1999

Federal and State Audit Issues

William L.S. Rowe

D. French Slaughter III

Repository Citation

Copyright © 1999 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository. https://scholarship.law.wm.edu/tax
WILLIAM & MARY TAX CONFERENCE

FEDERAL AND STATE AUDIT ISSUES

William L. S. Rowe, Esq.
HUNTON & WILLIAMS
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219
(804) 788-8410

D. French Slaughter, III
MCGUIRE, WOODS
BATTLE & BOOTHE
418 East Jefferson Street
Courthouse Square Building
Charlottesville, Virginia 22902
(804) 977-2570

I.  FEDERAL AUDIT ISSUES

II.  STATE AUDIT ISSUES

A.  Corporate Income Tax.

1.  Court Opinions

   Delta Air Lines v. Forst, At Law No. 93-1238 (Arlington Cir. Ct., January 27, 1998). In determining its property and sales factors for Virginia corporate income tax purposes, Delta did not include overflight miles (the miles flown over Virginia without stopping in Virginia) in the numerator of either. The Tax Department contended that overflight miles should have been included in the numerator of both factors. The trial court held in favor of Delta. It explained that the relevant statutory language which required inclusion in the numerators of property “owned and used in the Commonwealth” and “sales in the Commonwealth” was unambiguous and did not include activity “over the Commonwealth.” The Virginia Supreme Court recently affirmed the trial court’s decision. Commonwealth of Virginia v. Delta Air Lines, 1999 Va. LEXIS 34 (February 26, 1999).

2.  Rulings of the State Tax Commissioner

   Consolidated Returns. P.D. 98-112 (June 30, 1998). A taxpayer who initially elected to file its Virginia returns on a consolidated basis was required to include two newly-acquired affiliates in its consolidated returns, i.e., the newly-acquired affiliates would not be allowed to file on a separate basis.

   Consolidated Returns. P.D. 98-175 (October 28, 1998). The Commissioner rejected the taxpayer’s argument that the unitary relationship between members of the affiliated group necessitated the filing of a consolidated return. He noted that a unitary relationship does not constitute an extraordinary circumstance that would warrant a grant of permission to change from filing separate returns to filing a consolidated return.
**Consolidated Returns.** P.D. 98-115 (June 30, 1998). Virginia taxpayer, which had filed separate returns with its affiliates in previous years, acquired two new groups of affiliated corporations which had filed returns previously on a consolidated basis. Permission for the new group to file on a consolidated basis denied. The acquired groups of corporations, even though they had previously filed on a consolidated basis, were required to adopt the separate return filing status previously elected by the Virginia based taxpayer which acquired them.

**Consolidated Returns.** P.D. 98-175 (October 28, 1998). The Commissioner rejected the taxpayer’s argument that the unitary relationship between members of the affiliated group necessitated the filing of a consolidated return. He noted that a unitary relationship does not constitute an extraordinary circumstance that would warrant a grant of permission to change from filing separate returns to filing a consolidated return.

**Combined Returns.** P.D. 98-53 (March 17, 1998). Unlike elections to change to or from a consolidated filing, permission to change from a separate return to a combined return is generally granted if requested in advance of the due date of the return.

**Combined Returns.** P.D. 98-56 (March 18, 1998). Corporation allowed to change filing method from combined to separate. Request allowed because it was filed before the due date of the return.

**Due Date.** P.D. 98-61 (March 25, 1998). Corporate tax returns are generally due on the 15th day of the fourth month following the close of the taxable year. If a Virginia extension is requested, the taxpayer can have an additional thirty days after the extended federal filing date or six months, whichever is longer. These rules apply to short year returns as well as regular returns.

**Foreign Source Income.** P.D. 98-171 (October 26, 1998). Fees paid to the taxpayer for technical information and services (e.g., technical literature, instructions, training materials, installation and operation assistance) it provided to its licensees in connection with the licensing of technology and trademarks were “technical fees” incidental to the licensing of the intangible personal property, and, therefore, qualified as foreign source income. The decision was based on the facts that the licenses would have been worthless without the services, and that the taxpayer would not have performed the services without the underlying license agreement protecting its intellectual property rights. Services such as internal audit services, tax advice, human resources planning, and marketing, advertising and accounting support do not qualify as foreign source income because they are not incidental to the licensing of the taxpayer’s technology.

**Foreign Source Income.** P.D. 98-169 (October 23, 1998). Following longstanding Department policy, taxpayer was required to allocate expenses to foreign source income. Department’s general policy is to use Form 1118 as a starting point and allow the taxpayer to establish a different allocation. Because the taxpayer refused to provide any expense allocation to the auditor, the appeal was denied.

-2-
Partnerships. P.D. 98-152 (October 14, 1998). A partnership that elected under the federal “check-the-box” regulations to be taxed as a corporation would be required to apportion income to Virginia and to file a Virginia corporation income tax return. The partners would not be required to include the partnership’s income or loss in their own Virginia taxable income.

LLC’s/Disregarded Entity. P.D. 99-57 (April 8, 1999). A single member LLC that is treated as a disregarded entity for federal income tax purposes will be similarly treated for Virginia income tax purposes; that is, it will not have to register and file income tax returns. No withholding will be required so long as the disregarded entity pays no salaries. Sales and use tax registration will be required if the disregarded entity sells tangible personal property or makes purchases on which use tax payments are required.

P.L. 86-272. P.D. 98-5 (January 14, 1998). Direct marketing/network sales company, organized as an S corporation, based outside of Virginia sold products to independent contractor/dealers and consumers within Virginia. Dealers did not accept orders, collect payment or pay a service or franchise fee. Company’s only contacts with Virginia were occasional one-day promotional tours that it conducted for dealers. Company’s shareholders are not subject to Virginia income tax, but Company is required to file a tax return stating the basis for exemption from income tax.

P.L. 86-272. P.D. 98-134 (August 21, 1998). Corporation employed a salesman who solicited sales in Virginia from his home office where he maintained inventory, had office equipment belonging to the taxpayer, and a separate telephone line for transacting company business. The salesman had the authority to approve sales, provide maintenance service, repair and warranty service. The Commissioner held that these activities went beyond “mere solicitation” and were taxable under P.L. 86-272.

P.L. 86-272. P.D. 98-176 (October 29, 1998). Taxpayer’s employees provided various services in Virginia utilizing customer equipment and software. Because taxpayer was not selling property, but was providing business services, its activities were not protected by P.L. 86-272.


Telephone Company Nexus: 86-272. P.D. 99-139 (June 11, 1999). Telephone company providing conference call service held to have no Virginia source income because no calls originated or terminated in Virginia, apparently because all calls are deemed to originate and terminate outside Virginia where the conference service is provided. The Commissioner avoids ruling on the constitutional and P.L. 86-272 issues.

Nexus: Intangibles. P.D. 98-168 (October 23, 1998). Corporation entered into contracts to provide extended warranty service to dealers’ customers. All repairs were performed by the
dealers and were paid for by a third party insurance company. The taxpayer had no tangible personal property in Virginia. Because the Department of Taxation applies the rule of PL 86-272 to sales of intangible property as well as tangible personal property, it was held that the taxpayer had no nexus.

**Apportionment Formula.** P.D. 98-177 (October 29, 1998). Taxpayer transporting fuel on barges to customers in Virginia required to apportion income utilizing standard three factor formula. Because employees did not have their base of operation in Virginia, the payroll factor was zero. Property factor was based on the value of the barges prorated for days spent in Virginia. Sales factor was based on cost of performance for barging services in Virginia to barging services everywhere with respect to those transportation contracts.

