State and Local Taxes in Virginia - 1994

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I. RECENT CASES

A. Local Tangible Personal Property Tax


(a) Issue. This November 1993 ruling of the Supreme Court of Virginia and followup action by the Virginia General Assembly in 1994 codifying the result creates the potential for many taxpayers owning computers and other rapidly depreciating assets to obtain refunds of local personal property taxes paid with respect to those assets.

(b) Facts. In TII, the Supreme Court has ruled that the value of personal property upon which the personal property tax can be assessed cannot exceed the property's fair market value including reductions in fair market value attributable to obsolescence and other market factors. For example, if your firm purchased a mainframe computer during 1990 for $1 million and the value of the computer, due to the introduction of a new advanced line of computers, was reduced to $250,000 by 1991, then the fair market value upon which the 1991 personal property tax could be assessed is $250,00. Contrary to this fair market value limitation, most Virginia localities have been valuing business equipment, including computers, for property taxation at a fixed percent of original cost so that the value of the computer during 1991 would be specified as a standard percentage of the $1 million original cost without regard to obsolescence and the real value of the equipment. For example, in Fairfax County, the second year percentage is fifty-five percent so that the country's determination of the 1991 value would have been $550,000, i.e., $300,000 in excess of the true fair market value. In its recent ruling, the Virginia Supreme Court ordered Fairfax County in this situation to refund all personal property taxes attributable to the $300,000 overassessment.

2. American Woodmark Corporation v. City of Winchester (Winchester Circuit Court, September 1994)

(a) Provision Involved. The "exemption" from local property tax of tangible personalty "used in manufacturing businesses." Va. Code § 58.1-1101(A)

(b) Law Strictly Construed Against the Locality. That tax exemptions are to be construed strictly against the taxpayer, and that the taxpayer has the burden of establishing entitlement to an exemption, is not applicable here. Compare Commonwealth v. Wellmore Coal Corp, 228 Va. 149, 320 S.E.2d 509 (1984); Sections 58.1-1100 and 58.1-1102(A)(2)
do not exempt from tax property which would otherwise be subject to taxation but classify and define what property is to be segregated for taxation solely by the Commonwealth (this is the old state "capital" or CNOT tax). Therefore, this is not an exemption but rather a limitation on the City’s authority to tax, and the standard of strict constitution is applied against the City and not the taxpayer. See Commonwealth v. General Electric Co., 236 Va. 54, 64, 372 S.E.2d 559, 605 (1988).

(c) Definition of "Manufacturing." The City claimed that American Woodmark’s business in the City is not part of a manufacturing business, but rather American Woodmark is engaged in four different businesses -- manufacturing, assembling, distribution, and sales.

(i) The Test. Manufacturing is an activity which "[transforms] the new material into an article or a product of substantially different character." Solite Corp. v. King George County, 220 Va. 661, 663, 261 S.E.2d 535, 536. See also County of Chesterfield v. BBC Brown Boveri, Inc., 238 Va. 64, 69, 380 S.E.2d 890, 893 (1989).

(ii) The Ancillary Rule. The term manufacturing is to be construed liberally because "the public policy of Virginia is to encourage manufacturing in the Commonwealth," and "when a party is engaged in both manufacturing and non-manufacturing activities, it will in nonetheless be classified as a manufacturer for tax purposes if the manufacturing portion of its business is substantial." County of Chesterfield v. Brown Boveri, supra at 69 and 65. The Commissioner of Revenue may not vivisect a Virginia business into its component activities in order to maximize taxes. See City of Norfolk v. Griffin Brothers, 120 Va. 524, 91 S.E. 640 (1917). American Woodmark is engaged in the integrated manufacturing business, because it transforms raw materials into cabinets, which is an article of "substantially different character" from the original raw wood and other materials.

(d) Equipment At Corporate Headquarters is Still "Used in Manufacturing." The fact that American Woodmark does not engage in any production activities at its headquarters facility in the City of Winchester does not alter American Woodmark’s status as a manufacturing business. The corporate headquarters facility is clearly part of that manufacturing business.

(e) Such Equipment Is Not Taxable As "Machinery and Tools." Computers and office equipment in a corporate headquarters of a manufacturing business are machines, but they belong to the broad class of "personal property, tangible in fact, used in a manufacturing business" and are therefore capital, they are not "machinery and tools" subject to local taxation. While a computer in a plant could be an integral part of manufacturing machinery, being part of "an assemblage of machines," that is not the type of computer at issue in this case. See Tultex v. City of Martinsville, 238 Va. 59, 338 S.E.2d 6 (1989).
B. **Local Business License Tax**


   (a) **Electricity Production is Manufacturing and Electricity is a "Good".** Court held that generation of electricity by privately owned cogeneration plants for sale to Virginia Power constituted the "manufacture and sale of goods, wares, and merchandise at wholesale at the place of manufacture." Thus the revenue the plants received from Virginia Power, including capacity payments not directly tied to the actual production of power, were not taxable under the local license tax. Va. Code § 58.1-3703(B)(4).

C. **Sales Tax**


D. **State Income Tax**


II. **1994 TAX LEGISLATION.**

A. **Major Business Facility Job Tax Credit - New**

House Bill 1407 (Chapter 768) and Senate Bill 606 (Chapter 750) allow individuals, estates, trusts, corporations, banks, insurance companies and public service corporations engaging in qualifying industries a Virginia tax credit if the taxpayer creates over 100 new full-time jobs in Virginia. The bills also allow a tax credit to businesses engaged in any industry if the taxpayer establishes a qualifying administrative facility in Virginia and creates over 100 new full-time jobs. If a taxpayer is located in an enterprise zone, or in an economically distressed city or county, the threshold at which a company earns a credit is reduced from 100 new jobs to 50. An area will be designated as "economically distressed" by the Department of Economic Development if it is a city or county with an unemployment rate for the preceding year of at least .5% higher than the previous year’s average statewide unemployment rate.

The credit is equal to $1,000 per each qualifying new job in excess of the 100 job threshold, and allowed ratably in thirds over a three year period. The credit only applies to facilities where an announcement to expand or establish such a facility was made on or after January 1, 1994.
Qualifying industries include: (i) manufacturing or mining; (ii) agriculture, forestry or fishing; (iii) transportation or communications; or (iv) a public utility subject to the corporation income tax. In addition, an administrative facility engaged in the following activities may satisfy the requirements for the credit (i) central administrative offices and warehouses; (ii) research, development and testing laboratories; (iii) computer programming, data processing and other computer related services facilities; and (iv) financial, insurance and real estate services.

The credit is limited to the amount of tax paid by the company. The credit is not refundable, but unused credits may be carried forward to the five succeeding taxable years; no carrybacks are permitted. The bills also contain a recapture provision that ensures that the credit will not be available unless the positions are of a permanent, long-term nature. The credit will be reduced proportionately if employment decreases during the five years following the initial credit year. However, if employment falls below the 100 employee threshold (50 for enterprise zones or economically distressed areas) during the five years following the credit year, all of the credit will be recaptured. Additionally, the bills limit job churning -- transfers of job functions and/or employees between related parties.

Effective Date: Taxable years beginning on or after January 1, 1995, but before January 1, 2005

Code Section Added: § 58.1-439

B. Out-of-State Tax Credit for Taxes Paid on Sale of Principal Residence

House Bill 335 (Chapter 195) expands the current out-of-state tax credit to allow Virginia residents to claim a credit for income taxes paid to another state on the sale of a principal residence. Currently, the credit is limited to taxes paid to another state on earned or business income subject to taxation in another state.

Presently, an individual who has moved into Virginia and sells a principal residence located in another state potentially could be taxed on the gain by Virginia and the state in which the home is located. The existing out-of-state credit would not be applicable as the gain on the sale of the home represents neither earned nor business income.

This bill would allow a credit for income taxes paid to another state on the sale of a former home only to the extent that any portion of the gain is included in federal adjusted gross income and subject to taxation in Virginia.

Effective Date: Taxable years beginning on and after January 1, 1994

Code Section Amended: § 58.1-332

C. Taxation of Remainder Interests
House Bill 700 (Chapter 208) clarifies that remainder interests coupled with a general power of appointment will not be subject to the inheritance tax if they are included in the federal taxable estate of the life tenant. The bill stipulates that it is declarative of existing law.

