelop. See Circuit City case cited above.


4. Recordation Tax Applies to Qualified Intermediary. P.D. 04-97 (September 8, 2004). Transfers to a qualified intermediary and transfers from a qualified intermediary ("QI") are both subject to Virginia recordation taxes when part of a tax-free like-kind exchange under IRC §1031. The Tax Department finds these transactions analogous to the taxable transfers to a "strawman" for the purchaser's convenience as described in 23 VAC 10-320-20(A)(1).

5. No Virginia Estate Tax Refund Due for Tax Paid to EGTRRA Conforming State. P.D. 04-93 (September 7, 2004). An estate that paid both Virginia estate tax and another state's estate tax was not entitled to a refund of a portion of its Virginia estate tax on the theory that the other state's conformity with the 25% estate tax reduction under the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), to which Virginia does not conform, had resulted in a lower credit being given for the estate tax paid to the other state. The taxpayer claimed that the difference in estate tax liability between Virginia, which does not conform, and the other state, which did, was tantamount to Virginia imposing an unconstitutional estate tax on the property located in the other state. Virginia law clearly limits the credit for tax paid to another
state to the amount of tax actually paid and credited against the federal estate tax, and that credit was allowed in this case. The other state's choice to confirm its estate tax laws to federal law was an election made in the exercise of its sovereignty, as was Virginia's choice to leave its estate tax law intact after the federal change. No action of the other state could render Virginia's estate tax law unconstitutional.

D. Opinions of the Attorney General

1. **Virginia Wills/Administration Tax-Probate Estate Only.** Op. No. 04-025 (May 19, 2004). Assets not part of the probate estate are not subject to the probate tax, even if the assets are included in the calculation of the augmented estate. Here, VRS retirement benefits payable to a third party were claimed by a surviving spouse under an elective share of the augmented estate. As the retirement benefits are not part of the probate estate, they are not subject to the probate tax.

2. **Consumer Utility Taxes.** Op. No. 04-044 (September 7, 2004). The Attorney General opined that where a county, city or town has opted in to impose a consumer utility tax on mobile service providers pursuant to Virginia Code §58.1-3812, the local taxing jurisdiction may require the service provider to collect a consumer utility tax on each telephone number included in a bundled mobile telecommunications service plan billed to a mobile service consumer (e.g., a family plan or affinity group participants). The service provider shall apply a 10 percent tax to monthly gross charges not exceeding $30 that are attributable to each itemized or non-itemized local mobile telecommunications service number included in the bill.

3. **Transient Occupancy Tax.** Op. No. 04-063 (September 7, 2004). A County has no authority to levy the transient occupancy lodging tax on the amount a hotel charges transients for the rental of banquet facilities to accommodate events of limited duration. The ordinance references to "room or space rental" applies only to the amount a hotel charges for living accommodations, and not on charges for meeting rooms and banquet facilities. Virginia Code §58.1-3819 evidences no legislative intent to apply the transient occupancy tax to such non-living rooms or accommodations.
APPENDIX A

§ 58.1-402. Virginia taxable income.

A. For purposes of this article, Virginia taxable income for a taxable year means the federal taxable income and any other income taxable to the corporation under federal law for such year of a corporation adjusted as provided in subsections B, C and D.

For a regulated investment company and a real estate investment trust, such term means the "investment company taxable income" and "real estate investment trust taxable income," respectively, to which shall be added in each case any amount of capital gains and any other income taxable to the corporation under federal law which shall be further adjusted as provided in subsections B, C and D.

B. There shall be added to the extent excluded from federal taxable income:

1. Interest, less related expenses to the extent not deducted in determining federal taxable income, on obligations of any state other than Virginia, or of a political subdivision of any such other state unless created by compact or agreement to which the Commonwealth is a party;

2. Interest or dividends, less related expenses to the extent not deducted in determining federal taxable income, on obligations or securities of any authority, commission or instrumentality of the United States, which the laws of the United States exempt from federal income tax but not from state income taxes;

3. [Repealed.]