**Apportionment: Financial Corporation.** P.D. 99-50 (April 6, 1999). Apportionment for financial corporations is based on costs of performance that are directly related to income producing activities. The auditor incorrectly attempted to distinguish direct costs from indirect costs. The ruling does not describe the particular costs at issue.

**Apportionment: Passive Investment Income.** P.D. 98-63 (March 25, 1998). The Commissioner stated the Department of Taxation’s position with respect to AlliedSignal v. Director, Division of Taxation, 112 S.Ct. 2251 (1992). The issue was whether interest from investments in municipal securities could be excluded from Virginia apportionable income. Although a number of Virginia taxpayers have prevailed in excluding capital gains from the sale of non-unitary investments from Virginia apportionable income, very few taxpayers have succeeded in excluding interest income. In this recent ruling, the Department of Taxation clarified its position with respect to the “operational function” branch of AlliedSignal, stating that there is “a strong presumption that cash reserves or investments fulfill an integral operational function” when the taxpayer has “significant amounts of debt.” In this case, the taxpayer had no long-term debt during the years under audit, and the taxpayers cash accounts were sufficient to cover its current liabilities during those years. Under these circumstances, the Commissioner ruled that the interest income in question was generated “through a passive investment” and was not subject to apportionment under AlliedSignal.

**Apportionment: Passive Investment Income.** P.D. 98-79 (April 27, 1998). The Commissioner expressed the Department of Taxation’s position with respect to AlliedSignal v. Director, Division of Taxation, 112 S.Ct. 2251 (1992). The issue was whether interest from investments in municipal securities could be excluded from Virginia apportionable income. Although a number of Virginia taxpayers have prevailed in excluding capital gains from the sale of non-unitary investments from Virginia apportionable income, very few taxpayers have succeeded in excluding interest income. In this recent ruling, the Department of Taxation clarified its position with respect to the “operational function” branch of AlliedSignal. Stating that there is “a strong presumption that cash reserves or investments fulfill an integral operational function” when the taxpayer has “significant amounts of debt.” In this case, the taxpayer had no long-term debt during the years under audit, and the taxpayer’s cash accounts were sufficient to cover its current liabilities during those years. Under these circumstances, the Commissioner
ruled that the interest income in question was generated “through a passive investment” and was not subject to apportionment under *AlliedSignal*.

**Interest.** *P.D. 98-179 (October 29, 1998).* Although an extension to file the Virginia return was granted, that extension does not defer the due date of the income tax payment. Accordingly, interest was properly assessed from the original due date of the return without regard to the extensions. Penalty was not properly assessed.

**Conformity: Elections.** *P.D. 98-3 (January 13, 1998).* An IRC § 338 election will be treated exactly the same way for Virginia purposes as for federal income tax purposes. Thus, a taxpayer could not make a 338 election solely for Virginia tax purposes if the same election was not made for federal tax purposes.

**FSC’s.** *P.D. 98-54 (March 17, 1998).* Commissions paid to a foreign sales corporation (“FSC”) were disallowed by the auditor. The Commissioner overruled the auditor’s action holding that the Department’s regulations on point did not change until legislation became effective July 31, 1995.

**Binding Settlement.** *P.D. 98-116 (July 1, 1998).* Department of Taxation and the taxpayer’s bankruptcy trustee entered into a settlement agreement which was approved by the United States Bankruptcy Court. Taxpayer subsequently attempted to challenge that agreement on the theory that it did not have taxable nexus for the year in question. Taxpayer’s request for refund was denied on the basis that the settlement agreement was final and binding.

**Recycling Credits/Statute of Limitations.** *P.D. 99-48 (April 2, 1999).* Taxpayer attempted to amend its 1993 tax return based on certification by DEQ of certain credits in late 1997. The amended returns were barred by the statute of limitations. Virginia law has no provision holding the income tax statute of limitations open pending certification of necessary facts by another agency.

**Coalfield Tax Credit.** *P.D. 99-3 (January 8, 1999).* Credits are allowed based on taxable years rather than the year in which a tax return may be filed. Thus, the 1999 credit must be claimed on the return for the company’s 1999 taxable year.

**Coalfield Tax Credit.** *P.D. 99-16 (January 19, 1999).* When stock in the corporation that earns a coalfield tax credit is sold, the credit remains with the corporation that is sold. That credit can then be used to offset either the income tax of that company or the members of the new group with which it files a consolidated or combined return. Any excess credit can then be used to offset only other state taxes payable by the company that earned the credit.

3. **Legislation**

**Tax Credits.** A variety of income tax credits have been enacted or expanded. Many are subject to special budgetary limitations that may “un-enact” them.
R&D. A credit equal to 15% of R&D expenditures for which a federal credit is available is now allowed against Virginia taxes. The credit is limited to $100,000 per tax, per year and is subject to a $5 million annual cap for all taxpayers.

Disabled. Employers of disabled individuals can claim a credit equal to 20% of the first $6,000 of annual wages. Credit has three year carryover provision.

Neighborhood Assistance. The Neighborhood Assistance Act credits have been expanded to include “contracting services” for the poor and qualified organizations at $50 an hour and to include nurse practitioners, dental hygienists, and physician assistants and pharmacists who donate time at qualified clinics.

Land Preservation. 50% of the fair market value of land transferred for conservation and preservation purposes can be claimed as a Virginia income tax credit. The maximum credit is $50,000 in 2000, $75,000 in 2001, and $100,000 after 2001. There is a five year carryforward.

Open Space. An individual who sells land to an organization which dedicates it for open space use is entitled to deduct the gain on that sale.

Double Weighting. Effective January 1, 2000, Virginia will join some thirty or more states in double weighting or otherwise favoring the sales factor in apportioning income of entities using a three factor formula.

Charitable Conservation Gifts. Effective January 1, 2000, certain gifts of land or interests in land to qualified conservation entities will be allowed a 50% Virginia income tax credit. There is a ceiling limiting the benefit to $50,000 in 2000, and increasing by $25,000 a year until 2002.

B. Retail Sales & Use Tax.

1. Court Opinions

Commonwealth v. Blanks Oil Co., No. 970938, 1998 Va. LEXIS 54 (February 27, 1998). The Virginia Supreme Court held that the place of a sale of fuel oil was the taxpayer’s office in Campbell County, where the orders were taken, not the place of delivery. Accordingly, the taxpayer’s sales were subject to the local sales tax on heating fuel, which is exempted from taxation by certain localities.

Steuart Petroleum Co. v. Virginia Department of Taxation, No. LC 1390-4 (Richmond Cir. Ct., February 4, 1998). Steuart liquidated its service station/convenience store business by selling its stores to five different purchasers in five different transactions. On audit, the Department determined that the transactions did not qualify for the occasional sale exemption because five transactions constituted a series of sales sufficient in “number, scope, and character...
to constitute an activity requiring the holding of a certificate of registration," and assessed sales
tax and interest on the transactions. The trial court held that the Department had misapplied its
own regulation relating to occasional sales, 23 VAC 10-210-1080. Because the transactions
accomplished the complete liquidation of the entire business, the occasional sale exemption
applied and no sales tax was due.