The bill addresses a perceived double tax upon the death of a person who was the beneficiary of a certain kind of trust. When the inheritance tax was repealed effective for decedents dying on and after January 1, 1980, the old law continued in effect until all of the postponed inheritance taxes on remainder interest had been collected. Thus, two tax liabilities may have been triggered by the death of a beneficiary: an estate tax on the beneficiary estate and the postponed inheritance tax on remainder interest. In most cases, the remainder interest would not be subject to both. However, certain kinds of trusts are required to be included in the federal taxable estate, which would subject it to both tax liabilities.

This bill makes it clear that no additional inheritance taxes are to be collected if the remainder interest under consideration has been taxed previously as follows: (i) the estate of the original decedent paid a "pick-up" tax (equal to the federal estate tax credit) on the estate which included such remainder interest in its valuation or (ii) a pick-up tax has been paid on an estate which included the remainder interest in its valuation, even though the estate tax return covers a different decedent.

**Effective Date:** Declarative of existing law

**Amended:** Second enactment clause of Chapter 838 of the Acts of Assembly of 1978.

D. **BPOL Tax Guidelines**

House Bill 505 (Chapter 267) requires TAX to update its guidelines for the local Business, Professional and Occupational License (BPOL) Tax by July 1, 1995, and every three years thereafter. It is anticipated that the updated guidelines will reflect recent court decisions, opinions of the Attorney General and Tax Commissioner, and the development of new types of businesses. The bill results from the joint subcommittee studying the BPOL tax pursuant to 1993 HJR 526.

**Effective Date:** July 1, 1994

**Code Section Amended:** § 58.1-3701

E. **BPOL Tax - Definition of Gross Receipts**
House Bill 1087 (Chapter 397) creates a "pass-through" provision for determining gross receipts for BPOL tax purposes on receipts from real estate sales transactions.

Commissions received by real estate brokers and agents are considered gross receipts for BPOL tax purposes. Under current law, the broker is subject to the BPOL tax on the entire commission realized on the sale, while the agent is subject to the tax on that portion of the commission received from the broker.

This bill creates an exception to the BPOL tax by allowing the broker to deduct commissions paid to agents in determining gross receipts, provided the agent is subject to the BPOL tax and is identified as receiving excluded receipts by the broker on its BPOL application.

**Effective Date:** July 1, 1994

**Code Section Added:** § 58.1-3732.2

F. **Situs of Motor Vehicle by Student Attending College**

House Bill 772 (Chapter 961) and House Bill 818 (Chapter 962) provide that when the owner of a motor vehicle is a student attending an institution of higher education, the situs for assessment of tangible personal property will be the domicile of the vehicle’s owner.

Currently, taxable situs is established where a vehicle is normally garaged or parked for a tax year. When this cannot be determined, the domicile of the owner is used as the taxable situs. This bill provides that even if situs can be established, taxable situs will be the domicile in every case in which the owner is a student attending and institution of higher education.

House Bill 818 also addresses the local licensing of student-owned vehicles in a similar manner and provides that situs for purposes of license fees shall be the domicile of the student.

**Effective Date:** July 1, 1994

**Code Section Amended:** §§ 46.2-752 and 58.1-3511

G. **Condition of Tangible Personal Property to Include Technological Obsolescence**

Senate Bill 111 (Chapter 827) emphasizes accounting for "technological obsolescence" when determining the condition of tangible personal property for tax assessment purposes.
Current law allows a commissioner of the revenue to take into account the condition of the property when valuing tangible personal property. Condition of the property from an appraisal standpoint includes depreciation from all causes, including functional and economic obsolescence and physical deterioration. This legislation requires that a commissioner of the revenue consider the condition of the property, which shall include technological obsolescence, upon request.

The legislation may be seen as codifying the recent decision of the Virginia Supreme Court in Board of Supervisors of Fairfax County v. Telecommunications Industries, Inc., 246 Va. 472 (11/5/93), in which the Court rejected the argument that application of a depreciation schedule was uniform and could be reasonably expected to determine actual fair market value in all cases. While the county's depreciation method may approximate fair market value, the Court noted the definition of fair market value as the "price property will bring when offered for sale by a seller who desires but is not obligated to sell and bought by a buyer under no necessity of purchasing." The Court held that the technological obsolescence of tangible personal property may affect its fair market value and must be considered by the tax assessor and the courts under the appropriate circumstances, if necessary to make a determination of fair market value.

Effective Date: July 1, 1994

Code Section Amended: § 58.1-3503

H. Exemption for Certain Rehabilitated or Industrial Real Estate

Senate Bill 233 (Chapter 608) reduces the age requirement for real estate tax relief to be granted to rehabilitated real estate from 25 to 15 years for commercial or industrial property located in an enterprise zone. It also clarifies that replacement property may also be granted a partial exemption. However, the replacement structure may not exceed the square footage of the previous structure, except in an enterprise zone where it may not exceed 110% of the previous square footage.

Effective Date: July 1, 1994

Code Section Amended: § 58.1-3221

I. Exemption for Rehabilitated Residential, Hotel/Motel, Commercial & Industrial Property

House Bill 879 (Chapter 424) and Senate Bill 369 (Chapter 435) expand the definition of residential, hotel/motel, commercial and industrial structures eligible for reduced real estate tax rates for "substantially rehabilitated" property. Any structure or other improvement which has undergone substantial rehabilitation, renovation or replacement is
eligible for the reduced rate. The bill also increases the $20 cap on fees that localities may charge for processing applications requesting a partial exemption for residential, commercial and industrial structures to $50. Similar fees for hotel/motel structures are not capped.

Additionally, House Bill 879 provides that the partial exemption will not apply to commercial or industrial real estate where rehabilitation is achieved through the demolition or replacement of a structure that is a registered Virginia landmark or is determined by the Department of Historic Resources to contribute to the significance of a registered historic district.

**Effective Date:** July 1, 1994

**Code Sections Amended:** §§ 58.1-3220.1 and 58.1-3221
J. Cellular Phone and Other Mobile Services

House Bill 756 (Chapter 560) authorizes localities to extend the consumer utility tax collection responsibility to all providers of cellular phone and other mobile telecommunication services. A maximum tax of 10% of the service charge, up to $3 per month, for each mobile service consumer would be established.

Under current law, localities are permitted to levy a consumer utility tax on the consumers or services provided by telegraph and telephone companies or other companies that qualify as public service corporations. The utility is required to collect the tax from the consumer and remit it to the locality. However, localities are restricted to imposing the tax on services provided by federally licensed, state regulated providers of telecommunications.

This bill would extend the levy to all telecommunication service providers, mobile or otherwise. The bill also makes the following changes to the consumer utility tax:

- If a locality is not currently collecting the tax on local mobile telecommunications service, it may not begin to collect the tax until September 1, 1994.
- The three localities presently collecting the tax (Charlottesville, Lynchburg and Albemarle County) are grandfathered in and will be allowed to phase their rates downward over a 3-year period to meet the 10%, $3 per month rate cap.
- Taxes will be deemed held in trust by the service provider for the locality.
- Service providers would remit monthly to the appropriate locality the amount of tax billed during the preceding month. Providers will not be held liable for amounts attributable to bad debts and consumers that refuse to remit the tax.
- Double taxation is prevented by allowing a refund to consumers for a legally imposed tax paid to a jurisdiction outside Virginia.

Effective Date: July 1, 1994; however, localities not currently taxing mobile telephone service may not begin to collect the tax before September 1, 1994

Code Section Amended: § 58.1-3812
K. Tax Amnesty - City of Richmond

House Bill 1342 (Chapter 302) authorizes the City of Richmond to establish a local tax amnesty program to increase and accelerate collection of taxes.

The amnesty program would be conducted such that:

- Individuals, corporations, estates or partnerships would be eligible to participate.
- Taxes eligible for amnesty would include personal property, machinery and tools, and real property.
- Civil penalties on current accounts receivables and previously unknown amounts would be waived provided that the tax and interest are paid in full.
- Parties who are presently or at the date of the inception of the program under investigation or prosecution for fraud or evasion could not participate in the program.
- Taxpayers with assessments dated or taxes due on or after January 1, 1993, would not be eligible for amnesty.