4. The amount of any net income taxes and other taxes, including franchise and excise taxes, which are based on, measured by, or computed with reference to net income, imposed by the Commonwealth or any other taxing jurisdiction, to the extent deducted in determining federal taxable income;

5. Unrelated business taxable income as defined by § 512 of the Internal Revenue Code;

6. The amount of employee stock ownership credit carry-over deducted by the corporation in computing federal taxable income under § 404 (i) of the Internal Revenue Code;

7. The amount required to be included in income for the purpose of computing the partial tax on an accumulation distribution pursuant to § 667 of the Internal Revenue Code.

8. a. For taxable years beginning on and after January 1, 2004, the amount of any intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes. This addition shall
not be required for any portion of the intangible expenses and costs if one of the following applies:

1. 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, or a foreign government that has entered into a comprehensive tax treaty with the United States government;

2. The related member derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members, and the transaction giving rise to the expenses and costs between the corporation and the related member was made at rates and terms comparable to the rates and terms of agreements that the related member has entered into with parties who are not related members for the licensing of intangible property; or

3. The corporation can establish to the satisfaction of the Tax Commissioner that the intangible expenses and costs meet both of the following: (i) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person who is not a related member, and (ii) the transaction giving rise to the intangible expenses and costs between the corporation and the related member did not have as a principal purpose the avoidance of any portion of the tax due under this chapter.

b. A corporation required to add to its federal taxable income intangible expenses and costs pursuant to subdivision a may petition the Tax Commissioner, after filing the related income tax return for the taxable year and remitting to the Tax Commissioner all taxes, penalties, and interest due under this article for such taxable year including tax upon any amount of intangible expenses and costs required to be added to federal taxable income pursuant to subdivision a, to consider evidence relating to the transaction or transactions between the corporation and a related member or members that resulted in the corporation's taxable income being increased, as required under subdivision a, for such intangible expenses and costs.

If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and convincing evidence, that the transaction or transactions between the corporation and a related member or members resulting in such increase in taxable income pursuant to subdivision a had a valid business purpose other than the avoidance or reduction of the tax due under this chapter, the Tax Commissioner shall permit the corporation to file an amended return. For purposes of such amended return, the requirements of subdivision a shall not apply to any transaction for which the Tax Commissioner is satisfied (and has identified) that the transaction had a valid business purpose other than the avoidance or reduction of the tax due under this chapter. Such amended return shall be filed by the corporation within one year of the written permission granted by the Tax Commissioner and any refund of the tax imposed under this article shall include interest at a rate equal to the rate of interest established under § 58.1-15 and such interest shall accrue as provided under § 58.1-1833. However, upon the filing of such amended return, any related member of the corporation that subtracted from taxable income amounts received pursuant to subdivision C 21 shall be subject to the tax imposed under this article on that portion of such amounts for which the corporation has filed an amended return.
return pursuant to this subdivision. In addition, for such transactions identified by the Tax Commissioner herein by which he has been satisfied by clear and convincing evidence, the Tax Commissioner may permit the corporation in filing income tax returns for subsequent taxable years to deduct the related intangible expenses and costs without making the adjustment under subdivision a.

The Tax Commissioner may charge a fee for all direct and indirect costs relating to the review of any petition pursuant to this subdivision, to include costs necessary to secure outside experts in evaluating the petition. The Tax Commissioner may condition the review of any petition pursuant to this subdivision upon payment of such fee.

No suit for the purpose of contesting any action of the Tax Commissioner under this subdivision shall be maintained in any court of this Commonwealth.

c. Nothing in subdivision B 8 shall be construed to limit or negate the Department's authority under § 58.1-446.