2. **Opinions of the Attorney General**

*Industrial Development Authorities.* In an unpublished ruling dated January 7, 1999, the
Attorney General opined that an industrial development authority (an “IDA”) does not have the
statutory power to enter into a contract with a manufacturer for the purpose of serving as the
general contractor for the construction of the manufacturer’s new plant. In recent years, a fairly
common practice has been that a private entity would engage an IDA, a political subdivision, to
serve as the general contractor for the entity’s construction project in a particular city or county.
The IDA would purchase, either directly or through an agent, the building material tax-exempt
under the governmental entity exemption (Virginia Code § 58.1-609.1(4)), thereby allowing the
private entity to avoid incurring sales tax in connection with the construction project. The effect
of the Attorney General’s opinion is to disallow this practice.

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

*Church Meals.* P.D. 98-185 (November 5, 1998). Meals provided by a church during the
course of a religious worship service are not exempt. The Commissioner ruled that the church
purchased catered meals, which are considered a taxable service. The exemption for churches
applies only to tangible personal property, not taxable services. **QUERY:** Is this ruling
inconsistent with P.D. 98-96 (May 19, 1998), discussed below?

*Hospital Meals.* P.D. 98-96 (May 19, 1998). Meals provided by a hospital to its
employees at employee functions, to its volunteers, and to attendees of hospital-related seminars
are taxable because they are not “used or consumed” by the hospital in the rendition of its
medical services. By contrast, meals that the hospital provides to its patients are exempt because
they are used or consumed by the hospital in the rendition of medical services. See also P.D. 98-
95 (May 19, 1998). **NOTE:** The Department of Taxation appears to be using a double standard
when defining the term “use.” See, e.g., P.D. 85-216 (December 9, 1985) and 97-152 (March 28,
1997) (meals donated to employees and clients are “used” by employer).

*Dual Capacity (Contracting and Fabrication).* P.D. 98-75 (April 23, 1998). This ruling
provides a review of the criteria considered in determining whether a taxpayer is primarily a
contractor or a fabricator and the attendant tax consequences, the tax treatment of the sale and
delivery of property outside of Virginia, and the tax treatment of the sale and installation of
property in connection with real property construction contracts.

*Electricity.* P.D. 98-150 (October 13, 1998). The co-generation equipment used by a
taxpayer to produce electricity to power its exempt production machinery is itself exempt
because the electricity it produces is “used directly” in its production process. To the extent that
the taxpayer generates excess electricity and sells it to local power companies, the manufacturing exemption is still available because it is used in the production of a product, i.e., electricity, for resale.

**Manufacturing.** P.D. 98-173 (October 26, 1998). Insulation on piping essential to maintain temperatures of gasses during the production process was not “used directly” in that process and, therefore, was not exempt. LESSON: buy an insulated pipe instead of insulating the pipe in a separate transaction.

**Gifts to Schools.** P.D. 98-101 (May 26, 1998). The donation of educational software by the manufacturer to out-of-state schools constituted a taxable use of the software by the manufacturer. For tax purposes, the value of the gift is determined in the same manner as the sale price, and is not limited to the relatively minimal cost of the disk that contains the programs. The donation of educational software by the manufacturer to in-state schools is covered by a specific exemption. But see Virginia Code § 58.1-623C (withdrawals from inventory taxed at cost).

**Hotels.** P.D. 98-117 (July 10, 1998). A hotel is the taxable user and consumer of amenities such as shampoo, soap, notepads, and other items provided to hotel guests as part of the room accommodations. NOTE: In a previous ruling, P.D. 95-172 (June 26, 1995), the Tax Commissioner ruled that a hotel could purchase food items to be provided to guests as part of a complementary continental breakfast tax-exempt because the cost of the continental breakfast food items was included in the taxable room charge. QUERY: Are these rulings inconsistent?

**Jails: The True Object Test.** P.D. 98-198 (November 10, 1998). A taxpayer who, pursuant to contracts with state and local government agencies, operates jail commissary facilities (includes the preparation of meals), is providing a taxable service. The taxpayer may purchase commissary products for resale to jail inmates exempt.

**Laser Personalization Services.** P.D. 98-32 (February 23, 1998). Laser personalization services that are performed on customer-provided letterhead or paper stock constitute the provision of an exempt service. However, if the person performing the personalization service also provides the letterhead or paper stock in addition to the printing services, then the final product constitutes tangible personal property. Sales tax is due on the entire charge, including the charge for the personalization services.

**Research Services.** P.D. 98-105 (May 29, 1998). The taxpayer, a manufacturer, contracted a third party to develop a new process for the production of low voltage emitters. From time to time, the samples of the emitters were delivered to the taxpayer for testing. After testing them, the taxpayer destroyed the sample emitters. The Commissioner ruled that the true object of the contract between the taxpayer and the third party was the provision of research services. Accordingly, the contract price was not subject to tax.

**Research Services.** P.D. 98-121 (July 24, 1998). The taxpayer, a government contractor, entered a contract to provide “research and development ... for satellite design, computer
modeling, experiment design, data analysis, instrument packing and payload testing.” The Commissioner ruled that the true object of the contract was the provision of services. However, the tangible personal property used in performing those tasks that qualify as “research and development activities” is exempt from tax.

First Use. P.D. 99-40 (March 31, 1999). A contractor who had building materials and other supplies delivered to his Virginia warehouse, pending shipment to construction sites inside and outside of Virginia, was deemed to have made a taxable “first use” of the property in Virginia by virtue of receipt and storage at the warehouse.

Leases. P.D. 98-94 (May 19, 1998). The monthly gross proceeds received by the taxpayer-lessor from the lease of equipment is subject to tax. Gross proceeds include finance or interest charges, insurance charges, charges for property tax on the equipment being leased, and other similar charges. The sales tax due on the entire lease amount (the sum of the periodic lease payments) may be paid up front. Up-front payment does not protect the lessee from incurring additional tax liability if the tax rate changes during the term of the lease.

Occasional Sale. P.D. 98-11 (January 20, 1998). The sale of eight hotels (including tangible personal property) to eight separate buyers in eight separate transactions occurring over the course of seven months is not an occasional sale. The seller was a limited partnership formed to liquidate properties acquired by its partners through foreclosure and bankruptcy proceedings, and did not operate the hotels. But see Steuart Petroleum v. Department of Taxation, 44 Va. Cir. 392 (1998) (sales to five buyers pursuant to plan of liquidation is exempt). QUERY: what if eight hotels were held in eight single member LLC’s and the stock sold? See P.D. 98-157 (October 20, 1998) below (single member LLC not disregarded for sale and use tax purposes).

Occasional Sale. P.D. 98-38 (February 26, 1998). The sale by a taxpayer of its laboratory division was not an occasional sale because the laboratory operations were not separate and distinct from the corporation. The taxpayer was engaged in the refining of petroleum to produce heating oil and gasoline. The laboratory division performed quality control functions. In the Commissioner’s view, the laboratory assets were inextricably linked to the taxpayer’s production process. QUERY: what if assets of lab were dropped into LLC and ownership in LLC were sold?

Occasional Sale. P.D. 99-53 (April 7, 1999). Where an entity was formed solely to effect the liquidation of a number of hotels, the occasional sale exemption did not apply to the sale of all of the selling entity’s assets. The hotel operator went bankrupt, and the creditor did not want the hotels. Seller was formed to acquire the hotels from the creditor and to liquidate them. The seller sold all of the hotels in a relatively small number of transactions completed over a relatively short period of time such that it met the Steuart Petroleum criteria for the occasional sale exemption. However, the Commissioner ruled that the occasional sale exemption did not apply because the seller acquired the hotels with the stated purpose of selling them. QUERY: Is there any legal basis for the Commissioner’s conclusion that “the fundamental characteristic of an occasional sale is that it lacks continuity and regularity and it occurs without
being expected or without design”? Does this mean that "occasional sales" must happen without any planning?