Effective Date: Amnesty program would run during the city’s 1994-1995 fiscal year

Added: New act

III. 1994 RULINGS BY THE DEPARTMENT OF TAXATION

A. Income Tax: Allied-Signal Rulings.


Facts. Taxpayer is a large manufacturer with a non-Virginia corporate domicile. Taxpayer contests apportionment of various items of passive income for Virginia corporate income tax purposes.

Issue 1: Whether income earned on short-term investment of idle cash may be allocable to Taxpayer’s out-of-state commercial domicile as a non-operational passive investment.

Holding 1: Income from investment of idle cash is allocable to Virginia as income from an operational account where Taxpayer failed to present evidence relating to its operational cashflow needs or establishing that the cash fund was not necessary to the operational retirement of long-term debt service.
Issue 2: Whether income received on the sale of Taxpayer's interest in a foreign subsidiary to an unrelated party constitutes non-operational income from a passive investment.

Holding 2: The interest income arising from the installment sale obligation constituted income arising from the sale of a non-unitary asset unrelated to the operational activities of the Taxpayer because the Taxpayer exercised no control over the subsidiary, shared no services, assets, or facilities with the subsidiary, and engaged in no transactions with the subsidiary on other than an arm’s-length basis.

Issue 3: Whether interest derived from various notes receivable from unrelated third parties should be allocable to Virginia.

Holding 3: Such income is allocable to Virginia because Taxpayer failed to provide evidence indicating that the income arose from a non-unitary relationship or that the income did not arise from an operational rather than a passive investment function.

Issue 4: Whether gain on the sale of preferred stock in an unrelated, publicly-traded corporation should be allocated to the state of Taxpayer's commercial domicile as income from an investment unconnected with operational activities in Virginia.

Holding 4: Because Taxpayer acted only as a preferred stockholder having no managerial control over the corporation, Taxpayer’s investment constitutes a discrete investment function having no connection with the operational activities of the Taxpayer carried on in Virginia. Therefore, the gain on the sale of the Taxpayer’s interest is not allocable to Virginia.

Issue 5: Whether gain on the sale of third-party leases may be allocable to Taxpayer’s state of commercial domicile as a discrete investment function not connected with operational activities carried on in Virginia.

Holding 5: The sale of third-party leases constituted a non-operational, investment function because the real estate subject to the leases was physically separated from Taxpayer’s offices, and, due to market conditions, Taxpayer was able to realize a substantial gain from the sale of the leases.

Issue 6: Whether royalties received by Taxpayer for the right to extract minerals and oil from Taxpayer’s property constitute income from a discrete, non-operational business investment subject to allocation to the states in which such real property is located.

Holding 6: Taxpayer’s real estate holdings are utilized for the purpose of extraction of natural resources used in its manufacturing operations. Because the holdings relate to
Taxpayer’s unitary business operations, the royalties paid to Taxpayer are allocable to Virginia for income tax purposes.


**Facts.** Taxpayer received rental income from third parties relating to property located outside Virginia. Taxpayer also received interest income from banks located in its out-of-state commercial domicile, which income is allocated to its state of commercial domicile for purposes of that state’s corporate income tax.

**Issue:** Whether rental income received in connection with out-of-state real property and interest income received from out-of-state banking institutions may be allocated to Virginia for Virginia corporate income tax purposes.

**Holding:** The rental and interest income arose from the utilization of land holdings and cash constituting operational assets and is, therefore, allocable to Virginia for corporate income tax purposes. The fact that the interest income may also be allocable to another state does not bar Virginia from taxing such income provided its method of allocation and apportionment is rationally related to business transacted within the state.


**Facts.** Taxpayer, a large multi-national corporation headquartered outside Virginia acquired a minority interest in a company engaged in a non-related industry ("Company A"). No connection existed between Company A and Taxpayer other than Taxpayer’s minority representation on Company A’s board of directors and an immaterial amount of intra-company sales.

**Issue:** Whether the gain from the sale of Taxpayer’s interest in Company A arose from a unitary relationship between the parties or an investment connected to Taxpayer’s operational activities.

**Holding:** No unitary relationship existed between Taxpayer and Company A because there was no integration or centralization of management between the parties, no economies of scale were achieved, and, thus, there was no flow of goods or values between the parties. Taxpayer’s investment in Company A was not of an operational nature because Company A’s business did not complement Taxpayer’s operational activities, no integration of the businesses occurred, the management of the companies remained separate and no business transactions occurred between the parties.

Facts. Taxpayer, a large manufacturer with a non-Virginia corporate domicile, contests Virginia's taxation of various items of passive income. The Taxpayer contends that such income is allocable to its state of commercial domicile.

Issue 1: Whether interest income received on the installment sale of Taxpayer's interest in a non-U.S. subsidiary may be allocable to Virginia as income arising from the sale of a unitary asset related to the operational activities of the Taxpayer.

Holding 1: Taxpayer’s interest in the subsidiary constituted a passive investment because Taxpayer exercised no control and shared no services, facilities or relationships with the subsidiary during Taxpayer’s period of ownership. Taxpayer derived no special or unique benefit from any intra-company transactions. Therefore, income arising from the sale of Taxpayer's interest constituted income from a non-unitary asset unrelated to the operational activities of the Taxpayer. Such income was allocable to the Taxpayer’s state of commercial domicile.

Issue 2: Whether gain on the sale of stock in an unrelated company ("Company B") pursuant to a stock repurchase agreement constituted income arising from a non-operational investment.

Holding 2: Taxpayer’s investment in Company B constituted a discrete investment function unconnected with its operational activities carried on in Virginia because Taxpayer lacked control of Company B and shared no services, facilities, or relationships with Company. All intra-company transactions were on an arm's-length basis. Therefore, the gain recognized on the sale of Taxpayer’s interest may be allocated to Taxpayer’s state of commercial domicile.

Issue 3: Whether royalties received from third parties for the right to extract minerals and oil from Taxpayer’s property should be allocated to the states in which such real property is located as income unrelated to the Taxpayer’s operations carried on in Virginia.

Holding 3: Taxpayer’s land holdings are used in connection with its unitary business operations in that Taxpayer extracts natural resources for use in manufacturing its products. Because the royalty income arises from an operational function, the income is allocable to Virginia regardless of the fact that it is paid by unrelated third parties.

Issue 4: Whether income arising from the rental of timberland and the permitting of hunting, fishing and geophysical exploration rights arises from Taxpayer’s operational activities.

Holding 4: Taxpayer failed to demonstrate that such incidental business income arising from timberland acquired, managed and used in its trade or business is not related to
its operational activities. Therefore, Taxpayer failed to establish that such income should not be allocable to Virginia.

**Issue 5:** Whether imputed interest income from the sale of a foreign corporation in which Taxpayer held a 51% interest arose from a passive, non-operational investment.

**Holding 5:** Taxpayer failed to provide evidence indicating that the income arose in the absence of a unitary relationship or that the income was not operational in nature. Therefore, the income would be allocable to Virginia for corporate income tax purposes.


**Facts.** Taxpayer acquired a 49% interest in a foreign corporation ("Company A"). Although Taxpayer was represented on Company A’s board of directors, Taxpayer could exercise no unilateral control over the management of Company A. Company A’s operations were controlled by the majority shareholder, an unrelated party. Taxpayer clashed with the majority shareholder over its failure to maximize dividends paid by Company A. Taxpayer shared no services, facilities, or relationships with Company A. Transactions between Taxpayer and Company A were minimal and were conducted on an arm’s length basis.

**Issue:** Whether the gain on Taxpayer’s sale of its interest in Company A arose from a unitary relationship between Taxpayer and Company A or an investment connected with the Taxpayer’s operational activities.

**Holding:** No unitary relationship existed between the parties because there was no functional integration, centralization of management, or economies of scale achieved, and, thus, there was no flow of goods or values between the parties. Taxpayer’s interest in Company A constituted a passive investment not of an operational nature because Company A’s business did not complement Taxpayer’s operational activities, the businesses were never integrated, no economies were achieved, and there was no attempt to take advantage of the fact of common ownership. Therefore, the gain on the sale of Taxpayer’s interest in Company A is not included in Taxpayer’s Virginia apportionable income.