9. a. For taxable years beginning on and after January 1, 2004, the amount of any interest expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with one or more related members to the extent such expenses and costs were deductible or deducted in computing federal taxable income for Virginia purposes. This addition shall not be required for any portion of the interest expenses and costs, if:

(1) The related member has substantial business operations relating to interest-generating activities, in which the related member pays expenses for at least five full-time employees who maintain, manage, defend or are otherwise responsible for operations or administration relating to the interest-generating activities; and

(2) The interest expenses and costs are not directly or indirectly for, related to or in connection with the direct or indirect acquisition, maintenance, management, sale, exchange, or disposition of intangible property; and

(3) The transaction giving rise to the expenses and costs between the corporation and the related member has a valid business purpose other than the avoidance or reduction of taxation and payments between the parties are made at arm's length rates and terms; and

(4) One of the following applies:

(i). 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, or a foreign government that has entered into a comprehensive tax treaty with the United States government;

(ii). Payments arise pursuant to a pre-existing contract entered into when the parties were not related members provided the payments continue to be made at arm's length rates and terms;
(iii). The related member engages in transactions with parties other than related members that generate revenue in excess of $2 million annually; or

(iv). The transaction giving rise to the interest payments between the corporation and a related member was done at arm's length rates and terms and meets any of the following:
(a) the related member uses funds that are borrowed from a party other than a related member or that are paid, incurred or passed-through to a person who is not a related member; (b) the debt is part of a regular and systematic funds management or portfolio investment activity conducted by the related member, whereby the funds of two or more related members are aggregated for the purpose of achieving economies of scale, the internal financing of the active business operations of members, or the benefit of centralized management of funds; (c) financing the expansion of the business operations; or (d) restructuring the debt of related members, or the pass-through of acquisition-related indebtedness to related members.

b. A corporation required to add to its federal taxable income interest expenses and costs pursuant to subdivision a may petition the Tax Commissioner, after filing the related income tax return for the taxable year and remitting to the Tax Commissioner all taxes, penalties, and interest due under this article for such taxable year including tax upon any amount of interest expenses and costs required to be added to federal taxable income pursuant to subdivision a, to consider evidence relating to the transaction or transactions between the corporation and a related member or members that resulted in the corporation's taxable income being increased, as required under subdivision a, for such interest expenses and costs.

If the corporation can demonstrate to the Tax Commissioner's sole satisfaction, by clear and convincing evidence, that the transaction or transactions between the corporation and a related member or members resulting in such increase in taxable income pursuant to subdivision a had a valid business purpose other than the avoidance or reduction of the tax due under this chapter and that the related payments between the parties were made at arm's length rates and terms, the Tax Commissioner shall permit the corporation to file an amended return. For purposes of such amended return, the requirements of subdivision a shall not apply to any transaction for which the Tax Commissioner is satisfied (and has identified) that the transaction had a valid business purpose other than the avoidance or reduction of the tax due under this chapter and that the related payments between the parties were made at arm's length rates and terms. Such amended return shall be filed by the corporation within one year of the written permission granted by the Tax Commissioner and any refund of the tax imposed under this article shall include interest at a rate equal to the rate of interest established under § 58.1-15 and such interest shall accrue as provided under § 58.1-1833. However, upon the filing of such amended return, any related member of the corporation that subtracted from taxable income amounts received pursuant to subdivision C 21 shall be subject to the tax imposed under this article on that portion of such amounts for which the corporation has filed an amended return pursuant to this subdivision. In addition, for such transactions identified by the Tax Commissioner herein by which he has been satisfied by clear and convincing evidence, the Tax Commissioner may permit the corporation in filing income
tax returns for subsequent taxable years to deduct the related interest expenses and costs without making the adjustment under subdivision a.

The Tax Commissioner may charge a fee for all direct and indirect costs relating to the review of any petition pursuant to this subdivision, to include costs necessary to secure outside experts in evaluating the petition. The Tax Commissioner may condition the review of any petition pursuant to this subdivision upon payment of such fee.

No suit for the purpose of contesting any action of the Tax Commissioner under this subdivision shall be maintained in any court of this Commonwealth.

c. Nothing in subdivision B 9 shall be construed to limit or negate the Department's authority under § 58.1-446.

d. For purposes of subdivision B 9:

"Arm's length rates and terms" means that (i) two or more related members enter into a written agreement for the transaction, (ii) such agreement is of a duration and contains payment terms substantially similar to those that the related member would be able to obtain from an unrelated entity, (iii) the interest is at or below the applicable federal rate compounded annually for debt instruments under § 1274(d) of the Internal Revenue Code that was in effect at the time of the agreement, and (iv) the borrower or payor adheres to the payment terms of the agreement governing the transaction or any amendments thereto.