**Software Licensing.** P.D. 98-39 (March 5, 1998). Pursuant to a licensing agreement, the taxpayer received the right to reproduce the licensor’s software products on any medium and to distribute it by sublicense to distributors and end-users. The reproduced copies of the software were transmitted to end users by modem. The taxpayer also had the right to use the licensor’s software for internal purposes. Title to and ownership of all reproduced copies remained with the licensor, and royalties (paid by the taxpayer) accrued to the licensor with respect to each sublicense sold by the taxpayer to an end user. The Commissioner ruled that the transaction between the taxpayer and the licensor was a retail sale on the basis that the licensor was obligated to transfer master copies of the software to the taxpayer in exchange for consideration. The Commissioner also ruled that the reproduction of the master copies constituted a taxable use by the taxpayer, and, therefore, the resale exemption did not apply.

**Transactions Between Affiliates.** P.D. 98-157 (October 20, 1998). The Commissioner reviews three scenarios. First, if Affiliate #1 “leases” equipment to Affiliate #2 pursuant to an unwritten agreement for no consideration, then the “lease” does not constitute a “sale” or “lease” for retail sales and use tax purposes, and the transaction is not taxable. However, under this scenario, Affiliate #1’s purchase of the equipment to be “leased” is taxable. Second, if Affiliate #1 leases equipment to Affiliate #2 for full fair lease value, then the lease transaction is a taxable lease. Affiliate #1 operates as a dealer, and is required to register as such, and collect and remit the applicable tax. However, Affiliate #1’s purchase of the equipment to be leased is tax-exempt because it constitutes a purchase for resale. Third, if Affiliate #1 leases equipment to Affiliate #2 for a fraction of the full fair lease value (e.g., $100 per year rather than $100,000 per year), the lease still constitutes a taxable lease, and Affiliate #1 would be required to register as a dealer. Affiliate #1 would be entitled to purchase the equipment to be leased to Affiliate #2 non-exempt as a purchase for resale. However, the Commissioner is authorized to fix the lease amount at the full fair lease value and assess tax on that higher amount. Finally, the Commissioner noted that if a single member LLC or a qualified subchapter S subsidiary (QSSS) is disregarded as a separate entity for federal income tax purposes, then it will be disregarded for Virginia income tax purposes also. It will not, however, be disregarded for Virginia sales and use tax purposes, and transactions between the affiliated entities will be taxable.

**Nonprescription Drugs.** P.D. 98-98 (May 15, 1998). Effective July 1, 1998, nonprescription drugs and proprietary medicines are exempt from sales tax. P.D. 98-98 provides guidance regarding what constitutes a nonprescription drug or proprietary medicine.


**Software Licensing.** P.D. 98-39 (March 5, 1998). The Commissioner ruled that a software licensing agreement was a retail sale subject to tax because the licensor was obligated to
transfer master copies of the software to the taxpayer in exchange for consideration. The taxpayer (licensee) received the right to reproduce the licensor’s software products on any medium and to distribute them by sublicense to distributors and end-users. The reproduced copies of the software were transmitted to end users by modem. The taxpayer also had the right to use the licensor’s software for internal purposes. Title to and ownership of all reproduced copies remained with the licensor, and royalties (paid by the taxpayer) accrued to the licensor with respect to each sublicense sold by the taxpayer to an end user. The Commissioner also ruled that the reproduction of the master copies constituted a taxable use by the taxpayer, and, therefore, the resale exemption did not apply.

_Bad Debt._ P.D. 99-37 (March 30, 999). The assignee of an installment sale contract is entitled to claim a bad debt credit against his retail sales and use tax liability on the return filed following the period in which the debt was declared uncollectable. A prerequisite to claiming the credit is that the assignee must be a Virginia-registered dealer.

_Royalty Payments._ P.D. 99-7 (January 8, 1999). Royalties paid under a licensing agreement that covers intellectual property as well as tangible personal property (still photographs, film footage, text, artwork, etc.) are subject to sales tax. By contrast, royalties paid under a licensing agreement that covers intellectual property only are not subject to tax because no tangible personal property is involved.

_Sale-Leaseback._ P.D. 99-104 (May 5, 1999). A vendor must obtain a resale certificate from the purchaser to whom taxable tangible personal property is invoiced. Where the purchaser intended to acquire tangible personal property from the vendor and to simultaneously sell the property to a third party for subsequent taxable leaseback to the purchaser, the purchaser must provide resale certificate to the vendor even though the third party will pay the vendor’s bill directly.

_Trial Merchandise._ P.D. 99-62 (April 12, 1999). A taxpayer’s providing of products to a customer on a “trial basis” does not constitute a taxable use of the product by the taxpayer, and the product does not lose its status as part of the taxpayer’s resale inventory. The taxpayer allowed customers to use products on a “trial basis” for a specified period of time, and issued a “no charge” invoice. Products returned within the trial period were returned to the taxpayer’s resale inventory, and the customer was not charged; products not returned within the trial period were invoiced to the customer.

4. _Legislation_

_Food Tax._ The sales and use tax rate on food sold for human consumption is reduced by two percentage points over a four year period. When fully phased in, the combined state and local tax rate applicable to food products for human consumption (on or after April 1, 2003) will be 2.5%.

_Medicines._ The exemption for medicine and drugs is expanded to include eyeglass cases and contact lens storage containers, solutions and kits when distributed free of charge by
optometrists, etc. The exemption for controlled drugs is also expanded to include certain purchases by optometrists, licensed nurse practitioners, and licensed physician assistants.

**Internet.** The definition of “retail sale” is changed to exempt computer hardware and software and certain distribution equipment purchased by an internet service provided.

**Hospitals.** Medicines and drugs purchased for use or consumption by a licensed, for-profit hospital are exempt effective July 1, 2000.

**IDA Sales and Use Taxes.** The sales and use tax exclusion for purchases by a governmental entity, Virginia Code § 58.1-609.1(4), is narrowed so that it does not apply to tangible personal property that will be used to create facilities for a non-governmental entity. The express purpose of the legislation is to eliminate the practice by some local governments of using IDAs to build, free of sales and use taxes, facilities for new businesses.

**Leasing Businesses.** The definition of “sales price” in Virginia Code 58.1-602 will be amended for sales and use tax purposes to exclude separately stated local property taxes collected. Thus, leasing businesses that correctly account for local property taxes on leased equipment will no longer be required to pay Virginia sales and use taxes on those payments collected from lessees.

**Manufacturer’s Tooling.** The definition of “retail sale” in Virginia Code § 58.1-602 will be amended effective July 1, 1999 to exclude from taxation certain tooling used by a “sub” manufacturer and thereafter purchased by the “prime” manufacturer. The subsequent sale must be required by contract at the time the tooling is originally purchased, and the tooling must be resold for an amount equal to or greater than original cost.

## C. Business, Professional and Occupational License Tax.

### 1. Court Opinions.

**Mutual Broadcasting System, Inc. v. Arlington County.** Law Nos. 97-1232 and 94-1483 (Arlington County Cir. Ct., May 6, 1999). Mutual Broadcasting System, Inc. produced a variety of live and recorded radio programs at a studio located in Arlington, Virginia, and at its off-site mobile facilities. Its programming was transmitted to an earth station and then to a satellite from which the signal was transmitted to a variety of radio broadcasting stations located throughout North America and the world, most of which are contractual affiliates of the company. Arlington County took the position that since the company did not broadcast directly to the public, but rather transmitted its signal to its affiliates which thereafter broadcast to the public, it was not entitled to a “radio broadcasting service” as that term is defined in Va. Code § 58.1-3703(B)(3).