**Facts.** Taxpayer acquired common stock and warrants to acquire additional common stock in an unrelated, publicly-traded company ("Company A"). The common stock owned (or purchasable) by Taxpayer represented approximately 11% of the total outstanding stock of Company A. The acquisition was subject to Taxpayer’s agreement to hold the stock and warrants solely for investment. Other than its minority interest in Company A, Taxpayer had no relationship with the Company. Taxpayer’s interest was eventually sold on the open market.
In 1985, the Taxpayer transferred three major lines of business from one of its divisions to a newly-created company in exchange for an interest in the company ("Company B"). After the transfer, a significant amount of operational connections existed between Taxpayer and Company B relating to employment and benefit plans. Taxpayer and Company B also entered into a mandatory supply and distribution agreement and an agreement providing for general and administrative services to be performed by Taxpayer on behalf of Company B.

**Issue:** Whether Taxpayer's interest in the common stock and warrants of Company A constituted a discrete investment function unconnected with its operational activities and whether Taxpayer's interest in Company B constituted a passive investment.

**Holding:** Taxpayer's interest in Company A constituted a discrete investment function not related to Taxpayer's operational activities carried on in Virginia because Taxpayer maintained no relationship to Company A other than that of a minority shareholder. Therefore, its gain on the sale of stock and warrants in Company A was allocable to the state of Taxpayer's commercial domicile.

However, Taxpayer's interest in Company B did not constitute a passive investment function. Taxpayer transferred integral parts of its business to Company B and failed to demonstrate that the unitary relationship with the assets transferred changed significantly after the transfer. A significant operational connection also existed after the transfer in that Taxpayer maintained a significant ownership interest in Company B, was required by contract to utilize Company B as a market for its products, and provided significant administrative services, managerial support and personnel to Company B. Therefore, the gain on the sale of Taxpayer's interest in Company B was allocable to Virginia for income tax purposes.


**Facts.** Taxpayer is a multi-national manufacturer headquartered outside of Virginia. Taxpayer formed a banking company to operate outside Virginia. Given state and federal banking regulations, Taxpayer exercised no control over the bank and did not engage in business with the bank other than *de minimis* transactions. In 1982, Taxpayer sold 100% of the stock of the banking company and allocated the gain from the sale to its state of commercial domicile.

**Issue:** Whether the income from the sale of the banking company arose from a unitary relationship between Taxpayer and the banking company or investment connected to Taxpayer's operational activities.

**Holding:** No unitary relationship existed between Taxpayer and the banking company because there was no flow of goods or values between the parties. Taxpayer’s interest in the
A banking company constituted a passive investment not of an operational nature because the banking company's business did not complement Taxpayer's operational activities, no integration of the businesses occurred, no economies were achieved, the management of the companies remained separate, and there was no attempt to take advantage of the fact of common ownership. Therefore, the gain recognized on the sale of the banking company was properly allocable to Taxpayer's state of commercial domicile.


**Facts.** Taxpayer acquired a majority interest in a corporation located in a foreign country ("Company A"). Taxpayer did not integrate the business of Company A into its other operations within the foreign country. Taxpayer’s interaction with Company A consisted primarily of non-binding oversight of its officers and directors. Taxpayer held 4 of the 13 seats on Company A’s board of directors and maintained no common managers, directors or personnel with Company A. There were no common administrative relationships between the companies, and there was no instance where Taxpayer controlled the management of Company A without the approval of Company A’s board of directors. There was no sharing of services or products between the companies and there were no transactions between them. Taxpayer sold its investment in Company A based on the appreciation of the currency and real estate of the country in which the Company was located.

**Issue:** Whether the income from the sale of Taxpayer’s interest in Company A arose from a unitary relationship between Taxpayer and Company A or an investment connected to Taxpayer’s operational activities.

**Holding:** No unitary relationship existed between Taxpayer and Company A because there was no indication of a flow of goods or values between the parties. The investment was not of an operational nature because Company A did not complement Taxpayer’s operational activities, no economies were achieved, no integration of the businesses ever occurred, the companies were physically separated at all times, there was no attempt to take advantage of the fact of common ownership and no material business transactions occurred between the companies.


**Facts.** Taxpayer owned a 50% interest in the stock of a foreign corporation (Company B) which owned a minority interest in another foreign corporation (Company A). To comply with EEC antitrust regulations, Taxpayer restructured its holdings, resulting in its acquisition of the 29% interest in Company A’s stock. Taxpayer had no representation on Company A’s board of directors and had no shared administrative, managerial, or business relationships with Company A. In 1989, Taxpayer sold its interest in Company A and allocated the gain on the sale to its state of commercial domicile.
Issue: Whether the income on the sale of Taxpayer's interest in Company A arose from a unitary relationship between Taxpayer and Company A or from an investment connected to Taxpayer's operational activities.

Holding: No unitary relationship existed between Taxpayer and Company A because there was no indication of a flow of goods or values between the parties. Taxpayer's interest in Company A was a passive investment not of an operational nature because Company A was not used to complement Taxpayer's operational activities, no economies were achieved, the businesses were never integrated, and the management of the parties was at all times separate and distinct.


Facts. Taxpayer is a large publicly-held corporation principally engaged in retail sales. After the sale of stock in a public offering, Taxpayer used the proceeds for capital expansion, payment of known cash commitments, and shareholder distributions, and placed the remaining proceeds in a segregated investment account. The segregated funds were managed by the assistant treasurer of Taxpayer under guidelines set by the board of directors. The funds were invested in stock and commercial paper issued by unrelated parties. The investment fund remained separate from Taxpayer's operational funds and Taxpayer had sufficient cash flow to support its operational activities without utilization of the investment fund.

Issue: Whether the income from the investment fund arose from a unitary relationship between Taxpayer and the payors of the investment fund income or whether the investment related to Taxpayer's operational activities.

Holding: No unitary relationship existed between Taxpayer and any payor of income on the assets held in the investment fund. The investment fund was not related to Taxpayer's operational activities because the investment activity did not complement Taxpayer's operational activities and the management of the fund was separate and distinct from the general management of Taxpayer and functioned under the direct authority of the board of directors. The investments were financed directly by the issuance of common stock and the funds were maintained in a segregated account separate from other working capital balances, and Taxpayer did not rely on these funds in its operations. Therefore, the income earned on the investment fund was not allocable to Virginia for income tax purposes.


Facts. Taxpayer owned 100% of the stock of Company X, which, in turn, owned approximately 5% of the stock of Company A, a foreign corporation. Taxpayer merged Company X and a subsidiary together and, in 1987, Taxpayer sold the stock of Company A
to an unrelated third party. The gain from the sale of Company A was allocated to Taxpayer’s state of commercial domicile.

**Issue:** Whether the income from the sale of Company A arose from a unitary relationship between Taxpayer and Company A or an investment connected to Taxpayer’s operational activities.

**Holding:** No unitary relationship existed between Taxpayer and Company A because there was no flow of goods or flow of values between the parties. Taxpayer’s interest in Company A was a passive investment not operational in nature because Company A was not used to complement Taxpayer’s operational activities, no integration of the businesses occurred, no economies were achieved, there was no attempt to take advantage of common ownership, and no business transactions occurred between the parties.


**Facts.** Taxpayer realized capital gains from numerous short-term investments of its idle funds in marketable securities. Taxpayer maintained significant trade receivables and cash investments and had significant amounts of long-term debt.

**Issue:** Whether the capital gains realized on the sale of Taxpayer’s investments may be allocated to Taxpayer’s state of commercial domicile as income from a passive investment not connected to Taxpayer’s operational activities.

**Holding:** Taxpayer failed to demonstrate how much of its cash and marketable securities was necessary for its operational cashflow needs. The presence of long-term debt suggests the need to reserve substantial working capital balances. Taxpayer failed to demonstrate by clear and cogent evidence that its investments were other than short-term positions taken to maximize return on working capital balances. Therefore, it could not be determined how much, if any, of Taxpayer’s investment could be characterized as a passive investment, and all income earned thereon was allocable to Virginia for corporate income tax purposes.


**Facts.** Taxpayer received interest income from the investment of excess working capital and also recognized gains on foreign currency transactions outside its regular business activities. Taxpayer allocated the income from such sources to its state of commercial domicile.