"Valid business purpose" means one or more business purposes that alone or in combination constitute the motivation for some business activity or transaction, which activity or transaction improves, apart from tax effects, the economic position of the taxpayer, as further defined by regulation.

C. There shall be subtracted to the extent included in and not otherwise subtracted from federal taxable income:

1. Income derived from obligations, or on the sale or exchange of obligations, of the United States and on obligations or securities of any authority, commission or instrumentality of the United States to the extent exempt from state income taxes under the laws of the United States including, but not limited to, stocks, bonds, treasury bills, and treasury notes, but not including interest on refunds of federal taxes, interest on equipment purchase contracts, or interest on other normal business transactions.

2. Income derived from obligations, or on the sale or exchange of obligations of this Commonwealth or of any political subdivision or instrumentality of this Commonwealth.

3. Dividends upon stock in any domestic international sales corporation, as defined by § 992 of the Internal Revenue Code, 50 percent or more of the income of which was assessable for the preceding year, or the last year in which such corporation has income, under the provisions of the income tax laws of the Commonwealth.
4. The amount of any refund or credit for overpayment of income taxes imposed by this Commonwealth or any other taxing jurisdiction.

5. Any amount included therein by the operation of the provisions of § 78 of the Internal Revenue Code (foreign dividend gross-up).

6. The amount of wages or salaries eligible for the federal Targeted Jobs Credit which was not deducted for federal purposes on account of the provisions of § 280C (a) of the Internal Revenue Code.

7. Any amount included therein by the operation of § 951 of the Internal Revenue Code (subpart F income).

8. Any amount included therein which is foreign source income as defined in § 58.1-302.

9. [Repealed.]

10. The amount of any dividends received from corporations in which the taxpaying corporation owns 50 percent or more of the voting stock.

11. [Repealed.]

12. [Expired.]


14. For taxable years beginning on or after January 1, 1995, the amount for "qualified research expenses" or "basic research expenses" eligible for deduction for federal purposes, but which were not deducted, on account of the provisions of § 280C (c) of the Internal Revenue Code.

15. For taxable years beginning on or after January 1, 2000, the total amount actually contributed in funds to the Virginia Public School Construction Grants Program and Fund established in Chapter 11.1 (§ 22.1-175.1 et seq.) of Title 22.1.

16. For taxable years beginning on or after January 1, 2000, the gain derived from the sale or exchange of real property or the sale or exchange of an easement to real property which results in the real property or the easement thereto being devoted to open-space use, as that term is defined in § 58.1-3230, for a period of time not less than 30 years. To the extent a subtraction is taken in accordance with this subdivision, no tax credit under this chapter for donating land for its preservation shall be allowed for three years following the year in which the subtraction is taken.

17. For taxable years beginning on and after January 1, 2001, any amount included therein with respect to § 58.1-440.1.

18. For taxable years beginning on and after January 1, 1999, income received as a result of (i) the "Master Settlement Agreement," as defined in § 3.1-1106; (ii) the National Tobacco Grower Settlement Trust dated July 19, 1999; and (iii) the Tobacco Loss
Assistance Program, pursuant to 7 C.F.R. Part 1464 (Subpart C, §§ 1464.201 through 1464.205), by (a) tobacco farming businesses; (b) any business holding a tobacco marketing quota, or tobacco farm acreage allotment, under the Agricultural Adjustment Act of 1938; or (c) any business having the right to grow tobacco pursuant to such a quota allotment.

19. Effective for all taxable years beginning on and after January 1, 2002, but before January 1, 2005, the indemnification payments received by contract poultry growers and table egg producers from the U.S. Department of Agriculture as a result of the depopulation of poultry flocks because of low pathogenic avian influenza in 2002. In no event shall indemnification payments made to owners of poultry who contract with poultry growers qualify for this subtraction.