The Arlington County Circuit Court looked at the Virginia Supreme Court decision in **Chesterfield Cablevision, Inc. v. County of Chesterfield,** 241 Va. 252 (1991), which dealt with whether a cable television service was exempt from the BPOL tax under Va. Code § 58.1-
In the *Chesterfield Cablevision* decision, the Virginia Supreme Court held that since cable TV operators sent programming only to subscribers of the service and not to the public at large, Chesterfield Cable did not qualify as broadcasting stations or services. Arlington County argued that the *Chesterfield Cablevision* decision established that the broadcasting company at issue in this case did not operate a "broadcasting station or service" ad that its operation was similar to that of a cable TV system.

The Arlington County Circuit Court disagreed with the County and found that the equipment contained in Mutual Broadcasting System’s Arlington studios was involved in producing, enhancing, sustaining, processing and refining the broadcast signal. These activities constituted “radio broadcasting service” and thus was entitled to the exemption from license taxation afforded by Va. Code § 58.1-3703(B)(3).

2. **Opinion of the Attorney General**

“Section 58.1-3703(C)(4) prohibits a locality from assessing a business, professional and occupational license ("BPOL") tax “[o]n a manufacturer for the privilege of manufacturing and selling goods, wares and merchandise at wholesale at the place of manufacture.” The BPOL statutes do not define the term “manufacturer,” and the question often arises regarding whether the activity of a business constitutes manufacturing for purposes of the § 58.1-3703(C)(4) exemption. The Virginia Supreme Court has held that manufacturing contains three components: (1) a raw or original material; (2) a process whereby the material is changed; and (3) a resulting product that is different in character from the original material. Although the Court has applied this test to various types of business activities, I am aware of no case in which the Court has considered directly whether the assembly of parts into a finished product constitutes manufacturing. Moreover, while numerous prior opinions of the Attorney General also consider whether a particular business is engaged in manufacturing under the tax statutes, only one opinion applies the manufacturing test to an assembly process. The opinion considers whether the assembly of precut furniture kits constitutes manufacturing and concludes that the assembly is not manufacturing. The opinion notes that the original kit, without assembly, would be usable by consumers and that the company’s assembly for the consumer merely enhances the item, i.e., the furniture kit, without changing its character. An argument can be made that the assembly of materials lacks the “processing” component necessary for manufacturing to occur. No Virginia cases expressly so hold. Moreover, the Court has held that the manufacturing exemption is to be liberally construed in furtherance of the state’s public policy of encouraging manufacturing in the Commonwealth. Accordingly, it is my view that such a narrow interpretation should not be adopted unless clearly directed by the Court’s rulings. It is further my opinion that, in light of the Court’s liberal construction mandate, neither the BPOL guidelines nor the Commissioner’s advisory opinion are in conflict with Supreme Court rulings interpreting the term "manufacturer." Whether a company engaged in the assembly of materials is or is not a manufacturer remains a question of fact and will depend on an analysis of such factors as the type of material being assembled, the complexity of the process, and the product resulting from the assembly. It is my opinion that the facts provided would support a conclusion that the company is engaged in manufacturing for purposes of § 58.1-3703(C)(4). The final decision, however, must be made by the commissioner of revenue upon consideration of all of the facts.” Va. Atty.
3. **Rulings of the State Tax Commissioner**

**Classification: Franchisors.** P.D. 98-140 (October 7, 1998). A franchisor is engaged in a regular and continuous course of business and, therefore, may be subject to a locality's BPOL tax. The franchisor was engaged in a service business, and, because all services were not performed at the franchisee location, the franchisor's gross receipts are attributed to the franchisor's office, as that is the location from which the services are performed, directed or controlled.

**Classification: Warranties.** P.D. 99-121 (May 21, 1999). Company selling new tire warranties to purchasers of new automobiles is in engaged in a business service. It is not a merchant, because it does not sell "goods" and it is not providing a "financial service" as defined in the regulations.

**Classification: Manufacturing.** P.D. 98-40 (March 5, 1998). The Commissioner initially ruled that a taxpayer who acquired various components from original equipment manufacturers and assembled the same according to the customer's specifications was not engaged in manufacturing or processing, but in "assembling." The ruling also provides a review of what constitutes manufacturing or processing under Virginia law. NOTE: The Commissioner's initial conclusion is contrary to the holding of Fairfax County v. DataComp, 36 Va. Cir. 69 (1995). This ruling was reversed by P.D. 98-154 (October 16, 1998). The history of this issue undoubtedly reflects pressures by local governments to expand the BPOL tax.

**Classification: Printers.** P.D. 99-228 (August 10, 1999). Although printers are generally considered manufacturers for Virginia tax purposes, an insubstantial amount of printing activity will not cause the entire business to be exempt from local license taxation. Whether activity is substantial is a question of fact.

**Manufacturing Exemption.** P.D. 99-14 (January 19, 1999). The prohibition against business license taxation of manufacturers applies only to "manufacturing and selling at wholesale at the place of manufacture." Thus, a company that performed manufacturing activities on inventory owned by another person was subject to business license taxation because it could not be engaged in the business of selling those goods which it did not own. CAUTION: any contract for the performance of a manufacturing process in which the manufacturer does not take title to the goods or materials being processed potentially subjects the business to gross receipts license taxation.

**Classification: Retailer/Wholesaler.** P.D. 98-42 (March 6, 1998). The taxpayer is a nationwide distributor of various office products and supplies. It has a call center and several sales offices located in Virginia. The call center receives calls from customers placing orders for office products. The call center personnel enter the orders, process the billing information and
arrange for delivery. The Commissioner ruled that the call center is conducting business as a retailer and as a wholesaler, and, therefore, the taxpayer is subject to BPOL tax. The taxpayer is, however, entitled to a deduction for those receipts that are attributable to business conducted in another state in which the taxpayer is liable for an income tax or an income-like tax.

**Classification: Retailer/Wholesaler.** P.D. 98-160 (October 20, 1998). The sale of welding equipment and supplies and industrial gasses to contractors constitute retail sales, not wholesale sales. The determination whether a sale is a retail sale or a wholesale sale is based on the characteristics of the purchaser and the purchaser’s use of the equipment, and, to a lesser degree, the price. If the purchaser is the ultimate user of the product purchased, then the sale is generally classified as a retail sale. If the purchaser buys the product to resell it, then the sale is a wholesale sale.

**Classification: Wholesale Merchant.** P.D. 125 (May 26, 1999). Ruling indicates that localities are continuing to push at the definition of “wholesale merchant” and trying to reclassify them as “retail merchants.” Held that “fleet sales” of automobiles are generally recognized as wholesale sales.

**Classification: Wholesale Merchant.** P.D. 99-141 (July 11, 1999). Crushed stone was sold to various state and federal transportation departments, asphalt and ready-mix plants, and contractors. Sales to asphalt and ready-mix plants are wholesale sales because they will be incorporated into a new product for resale. With respect to the other sales, a facts and circumstances test is applied that focuses on (i) characteristics of the purchaser, (ii) the purchaser’s use of the merchandise and, (iii) to a lesser degree, the price and quantity of the product sold. As a general rule, sales in quantity or at a discount suggests wholesale transactions. Note necessity of “substantiating the lower prices.”