**Issue:** Whether Taxpayer’s working capital and investments are operational assets involved in a unitary business.
Holding: Taxpayer’s interest income and currency gain arose from an operational function in that the utilization of cash and transfers of currency generated through normal operations generally constitute operational assets. The fact that the income is also allocable to another state for tax purposes does not bar Virginia from apportioning and taxing the same income provided the method of allocation and apportionment is rationally related to the business transacted within the state.


Facts. In an IRC § 351 transaction, Taxpayer transferred one of its lines of business to a newly-created corporation (Company A) in exchange for 50% of Company A’s common stock. The balance of Company A’s stock was issued to an unrelated party, Company B. Pursuant to a joint venture agreement with Company B, significant connections between Taxpayer and Company A remained after the 1985 transaction. Company A retained employees of the Taxpayer and established administrative links between the parties. Company A’s products were available to Company B and the Taxpayer at preferential prices. Also, Taxpayer continued to conduct certain foreign operations on behalf of Company A after the transfer. Agreements between Taxpayer and Company A provided for purchase and resale of products and supplies between the parties. Taxpayer also agreed to provide general and administrative services and granted a non-exclusive, royalty-free license to Company A for the use of certain trademarks and technology. The transferability of Company A’s stock was restricted pursuant to a shareholder’s agreement. Taxpayer was entitled to preferential dividends from Company A.

**Issue:** Whether the income from the sale of Taxpayer’s interest in Company A arose from a unitary relationship between Taxpayer and Company A or from an investment connected with Taxpayer’s operational activities.

Holding: Taxpayer failed to overcome presumption that its unitary relationship with the assets transferred to Company A significantly changed after the transfer. The unitary nature of the relationship remained intact after the transfer because Taxpayer maintained a significant ownership interest in Company A with preferential dividend treatment and without the free transferability of its ownership interest normally enjoyed by an independent investor. Taxpayer and Company A established contracts for purchases and sales of products between them and maintained significant administrative links after the transfer. Significant operational connections existed after the transfer as evidenced by the creation of a joint venture between Taxpayer and Company B in the operation of Company A. The use of Taxpayer’s name in Company A’s name implies intent to create and foster name-brand recognition. The royalty-free license to use valuable intangibles also suggests the investment was a joint venture for profit as opposed to a passive investment. The existence of purchase and put options relating to Taxpayer’s interest suggests that Taxpayer’s intent was to dispose of part of its unitary business as opposed to the creation of a passive investment. Also, there was a clear flow of values between the companies in the form of shared assets, technology,
trade names and trademarks and significant business activities between them. The fact that the transfer occurred in an IRC § 351 transaction supports apportionment because, had the assets been sold in a taxable transaction, the gain would clearly have been apportionable.


**Facts.** Taxpayer contends that interest income and capital gain income should be allocated to its state of commercial domicile for Virginia corporate income tax purposes. Taxpayer also seeks to carryback a net operating loss from the 1991 taxable year to 1988.

**Issue:** Whether Taxpayer's interest income and capital gain income is allocable to Virginia for corporate income tax purposes and whether a net operating loss carryback is available to offset Virginia taxable income.

**Holding:** There is no express authority in the Code of Virginia for a Virginia net operating loss. Therefore, neither the adjustments required in determining Virginia taxable income nor allocable income may be used to create a Virginia net operating loss. The amount of income which Taxpayer may allocate out to Virginia is, therefore, limited to the sum of its federal taxable income and the adjustments required by Va. Code § 58.1-402. Because there is no provision for a Virginia net operating loss, Taxpayer's allocable income from the 1988 taxable year cannot be utilized to reduce Virginia taxable income in any other taxable year.


**Facts.** Taxpayer is a large multi-national corporation engaged in the retail sale of merchandise. Because of the size of Taxpayer's operations, Taxpayer represents a significant retail market and is an extremely important customer to its suppliers. Taxpayer purchased stock in its suppliers, usually ranging from 20% to 57% interests.

**Issue:** Whether the income from the sale of Taxpayer's interests in the suppliers arose from a unitary relationship between Taxpayer and the suppliers or from activities related to Taxpayer's operational activities.

**Holding:** Taxpayer presented insufficient information from which to determine the presence or absence of a unitary relationship between Taxpayer and the suppliers. However, the gain from the sale of the stock was apportionable to Virginia because of the strong operational relationships between Taxpayer and the suppliers. Although Taxpayer did not necessarily hold a controlling interest in each of the suppliers, it was able to exert significant influence by virtue of its importance as a customer of the suppliers' products. Taxpayer's ability to exercise control over its source of inventory also enhances Taxpayer's own earning potential from operational retail activities. Because there were operational reasons for making the investments, the relationship between Taxpayer and the suppliers was not found
to be that of a passive investor relying on the management of the suppliers for earnings, growth and enhanced value.


**Facts.** Taxpayer is a large manufacturer and retailer of commodities. In 1971, Taxpayer acquired a corporation engaged in retail sales of consumer specialty goods ("Company A"). Company A was engaged in a different industry from Taxpayer and neither sold products to Taxpayer nor purchased products from Taxpayer. In 1988, Taxpayer sold 100% of the stock of Company A and allocated the gain on the sale to its state of commercial domicile.

**Issue:** Whether the income earned on the sale of Taxpayer's interest in Company A arose from a unitary relationship with Company A or from an investment connected to Taxpayer's operational activities.

**Holding.** No unitary relationship existed between Taxpayer and Company A because there was no flow of goods or values between the parties. Taxpayer's interest in Company A constituted a non-operational passive investment because the business did not complement the Taxpayer's operational activities, no integration of the businesses occurred, no economies were achieved, the companies were engaged in unrelated industries, the companies had separate management, no attempt was made to take advantage of the fact of common ownership, and no material business transactions occurred between the parties.


**Facts.** Taxpayer is a member of a large affiliated group engaged primarily in the exploration, development and management of natural resources. The businesses of members of the group are highly complementary, resulting in a sharing of expertise and experience. Taxpayer made loans to related parties owned by various members of the group. The loans were made to those members of the group in need of funds, consistent with the group's pattern of moving capital between members on an as-needed basis. Taxpayer classified the interest income received under the loans as non-business income.

Taxpayer realized a capital gain stemming from a judicial award on a governmental taking of the right to extract minerals on Taxpayer's property. Taxpayer, as a member of the group, engages in mineral exploration both within and outside Virginia.

**Issue:** Whether the interest income received by Taxpayer from the repayment of loans to members of its affiliated group arose from a non-operational, passive investment and whether the capital gain from the governmental taking of mineral rights on Taxpayer's property arose from the taking of a non-operational asset.
**Holding.** The interest income received by Taxpayer from the repayment of loans made to members of its affiliated group is apportionable to Virginia for corporate income tax purposes because the loans were made between members of a unitary group of corporations. The benefits and services flowing between members of the group and the similarity of the group's overall undertakings indicate that the group is a unitary operation operating on a global basis. Moreover, the loans were made based on the operational needs of the group as a whole.

The capital gain arising from the governmental taking of mineral rights on Taxpayer's property relates to an operational function of Taxpayer. Taxpayer, as a member of the affiliated group, is engaged in mineral exploration and extraction. Taxpayer exploits its land holdings for their natural resources to be used in its manufacturing business. Therefore, the foregone mineral rights relate to Taxpayer's unitary business operations, and the capital gain stemming from the taking of such rights is apportionable to Virginia for corporate income tax purposes.

**B. Income Tax: Delaware Holding Companies**


   **Facts.** Taxpayer transferred patents and trademarks to a newly-formed subsidiary ("S") in exchange for 100% of the stock of "S". After the transfer, Taxpayer entered into a license agreement providing for the payment of royalties to "S". "S"s only activities consisted of the maintenance and management of the intangible assets transferred from Taxpayer. "S" entered into no transactions with any parties other than Taxpayer, and "S" employees rendered only _de minimis_ services to "S".

   **Issue:** Whether "S" lacked substantial economic substance such that the taxable income of "S" should be consolidated with that of Taxpayer for Virginia corporate income tax purposes.