20. For taxable years beginning on and after January 1, 2002, any gain recognized as a result of the Peanut Quota Buyout Program of the Farm Security and Rural Investment Act of 2002 pursuant to 7 C.F.R. Part 1412 (Subpart H, §§ 1412.801 through 1412.811) as follows:

a. If the payment is received in installment payments pursuant to 7 C.F.R. § 1412.807(a)(2), then the entire gain recognized may be subtracted.

b. If the payment is received in a single payment pursuant to 7 C.F.R. § 1412.807(a)(3), then 20 percent of the recognized gain may be subtracted. The taxpayer may then deduct an equal amount in each of the four succeeding taxable years.

21. For taxable years beginning on and after January 1, 2004, any amount of intangible expenses and costs or interest expenses and costs added to the federal taxable income of a corporation pursuant to subdivision B 8 or B 9 shall be subtracted from the federal taxable income of the related member that received such amount if such related member is subject to Virginia income tax on the same amount.

D. Adjustments to federal taxable income shall be made to reflect the transitional modifications provided in § 58.1-315.

§ 58.1-1206. Deductions from gross capital.

A. There shall be deducted from the gross capital otherwise ascertainable under § 58.1-1205:

1. The assessed value of real estate if otherwise taxed in this Commonwealth which is owned by such bank, or is used or occupied by such bank, if held in the name of a majority-owned subsidiary of the bank or of a bank holding company which owns a majority of the capital stock of such bank or of any wholly-owned subsidiary of the bank holding company which owns the majority of the capital stock of such bank and the assessed value, up to the amount of the unencumbered equity, of real estate in the nature of improvements which are owned by the bank, or used or occupied by the bank and held by a majority-owned subsidiary or a bank holding company or a wholly-owned subsidiary of a bank holding company, even if assessed in the name of some other person because of the ownership of the underlying land by such person. Real estate used or
occupied by a subsidiary or originally conveyed as collateral for loans made by a subsidiary of the bank and reacquired upon foreclosure of mortgage loans will be deemed to be used or occupied by the bank. The deduction for assessed value of real estate shall be the most recent assessment made prior to January 1 of the current bank franchise tax year for real estate owned by the bank or affiliate on January 1 of the current year.

2. The book value of tangible personal property which shall be held for lease and is otherwise taxed which is owned by such bank or in the name of a majority-owned subsidiary of the bank. If the bank does not own all the stock of such subsidiary, it shall be entitled to deduct only such portion of the assessed value of the real estate and the value of such tangible personal property as the common stock it owns in such subsidiary bears to the whole issue of common stock of such corporation.

3. An amount which shall equal the same percentage of the gross capital account, defined as its capital, surplus and undivided profits as set forth in § 58.1-1205 at December 31 next preceding as the obligations of the United States bear to the total assets of the bank. Such percentage of U.S. obligations shall be determined as of the four most recent (or less in case of a new bank) Reports of Condition and the percentage obtained shall be averaged. For purposes of computing such percentage, total assets shall not include the goodwill described in subdivision 5. The obligations of the United States as used herein shall include all obligations of the United States exempt from taxation under 31 U.S.C. § 3124, of the United States Constitution or any other statute, or any instrumentality or agency of the United States which obligations shall be exempt from state or local taxation under the United States Constitution or any statute of the United States.

4. The amount of retained earnings and surplus of subsidiaries to the extent included in the gross capital of the bank. In addition, any portion of the amount added to federal taxable income pursuant to subdivision B 9 of § 58.1-402 by a corporation that is for interest expenses and costs paid to the bank for a loan or other obligation made by the bank to such corporation shall be deducted from the gross capital of the bank provided that (i) at the time of payment of such portion to the bank, the bank was a related member of the corporation, and (ii) such portion has not otherwise been deducted from gross capital. For purposes of this subdivision, the terms "interest expenses and costs" and "related member" mean the same as those terms are defined in § 58.1-302.