**Wholesale Warehouse.** P.D. 99-199 (July 23, 1999). Business classified as a “wholesale merchant” is generally taxable with respect to “purchases” which are deemed to take place at the warehouse or place of delivery to the customer. No tax is owed at wholesale merchant’s office in a locality where goods are not delivered to the customer.

**Gross Receipts.** P.D. 98-138 (October 2, 1998). Other income reported on federal Schedule C is included in the business’ gross receipts. Specifically, the Commissioner considered the situation where two sole proprietor dentists share office space and expenses. Dentist #2 pays Dentist #1 half of the expenses and Dentist #1 pays the bills. The amounts paid to Dentist #1 constitute receipts from an ancillary activity and are included in Dentist #1’s gross receipts and taxed at Dentist #1’s primary activity rate. **QUERY:** Is the Commissioner correct in ruling that rent of office space is ancillary to a dental practice and not a separate trade or business? Put building in an LLC?

**Trustee Fees.** P.D. 99-208 (July 29, 1999). Taxpayer reported trustee’s commissions on a Schedule C of his 1040 and later amended that to reflect the commissions as “other income.” Held that this reporting methodology creates rebuttable presumption that the taxpayer is in the
business of being a trustee and subject to local license taxation. Insufficient facts provided Commissioner to make a final determination.

**Gross Receipts: Loan Companies.** P.D. 99-87 (April 23, 1999). Ruling addresses proper tax base for local office that originates loans and forwards them to another office for processing, etc. Commissioner concludes that it may be appropriate to determine local tax base using payroll apportionment. **Observation:** It may be possible to reduce total tax base by transferring loan portfolio to a special purpose entity to hold for investment.

**Gross Receipts.** P.D. 98-135 (September 15, 1998). Settlement funds received by an attorney and placed into the attorney’s trust account pending disbursement to the client are not “gross receipts” subject to the BPOL tax.

**Extraordinary Receipts.** P.D. 99-209 (July 29, 1999). Construction contractor restructured its business in preparation for retirement of the owner/brothers. Certain lot and construction inventory was sold to an LLC owned by family members. Commissioner holds that proceeds from the sale of these assets were subject to local license taxation because these inventory items were not “capital assets” and assets eventually would be sold to customers. **Comment:** The Commissioner’s use of income tax authorities in analyzing a privilege tax issue is questionable when one of the purposes of the “reformed BPOL tax laws” was to move administration away from an income tax approach. Although the facts in this ruling are sparse, it appears that this was a “bulk sale” that was not part of the usual course of business which is arguably beyond a locality’s power to tax.

**Charities.** P.D. 98-50 (March 12, 1998). A medical practice which had previously been subject to BPOL taxation was acquired by a local hospital and the previously self-employed doctors became employees of the non-profit hospital. HELD: Even though the doctors continued to provide the same services as before, no BPOL tax could be assessed unless the doctors were operating through a separate legal entity. Note the possible problem created because this medical practice continued to operate under its former name “for marketing purposes”, thereby giving the local Commissioner of the Revenue an opening to assess that “separate entity.”

**Charities.** P.D. 98-203 (December 7, 1998). A tax exempt hospital located in a neighboring state operated a medical center in Virginia. Because the legal entity was exempt from federal income taxation, the locality could not subject the medical center to a BPOL tax just because the charitable status of the entity was established by the laws of another state. The locality’s inability to tax the charitable entity also encompassed the employees of that entity.

**Situs: Leased Construction Equipment.** P.D. 98-155 (October 19, 1998). The BPOL tax is a separate tax from the tangible personal property tax. Thus, there was no legal impediment to a business being assessed with both taxes. With respect to the taxable situs of the equipment, the Commissioner, not as part of the formal ruling, suggested that the construction equipment could be taxed by the neighboring locality, where it was utilized, if it had become “part of the property of the locality.”
Situs: Professional Services. P.D. 98-204 (December 7, 1998). An engineering firm with offices in one locality filed mechanics liens as a subcontractor in the locality where construction services were being performed by a contractor. The Commissioner held that the locality of the construction site could not tax the engineering firm as a contractor because (i) the firm had no local office and (ii) the firm was clearly providing engineering services, not the services of a contractor.

Situs: Money Orders/Nexus. P.D. 99-234 (August 13, 1999). Money transfer and other financial services are offered through independent retailers to their customers. The Commissioner holds that the company whose financial services are sold by these independent retailers does not have an “office” in each locality where its services are provided and cannot be required to pay business license tax.

Situs: Foreign Offices. P.D. 99-236 (August 16, 1999). Professional corporation, in addition to its local office, was provided office space by a client in Italy. The Commissioner holds that this client-provided office may constitute a definite place of business so that receipts attributable to that office in Italy are not taxable in Virginia. Remanded to locality to determine facts. Further held that receipts, if taxable locally, could not be deducted because they were not in fact subjected to Italian income tax.

Situs: Consignment Sales. P.D. 97-305 (July 18, 1998). Pharmaceutical company shipped goods to a retail pharmacy which sold the goods on consignment. Although the pharmaceutical manufacturer had an inventory of goods in the locality, it had no office or employees there and therefore had no place of business in the locality. Accordingly, it is not subject to BPOL taxation there. If the retail pharmacy is deemed to be the agent of the pharmaceutical manufacturer, then the office of the pharmacy can be attributed to the pharmaceutical manufacturer.

Situs: Administrative Office. P.D. 99-92 (April 30, 1999). Bookkeeping office located in different locality than corporation's coal mine may be required to pay local fee ($100.00 or less) but has no taxable gross receipts unless it provides bookkeeping services to unrelated parties. OBSERVATION: Administrative offices generally are not subject to license taxation on gross receipts.

Situs: Independent Sales Representative. P.D. 99-10 (January 11, 1999). Independent contractor working out of his home and selling merchandise by catalog and by bringing customers to company showroom is licensable at his home as a commission merchant. Tax base is based on commission, not gross receipts from sales, because salesman does not take title to property.

Situs: Internet Sales. P.D. 99-137 (June 10, 1999). The fact that a company offered goods for sale over the internet did not mean that it had a "definite place of business" in Virginia for local license tax purposes.
**Interstate Receipts.** P.D. 99-238 (August 23, 1999). Company with only one place of business, which is in Virginia, must report all of its gross receipts for local taxation. It is entitled to a deduction, however, to the extent that it is liable for an income tax to another state and files a return with respect to that tax. **COMMENT:** Although the opinion pays lip service to *Short Brothers v. Arlington County*, 244 Va. 520 (1992), it appears to reach the correct conclusion that a deduction for interstate receipts is allowable, even by a single office taxpayer, if it is in fact subject to another state’s tax.

**Beginners Convention.** P.D. 99-210 (July 28, 1999). Ruling holds that the “true up” for a beginning business is made only in the first year and not in subsequent years. Although result may depend on local ordinance, the usual rule in applying the “beginners convention” is that prior years’ gross receipts are not used to measure the tax until the taxpayer has been in business for an entire year. Thus, year 1 is based on actual receipts; year 2 is based on actual receipts (because year one was a partial year); and year 3 is based on year 2’s receipts. No “true up” should be payable with respect to year 3’s tax base, but tax should be based on actual receipts for years 1 and 2 under many local ordinances.