   **Holding:** The transactions between Taxpayer and "S" were not at arm's-length because Taxpayer, as 100% owner of "S", at all times had control of "S" and its assets. "S" lacked economic substance because "S" engaged only in intra-company transactions and was formed for no practical purpose other than tax planning. Because the royalty arrangement resulted in a transfer of income from Taxpayer to "S" which inaccurately reflected Taxpayer's income earned from its business done in Virginia, the income earned by "S" from the royalty payments must be consolidated with Taxpayer's other taxable income for Virginia corporate income tax purposes.

Facts. Taxpayer paid royalties to a subsidiary ("S") for the license of technology vital to the production of product by Taxpayer. "S" engaged in the business of acquiring and developing technology for license to others and maintained an office employing full and part-time employees. "S" engaged Taxpayer to research and develop new technology and paid Taxpayer for such services. "S" also acquired technology and licensed technology to unrelated third parties.

Issue: Whether "S" lacks economic substance such that deductions claimed by Taxpayer for royalty payments to "S" should be disallowed for Virginia corporate income tax purposes.

Holding: "S" had a viable economic substance as evidenced by its employees, assets, and substantial business activity. The royalty payments reflected an arm's-length transaction in that they involved third parties and were approved by taxing authorities in other countries. The transactions between Taxpayer and "S" were of importance to Taxpayer's business, as evidenced by the licensing of the same technology to unrelated third parties on a regular and continuous basis by "S". In addition, the intangible assets licensed by "S" to Taxpayer were not used in Virginia. Therefore, the transactions between Taxpayer and "S" did not improperly reflect the income earned or the business done in Virginia, and deductions for the Taxpayer's royalty payments to "S" were allowed.


Facts. Taxpayer, a Virginia resident, owned stock in an S corporation subject to the District of Columbia franchise tax on its income. Taxpayer claimed a credit on his Virginia return for his pro rata share of the franchise taxes paid by the corporation. Taxpayer also sought to exclude his share of the corporation's income derived from the corporation's activities within the District of Columbia not paid to Taxpayer in the form of dividends.

Issue: Whether a credit from Virginia income tax is available for franchise taxes paid to another state and whether income of an S corporation earned outside Virginia and not paid as dividends is includable in the taxable income of a Virginia shareholder.

Holding: Va. Code § 58.1-332 specifically provides that a credit from Virginia income taxes is not allowed for franchise taxes paid to another state. Taxpayer's share of the S corporation's income was properly included in Virginia taxable income because Taxpayer's share of the S corporation's earnings are included in Taxpayer's federal adjusted gross income regardless of whether a dividend is paid to Taxpayer.

D. Income Tax: Wrigley Rulings.
1. **PD 94-219, July 13, 1994.**

**Facts.** Taxpayer operated a life insurance sales business headquartered outside Virginia. Taxpayer’s sales representatives travelled nationwide to meet with potential customers. Except for short meetings with potential customers, Taxpayer conducted no other business activities in Virginia.

**Issue:** Whether Taxpayer is subject to Virginia’s corporate income tax.

**Holding:** Taxpayer has income from Virginia sources attributable to a business, trade, profession or occupation carried on in Virginia and would, therefore, be subject to Virginia’s corporate income tax. However, under the Department’s interpretation of public Law 86-272, Taxpayer would not be subject to income tax where its only contacts with Virginia involved solicitation of orders for sales, including sales of intangible personal property. Because Taxpayer’s activities constituted solicitation or activities ancillary to solicitation or were de minimis in nature, Taxpayer would not be subject to the corporate income tax.

2. **PD 94-181, June 13, 1994.**

**Facts.** Taxpayer sells a service providing access to third-party computer databases. Taxpayer is located outside of Virginia, but proposes to engage a travelling sales force to solicit business in Virginia in the future.

**Issue:** Whether Taxpayer would be subject to Virginia corporate income tax.

**Holding:** Although Public Law 86-272 prohibits a state from imposing income tax where the only contacts with the state involve solicitation of orders for sales of tangible personal property, it does not extend to solicitation of orders for services of the type to be engaged in by Taxpayer. However, the Department also applies the "solicitation test" of PL 86-272 to solicitation of orders other than for tangible personal property. Thus, Taxpayer’s proposed activities would not be subject to tax to the extent they do not extend beyond solicitation or ancillary activities.

3. **PD 94-111, April 14, 1994.**

**Facts.** Taxpayer is an out-of-state corporation employing a salesman in Virginia to solicit sales of Taxpayer’s product. Taxpayer’s salesmen also provided limited repair services to customers and furnished display cases for marketing of merchandise.

**Issue:** Whether Taxpayer is exempt from imposition of Virginia corporate income tax under Public Law 86-272.
Holding: Taxpayer's solicitation of orders and ancillary activities would be exempt from Virginia corporate income tax. Advice to customers on advertising, display methods and merchandising are ancillary to solicitation of orders. On-the-spot inspection and repair of damaged items may constitute a non-ancillary activity outside the scope of PL 86-292. Likewise, the furnishing of elaborate display cases owned by Taxpayer would constitute property employed in Virginia falling outside the scope of PL 86-292. However, display racks provided at no cost to retailers may be ancillary to solicitation. Thus, Taxpayer's activities exceed mere solicitation and trigger the application of the Virginia corporate income tax.


**Facts.** Taxpayer is an out-of-state corporation selling its products in Virginia through independent contractors who either work solely for Taxpayer or represent a multiple number of unrelated corporations. In addition to soliciting sales, the independent contractors may assist customers by performing maintenance services.

**Issue:** Whether Taxpayer is exempt from the Virginia corporate income tax under Public Law 86-272.

**Holding:** Taxpayer's representatives in Virginia do not qualify as independent contractors under Public Law 86-272 because some of them work solely for Taxpayer. Therefore, maintenance of an office or acceptance of sales by these representatives in Virginia would not constitute exempt solicitation under Public Law 86-272. Maintenance activities assigned to in-state contractors are not solicitation and are not ancillary to solicitation even though such activities may facilitate future sales and build customer relations. Such activities would not be deemed to create only a *de minimis* connection to the Commonwealth if engaged in on a regular and continuous basis. Accordingly, Taxpayer is subject to Virginia corporate income tax.


**Facts.** Taxpayer is a foreign corporation with no contacts in Virginia other than the delivery of merchandise to customers in Virginia using its own delivery vehicles.

**Issue:** Whether the mere delivery of merchandise by Taxpayer constitutes "nexus" for Virginia corporate income tax purposes.

**Holding:** A corporation with income from Virginia sources is subject to Virginia income tax regardless of how the merchandise is delivered, unless otherwise exempted by federal law. As interpreted by the Department, Public Law 86-272 does not treat deliveries using Taxpayer's own vehicles as "solicitation" exempt from state taxation. Delivery activity creating more than a *de minimis* connection to the Commonwealth may constitute sufficient
nexus for imposition of the Virginia corporate income tax. In determining whether more than a de minimis connection exists, the Department will consider all other activities of Taxpayer not constituting solicitation and whether the deliveries are a regular and continuous activity carried on in Virginia. The Department is currently litigating this issue in the City of Alexandria Circuit Court (National Private Truck Council, Inc. v. Payne).


**Facts.** Taxpayer is a manufacturer of screen printing equipment and a distributor of screen printing supplies. Taxpayer maintains its headquarters and offices outside Virginia, but proposes to employ a Virginia resident to call on prospective customers in Virginia. Taxpayer will not furnish an office for the Virginia employee, and all orders will be approved and filled from an out-of-state location.

**Issue:** Whether the Virginia activities of Taxpayer's employee will constitute sales solicitation exempt from Virginia corporate income tax.

**Holding.** Taxpayer does not have sufficient nexus with Virginia to trigger the Virginia corporate income tax. Under Public Law 86-272, the mere presence of sales personnel in Virginia would constitute sales solicitation not subject to state income taxation. However, were Taxpayer to engage in any additional activities not ancillary to direct sales activities, Taxpayer would become subject to Virginia corporate income tax.

E. **Income Tax: I.R.C. 338(h)(10) Policy.**

**PD 94-106,** April 8, 1994.

**Facts.** Taxpayer is contemplating the sale of a Virginia domiciled subsidiary, subject to an election to treat the sale as a sale of assets under I.R.C. § 338(h)(10).