**Beginners Convention.** P.D. 99-229 (August 10, 1999). Company which can accurately forecast its gross receipts must nevertheless file in its third taxable year based on its second taxable year receipts. Assuming local ordinance bases current year’s tax (after beginners convention period) on prior year’s receipts, corporation must follow this methodology.

**Beginners Convention.** P.D. 99-232 (August 12, 1999). Factual dispute as to whether company started business on December 13, 1996 or January 1, 1997. For purposes of 1998 business license, Commissioner holds that tax should be based on 1997 receipts because company was in fact in business for the entire year.

**Beginners Convention.** P.D. 99-237 (August 23, 1999). Corporation which converted its business to an LLC was deemed to be a new business for business license tax purposes. Accordingly, it was required to be taxed under the “beginners convention.”

**Dual Businesses.** P.D. 99-211 (July 30, 1999). Taxpayer provided energy related services including (1) energy audits for homeowners and (2) quality control inspections of heat pump installations for an electric utility. Taxpayer had traditionally filed under two license categories, and locality attempted to change this, thereby forcing the taxpayer’s total receipts to exceed the minimum threshold. State Tax Commissioner rules that the taxpayer is engaged in two different businesses because it is (1) providing services to individuals and (2) providing services to corporations, and the two activities are independent of each other.

**Dual Businesses.** P.D. 99-233 (August 12, 1999). Company providing building inspection services to residential customers and to commercial customer held to be in two separate businesses. Receipts could not be aggregated by locality for purposes of determining whether business exceeded the threshold.

**Employees.** P.D. 99-122 (May 21, 1999). Taxpayer, who was employed by a governmental entity, was responsible for paying certain federal and state taxes which were then
reimbursed by a third party. On the advice of this CPA, taxpayer filed a Schedule C with his Form 1040. Taxpayer was clearly an employee and therefore was not subject to gross receipts taxation.

**LLC's.** P.D. 99-9 (January 11, 1999). Although disregarded for income tax purposes, a single member LLC is potentially subject to business license taxation if it has a definite place of business. **QUERY:** Can a single member LLC be used to shelter income from BPOL taxation? See comment to P.D. 99-87.

**Affiliates.** P.D. 99-176 (June 30, 1999). Individual was sole stockholder in a corporation and 99% owner of an LLC. Held that an LLC owned by an individual cannot be treated as member of an affiliated group so that transactions between the corporation and the LLC were subject to local license taxation.

**Trucking Company.** P.D. 99-212 (July 29, 1999). A motor vehicle carrier formerly certified by the ICC is exempt from business license taxation.

**Local Ordinances.** P.D. 98-37 (February 24, 1998). Localities have authority to create subclassifications to treat different types of businesses differently. Such a subclassification could treat car dealers differently from other merchants, but all car dealers must be treated the same.

**Real Estate Brokers.** P.D. 98-46 (March 11, 1998). A locality has authority to tax just real estate brokers, not real estate agents. In structuring its tax, the locality must allow a deduction for commissions paid to real estate agents who are subject to any Virginia locality's BPOL tax. A deduction does not have to be allowed for BPOL tax paid to out-of-state brokers. **Query:** Is this interpretation constitutional?

4. **Legislation**

**Contractors.** Contractors whose gross receipts in any locality exceed $25,000 during a license year will be required to pay a license fee or local business license tax even though the contractor has no definite place of business in the locality.

D. **Property Taxes.**

1. **Court Opinions**

The Mariners Museum v. City of Newport News, 255 Va. 40, 495 S.E.2d 251 (January 9, 1998). Virginia Code § 58.1-3603 provides that any real estate owned by a tax exempt entity becomes taxable to the extent that it is a source of revenue or profit. Thus, a charity that leases the top floor of its two-story building to a for-profit business incurs a tax on the value of the rented space. In this case, a real estate tax-exempt museum leased land to a real estate tax-exempt hospital. Notwithstanding that property owned by both entities was exempt from real
estate taxation, the Supreme Court of Virginia held that the lease was taxable because it was a source of revenue or profit to the lessor. The Court’s distinction of an earlier Virginia Supreme Court opinion suggests that no tax would have been incurred if the leasehold payments had been limited to amounts sufficient to cover mortgages and other costs of the lessor (i.e., there had been no “net” revenue or profit).

Coca-Cola Bottling Company of Roanoke, Inc. v. City of Clifton Forge, Law No. CL 97-15 (Clifton Forge Cir. Ct., January 14, 1998). The taxpayer’s vending equipment, scoreboards, furniture, fixtures, office equipment and computer equipment were held to be capital used in the taxpayer’s manufacturing business. Accordingly, they did not constitute machinery and tools, motor vehicles or delivery equipment subject to local property taxation.

Coca-Cola Bottling Co. of Roanoke v. County of Botetourt, Cir. Ct. Botetourt County (January 7, 1997). Issue was whether vending machines were “personal property, tangible in fact, used [indirectly, not directly] in a manufacturing business.” Trial court held (i) that bottling company was a manufacturer and (ii) that vending machines were used in a separate line of business (i.e., retailing). As a result, vending machines were taxable tangible personal property and not exempt manufacturer’s capital.

McLane Company, Inc. v. County of Stafford, Law No. 95000635 (Stafford Co. Cir. Ct., March 11, 1998). McLane operated a distribution center in Stafford County, and was engaged in interstate commerce. Using tractor trailers, it distributed foodstuffs to convenience stores located in Virginia, 12 Mid-Atlantic states and the District of Columbia. The County assessed the tractor trailer fleet at 100% of its value, refusing to apportion any taxes, despite the fact that McLane traveled only 34% of its total miles in Virginia. The Court held that McLane had (1) demonstrated that its vehicles traveled regular, scheduled routes, and were habitually employed outside of Virginia, (2) presented evidence of significant business transactions outside of Virginia, and (3) demonstrated its business activities in specific jurisdictions. Virginia Code § 58.1-351B requires the apportionment of personal property taxes on vehicles engaged in interstate commerce which are subject to property taxation in any other state. The Court held that although McLane had established a “tax situs” in each of the other 12 states and the District of Columbia, it was entitled to apportionment only with respect to those 3 states where it was actually subject to property taxation.

Tidewater Psychiatric Institute v. City of Virginia Beach, 256 Va. 136 (June 5, 1998). The taxpayer, a psychiatric facility, contested the City’s assessment of two parcels of real property that the taxpayer owned or leased as arbitrary, inequitable and excessive. The taxpayer contended that the City should have used the income method or an alternative method rather than the depreciated reproduction cost as the method for valuing the real estate. The Virginia Supreme Court disagreed, and held that the use of depreciated reproduction cost as the sole basis for determining the property’s fair market value was not erroneous because the City considered other methods for determining the fair market value, but lacked the reliable data necessary to apply those alternative methods.
Mountain View Limited Partnership v. City of Clifton Forge, 1998 Va. LEXIS 104 (September 18, 1998). A City ordinance increasing the refuse collection charges in the City based on a system of classifying residential and commercial users did not constitute a tax. The Virginia Supreme Court held that the ordinance did not constitute an invalid revenue generating measure solely because the fee set by the ordinance generated a surplus. The correct inquiry, in the Court’s view, is whether there is a reasonable correlation between the fee charged and the benefit conferred. In this case, the Court held that a reasonable correlation existed.

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

   **Interstate Common Carriers.** 1998 Va. AG Lexis 62 (December 16, 1998). To be allowed to apportion its local property taxes, an interstate common carrier does not have to prove that it has paid taxes on its vehicles in another state. It must prove, however, that the vehicles have a tax situs in another jurisdiction. This may include, for example, showing that the property traveled on fixed and regular routes or was habitually employed in a particular state.