**Issue:** Whether the sale of Taxpayer's subsidiary subject to an I.R.C. § 338(h)(10) election would be treated as a sale of stock or assets for Virginia corporate income tax purposes.

**Holding:** Virginia will follow the federal treatment of sales subject to an I.R.C. § 338(h)(10) election as set forth in P.D. 91-317 (12/30/91). However, for sales and use tax purposes, the sale would be treated as a sale of stock, not of assets, and therefore would not be subject to Virginia sales and use tax.

F. **Sales Tax: Agricultural Rulings.**

Facts. Taxpayer is a fertilizer product manufacturer using floater machines to mix and spread fertilizer for its customers. Taxpayer contends that the floater machinery is used exclusively to mix and spread fertilizer and, thus, the entire purchase price of the equipment is exempt from Virginia sales and use tax under Va. Code § 58.1-609.3(2).

Issue: Whether, under the preponderance of use rule, the manufacturing exemption from sales and use tax should apply to the entire purchase price of Taxpayer’s floater machinery or only to the mixing components thereof.

Holding: The manufacturing exemption applies only to the mixing tank and sprayer arms which are used directly in industrial processing, not to the tractor equipment upon which the mixing components are mounted. Because the mixing components constitute only 40% of the total purchase price of the floater machinery, the purchase was exempt only to that extent.

G. Sales Tax: Manufacturing, Processing, Etc.

1. Compressors, meters and gathering pipelines used in the extraction and transport of oil and natural gas are exempt from Virginia sales and use tax as tangible personal property used in mining. Storage tanks and pond/pit liners not used directly in mining reclamation activities may be exempt from sales and use tax if certified as pollution control equipment by Virginia Department of Environmental Quality. Expenses of reclamation of well-site access roads do not qualify for exemption from sales tax as reclamation activity or property directly used in mining. (PD 94-123).


2. Bulk quantities of drugs and medicines purchased by home health care provider are used in rendition of services and do not qualify as exempt purchase for resale. Assessment for period greater than three years is proper where taxpayer failed to file returns and executed waiver permitting examination of prior years’ records. (PD 94-145).

3. Virginia manufacturer liable for Virginia use tax on sample windows manufactured in Virginia and shipped out-of-state for promotional use by salesmen. (PD 94-146).


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H. Sales Tax: Occasional Sales.

1. A series of separate transactions resulting in liquidation of a retail convenience store business do not constitute "occasional sales" exempt from Virginia sales and use tax. (PD 94-134).

2. Out-of-state buyer liable for tax on purchases of equipment for its own consumption where tax not collected by seller. Purchase of data processing equipment by bank exempt from tax as an occasional sale. Penalty charges imposed for inadequate use tax compliance. (PD 94-143).

I. Sales Tax: Services or Sale?

Virginia sales tax due on total charge for multiple copies of word processing documents, including services connected therewith. Copying of previously-created word processing files is an exempt service. Reprints of previously-delivered word processing jobs are taxable. (PD 94-135).

J. Sales Tax: Government Contractors.

1. Governmental contracts for design and operation of computerized supply system and training program were for delivery of services, not tangible personal property, and did not qualify for resale exemption from tax. Corporate officer's payment of other corporate obligations while under notice of potential tax liability constitutes "wilful" failure to pay tax for purposes of converted tax assessment. (PD 94-140).

2. Equipment purchased and leased by government contractor in fulfillment of contract for provision of services did not qualify for resale exemption. However, equipment used directly and exclusively in research and development in scientific or technical field is exempt from sales tax. (PD 94-197).

3. Prime contract to provide support services to federal government for electronic digital switch systems was contract for provision of services and prime contractor liable for tax on tangible personal property used in contract. Subcontractors may also be liable for tax if designated as purchaser using prime contractor's credit. "First use" of property in Virginia includes exercise of any right over property which is not merchandise for resale. (PD 94-226).

4. Contractor under cost reimbursement service agreement with federal government liable for tax on tangible personal property used in connection with contract. Exemption for sales of tangible personal property used by government agency inapplicable unless credit of government agency is directly bound. (PD 94-231).
K. Sales Tax: Non-Profits.

1. A nonprofit corporation providing billing services to both nonprofit hospitals and private contracting physicians did not qualify for sales and use tax exemptions for nonprofit hospitals or nonprofit hospital corporations. (PD 94-150).

2. Building contractor could purchase tangible personal property free of Virginia sales tax as purchasing agent for nonprofit hospital. However, contractor liable for use tax on the property if used in hospital construction project. (PD 94-200).

3. 501(c)(3) Organizations engaged in publication and distribution of directories, handbooks, magazines and related materials to nonprofit educational institutions were liable for Virginia use tax on materials donated to educational institutions. Reference materials and publications not available to the general public do not qualify as exempt publications for sales tax purposes. However, catalogs, letters and brochures are exempt printed materials. (PD 94-214).

L. Sales Tax: Audits.

Auditor properly estimated sales using highest possible industry mark-up factor to cost of goods sold where buffet restaurant failed to maintain adequate sales records. (PD 94-213).

M. Local License Tax.

Facts. Taxpayer proposes to establish a mail order fulfillment center in Virginia which would be responsible for picking orders, packing items and shipping items to customers. No orders would be taken at the center, nor would any billings be issued or funds received at the center. (PD 94-100).

Issue: How would Taxpayer's mail order fulfillment center be classified for purposes of the local business license tax?

Holding: Taxpayer's activity would constitute a business required to obtain a business license. Although Taxpayer's overall business is retail sales, the fact that there is to be no direct contact between the retail customer and personnel at the fulfillment center may indicate that no retail sales are made at the fulfillment center and that the business would be taxable on the basis of gross receipts from retail sales. Alternatively, the fulfillment center may be classified as a business separate from the overall retail business. Because the fulfillment center will provide packing and shipping services to the overall business for which a separate charge will be made, such charges may be taxable as receipts from other business services. The fact that the charge may be billed and collected in another jurisdiction will not affect taxability if the services are attributable to a definite place of business in the locality.
N. Mortgage Interest Reportable by Former Virginia Homeowners.

**Facts.** Taxpayer, a former Virginia resident, sold a personal residence located in Virginia in exchange for a note secured by the real estate. Taxpayer realized no gain on the sale but reports the interest received on the mortgage note as income to Taxpayer's current state of residence. (PD 94-274)

**Issue:** Whether the interest received by Taxpayer under the mortgage note constitutes Virginia source income for purposes of filing a Virginia non-resident income tax return.

**Holding.** Interest income derived from a mortgage note secured by Virginia real property constitutes income received from an intangible asset taxable by Taxpayer's state of domicile. Because Taxpayer is no longer a resident of Virginia, Taxpayer will not be required to pay Virginia income tax on the interest income received despite the fact that the mortgage is secured by Virginia real estate.

O. Exempt Bonds.

**Facts.** Taxpayer requested that the Department issue an updated determination of the tax-exempt status of various types of financial instruments for Virginia income tax purposes. (PD 94-281).

**Holding.** The Department has published a list setting forth whether interest income paid on notes, bond and other obligations issued directly by various federally created organizations will be deemed taxable or exempt for purposes of Virginia income tax. With respect to mutual funds investing in tax-exempt U.S. or Virginia obligations, the income received by the fund and passed on to the mutual fund shareholders will retain its tax-exempt status in the hands of the shareholders. Where mutual fund income stems from exempt and non-exempt sources, the Department does not maintain a list of funds totally or partially exempt for Virginia tax purposes. However, the Department will issue rulings directly to a mutual fund approving the fund's method of determining the tax-exempt portion of its dividends. The Department's policy is to permit mutual fund shareholders to determine the taxable portion of their fund dividends for Virginia income tax purposes in reliance upon information provided by the mutual fund. With respect to obligations of Virginia or of any political subdivision thereof, Virginia law provides a subtraction from federal adjusted gross income for interest on such obligations.