   **Exemption for Hospitals.** 1998 Va. AG LEXIS 43 (October 6, 1998). The Attorney General opined that a medical center owned by a nonstock, nonprofit hospital corporation was not entitled to personal and real property tax exemptions because it did not qualify as a “hospital.” The medical center was located about twenty miles from the hospital and was staffed by one physician. The physician did not admit patients to the medical center; rather he treated them and referred them to the hospital. The Attorney General noted that “hospitals conducted not for profit but exclusively as charities” are entitled to the exemption, and, further, that because the medical center came into existence after 1977, the hospital exemption would be construed narrowly. The Attorney General considered the statutory definition of hospital set forth at Virginia Code §§ 32.1-123 and 32.1-134, which define hospitals as facilities in which the primary functions are diagnosis, treatment, and the provision of medical and nursing services, surgical and nonsurgical. A physician’s office does not qualify as a hospital unless surgical services are rendered there.

3. **Legislation.**

   **Administrative Appeals.** Following through with recent efforts by the Virginia Manufacturers Association and Virginia Chamber of Commerce, local administrative appeals procedures will be amended generally to permit appeals with respect to “local business taxes” to the State Tax Commissioner. The appeal procedure generally follows the procedure adopted for business license tax purposes effective January 1, 1997. The taxpayer has ninety days from the date of the initial assessment in which to file an appeal with the local assessing officer, and then ninety days from an adverse decision by that local officer in which to file an appeal with the State Tax Commissioner. Procedures apply generally to machinery and tools, merchants capital, and business personal property.
This new procedure is available for assessments made on and after January 1, 2000, but for valuation issues not until January 1, 2001. The purpose of the delayed effective date is to provide opportunity for assessing officers and business community to address deficiencies of current valuation processes and propose remedial legislation to the 2000 Session of the General Assembly.

_Interest on Refunds._ In a classic example of “fair for the goose being fair for the gander,” Virginia law now requires localities that charge tax on delinquent tax bills to pay interest on refunds at the same rate. The legislation does not indicate how this new provision will be applied when it takes effect July 1, 1999. One argument is that it should apply to all amounts actually refunded on or after that date. Another interpretation is that interest will be paid on refunds with respect to assessments made on or after that date.

E. **Procedural.**

1. **Legislation**

_Interest Rates._ Virginia Code § 58.1-15 is amended effective January 1, 2000 to equalize the interest rates on tax overpayments and underpayments. Rather than reduce the excessive underpayment rate, the overpayment rate (applicable to refunds) is increased by two percentage points.

F. **Individual Taxes.**

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

_Domicile And Residency._ P.D. 98-7 (January 14, 1998). The Commissioner reviews the rules governing the determination whether a taxpayer is a Virginia domiciliary. Ultimately, he concluded that a taxpayer who leased an apartment, registered his car, obtained a drivers license, registered to vote and received mail in another state had abandoned his Virginia domicile even though he kept his house in Virginia, his wife remained in Virginia and his daughter attended a Virginia state college as a Virginia resident.

_Domicile And Residency._ P.D. 98-183 (October 30, 1998). In determining the number of days that a person is present in Virginia for purposes of determining his residency, partial days are counted unless the person was in Virginia for no reason other than to travel to a destination outside of Virginia. In the case of a person who resides in Pennsylvania on weekends, and travels from Pennsylvania to Virginia each Monday morning, works and stays in Virginia until Friday, and then drives back to Pennsylvania each Friday evening, the Mondays and Fridays count as days that he is present in Virginia because he worked in Virginia on those days.

_Roth IRAs._ P.D. 98-44 (March 9, 1998). Under the principles of conformity, the Commissioner has confirmed that (1) distributions from a regular IRA that are rolled over into a
Roth IRA prior to January 1, 1999, are subject to Virginia tax to the extent that they are included in the taxpayer's federal adjusted gross income. The Commissioner noted that while the IRS might recognize an election to report the conversion of a regular IRA to a Roth IRA over a period of two or three years, Virginia will not recognize such an election. Rather, Virginia will require that taxpayer to report the distribution equally over a period of four years, in accordance with the federal statute. Qualifying distributions from Roth IRAs that are not includable in the taxpayer's federal adjusted gross income are not subject to Virginia tax.

Married Taxpayers  P.D. 98-132 (August 19, 1998). Married taxpayers filed separate Virginia returns on a combined form, and used 100% of the Virginia itemized deductions to offset one spouse's Virginia adjusted gross income. Subsequently, the other spouse submitted an amended Virginia return claiming 90% of the Virginia deductions. The Commissioner refused to acknowledge the change absent a statement of consent from the first spouse. Instead, he allowed the other spouse the itemized deductions to the extent claimed on the separate federal return.

S Corporations.  P.D. 98-184 (November 4, 1998). The Commissioner reviews the seven conditions which must be satisfied as a prerequisite to the grant of permission to an S Corporation to file a unified return on behalf of its nonresident shareholders. They are: (1) a schedule showing the total S Corporation income, and the amount attributable to Virginia under the apportionment statutes must be provided; (2) only the income/loss attributable to shareholders having no other Virginia source income may be reflected on the unified return; (3) all nonresident shareholders having no Virginia source income from sources other than the S Corporation must elect to join in the filing of the unified return, and must provide a statement to that effect to be included in the return; (4) the name, address, social security number, and Virginia taxable income for each nonresident shareholder must be reflected on the return; (5) each nonresident's Virginia tax liability will be computed at the rate set out in Virginia Code § 58.1-320 without the benefit of itemized deductions, standard deductions, personal exemptions or credit for income taxes paid to his state of residence; (6) each nonresident shareholder must sign a statement acknowledging his responsibility for his share of the total tax; and (7) if required, a similar return will be filed, and payment of estimated tax will be made.

S Corporations.  P.D. 98-60 (March 24, 1998). S Corporation shareholders electing to file a unified return may not carry back or forward a net operating loss to offset the income reported on the Virginia unified returns or the Virginia nonresident returns of the individual owners or beneficiaries.

2.  Legislation

Taxes Paid Other States. Virginia Code § 58.1-332 is amended to allow a credit to Virginia residents who pay tax to another state with respect to gain on the sale of a capital asset.

Political Contributions. Too late for the current year elections (the bill is effective January 1, 2000), Virginians can claim a tax credit for 50% of their political contributions to candidates for state and local offices. The maximum credit is $25 for an individual taxpayer ($50 filing joint).
**Disabled.** 25% of the total cost for making changes to one’s home to make it accessible to disabled individuals can be claimed as a credit. The total credit per individual is $500 maximum, with a $1 million per year state-wide ceiling.

**Military.** The first $15,000 of military pay for active duty personnel is exempted from Virginia individual income tax. The exemption phases out between $15,000 and $30,000.

**Tuition Trusts.** A deduction is allowed for up to $2,000 per year on account of contributions to a savings trust account with the Virginia Higher Education Tuition Trust Fund. Earnings on these accounts can also be subtracted from Virginia taxable income.

**Prepaid Tuition Contracts.** Persons who are age 70 or older can deduct the full amount paid to purchase a prepaid tuition contract and are not subject to the usual $2,000 per year limitation.

**School Teachers.** 20% of the tuition costs for continuing education required as a condition of employment can be conducted by licensed primary and secondary school teachers. No deduction if the individual is reimbursed for these costs or has claimed the deduction on his federal income tax return.