<table>
<thead>
<tr>
<th>Issuing Organization</th>
<th>Virginia Tax Status of Bond Issues</th>
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<tbody>
<tr>
<td>Armed Services Mortgage Insurance (12 U.S.C.A. § 1748b[f])</td>
<td>Exempt¹</td>
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</tbody>
</table>

¹Issued pursuant to the National Housing Act. (Housing and Urban Development)
Asian Development Bank  
Banks for Cooperatives (12 U.S.C.A. § 2134)  
Commodity Credit Corporation (15 U.S.C.A. § 713a-5)  
Export-Import Bank of the United States  
(12 U.S.C.A. § 635d)  
Farm Credit Bank (12 U.S.C.A. § 2023)  
Federal Deposit Insurance Corporation (FDIC)  
(12 U.S.C.A. § 1825)  
Farmers Home Administration  
Federal Home Loan Bank (12 U.S.C.A. § 1433)  
Federal Home Loan Mortgage Corporation  
(Freddie Mac)  
Federal Land Bank (12 U.S.C.A. § 2098)  
Federal National Mortgage Association  
(Fannie Mae)  
Federal Savings and Loan Insurance Corporation  
(FSLIC) (12 U.S.C.A. § 1725[e])

2See Banks for Cooperatives, Federal Land Bank and Federal Intermediate Credit, which are part of the Farm Credit System.

3Obligations issued by these agencies are exempt only if the full faith and credit of the United States is pledged to pay principal and interest in all events. Interest on these obligations is not exempt merely because it is guaranteed by the United States.
Financial Assistance Corporation (12 U.S.C.A. § 2278b-10[b])  Exempt
Financing Corporation (FICO) (12 U.S.C.A. § 1441[3][8])  Exempt
General Services Administration  Taxable³
Government National Mortgage Association  Taxable
Guam, Government of  Exempt⁴
Inter-American Development Bank  Taxable
International Bank for Reconstruction & Development  Taxable
Maritime Administration  Taxable³
Mutual Mortgage Insurance Fund (12 U.S.C.A. § 1710[d])  Exempt¹
National Defense Housing Insurance (12 U.S.C.A. § 1750c[d])  Exempt¹
Production Credit Association (12 U.S.C.A. § 2077)  Exempt
Puerto Rico, Government of  Exempt⁵
Rental Housing Insurance (12 U.S.C.A. § 1747[g])  Exempt¹
Small Business Administration  Taxable³
Samoa, American  Exempt⁶

⁴Only bonds issued by the Government of Guam or by its authority which are exempted by specific federal statutory exemption (48 U.S.C.A. § 1423a) qualify for the Virginia subtraction.

⁵Only bonds issued by the Government of Puerto Rico or by its authority which are exempted by specific federal statutory exemption (48 U.S.C.A. § 745) qualify for the Virginia subtraction.

⁶Only industrial development bonds exempted by specific federal statutory exemption (48 U.S.C.A. § 1670) qualify for the Virginia subtraction.
Student Loan Marketing Association (Sallie Mae)  
(20 U.S.C.A. § 1087-2(b)(2))  
Exempt

Tennessee Valley Authority (16 U.S.C.A. § 831n-4[d])  
Exempt

United States Treasury Bills, Notes and Bonds  
(31 U.S.C.A. § 3124[a])  
Exempt

United States Savings Bonds (Series e, EE, H, HH, etc.)  
(31 U.S.C.A. § 3124[a])  
Exempt

United States Postal Service (39 U.S.C.A. § 2005[d][4])  
Exempt

Virgin Islands, Government of  
Exempt

War Housing Insurance (12 U.S.C.A. § 1739[d])  
Exempt

P. **Hedge Funds.**


**Facts.** An out-of-state limited partnership and its general partner, an out-of-state S corporation, are proposing to relocate to Virginia. The partnership has no employees and owns no tangible or real property, but invests solely in stocks and bonds of companies listed on one of the major stock exchanges. The partnership is not considered a trade or business for federal income tax purposes.

**Issue:** Whether the non-resident limited partners and the non-resident shareholders of the general partner would have income from Virginia sources for Virginia income tax purposes in the event of a relocation of the partnership and the general partner to Virginia.

**Holding.** The non-resident limited partners would have no income from Virginia sources because the activities of the limited partnership would not be deemed to constitute a trade or business. The activities of the partnership are of a passive nature limited strictly to investing in stocks and bonds. The partnership would have no Virginia property or payroll and would amount to little more than a pooling of assets by investors similar to a mutual

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7 Only bonds issued by the government by the Virgin Islands or any municipality thereof which are exempted by specific federal statute exemption (48 U.S.C.A. § 1403) qualify for the Virginia subtraction.
fund. However, the activities of the general partner would constitute a trade or business because the general partner actively manages the investments, performs record-keeping functions, and receives a fee for its services. Therefore, each individual non-resident shareholder of the general partner would have income from Virginia sources and would be required to file a non-resident individual income tax return with Virginia.

IV. **VDOT MODEL BPOL ORDINANCE.** (September, 1994)

A. **Substantive Aspects - Key Points**

1. **“Business” Defined - All “Businesses” are subject to the tax.**

   "‘Business’ means a course of dealing which requires the time, attention and labor of the person so engaged for the purpose of earning a livelihood or profit. It implies a continuous and regular course of dealing, rather than an irregular or isolated transaction. It also implies that the person is holding himself out to the public as a particular business or occupation and is providing goods or services to others, rather than dealing exclusively for his own account. A person may be engaged in more than one business."

B. **“Definite Place of Business” Defined - Offices and Other “Places of Dealing”.**

   "‘Definite Place of Business’ means a location at which occurs a regular and continuous course of dealing. A person’s residence may be a definite place of business if there is no definite place of business maintained elsewhere and the person is not licensable as a peddler or itinerant merchant."

1. **“Purchase” Defined - Goods on Hand as the Test for Wholesale Merchants.**

   "‘Purchases’ means the gross purchase price paid, less returns and allowances, for all goods, wares and merchandise received for sale at each definite place of business of a wholesale merchant for sale at wholesale. However, when a wholesale merchant manufactures the goods, wares and merchandise sold at wholesale in the Commonwealth at a place other than the place of manufacture, the term "purchases" shall refer to the gross receipts from the sale of such goods, wares and merchandise."
Comment: This definition is derived from the definition used in the former state license tax on wholesale merchants contained in Va. Code § 58-304 before its repeal in 1966. As for defining purchases of a manufacturer to be gross receipts from sales, see 1990 Att’y Gen. Ann. Rep. 220, but compare to Va. Code § 58-317 (before repeal) which defined such purchases as the cost of manufacture."

2. Exemptions/Exclusions Carried Over (§2.3).

(a) Manufacturers selling at the loading dock.

(b) Real property renters (except hoteliers, etc.).

(c) Investment income not directly related.

(d) Occasional sales
Query: Are these really "exemptions"?

C. Apportionment Rules.


"§ 3.1 Situs of gross receipts.

The situs of gross receipts is the definite place of business which is regularly available to customers or from which customers are contacted or sales initiated. Specific items of gross receipts shall be attributed to a definite place of business if a greater portion of the activity and customer contact is made or initiated there than at any other definite place of business."

2. Fall Back Test: Fair apportionment based on VEC payroll allocation between taxing locality’s place of business and the taxpayer’s other facilities.

"The assessor may enter into an agreement with any other political subdivision of Virginia concerning the manner in which gross receipts shall be allocated to definite places of business in [locality] and the other political subdivision based on the nature of the activity and customer contact in each definite place of business or, if not easily ascertainable, on the basis of payroll or
some other method appropriate to the taxpayer’s records and method of doing business provided that the sum of the gross receipts allocated by the agreement shall not exceed the total gross receipts attributable to the definite places of business affected by the agreement."

3. **No Throwback Rule:**

"Comment: A rule is provided to determine which of several offices should be assigned gross receipts for purposes of the BPOL tax, and flexibility is allowed when two or more Virginia localities are involved and recordkeeping or other factors make the rule difficult to apply. The "greater portion" rule for attributing gross receipts when more than one office is involved is derived from the corporate income tax rule for determining situs of gross receipts from intangibles. The preference is to allocate 100% of a particular receipt to the one office with the most contact with that customer (most likely a sales office) rather than dividing it among headquarters, design office, manufacturing plant, warehouse, etc. When an apportionment formula is needed, use of VEC payroll information seems to be the preferred method among localities that already have such agreements. Localities may tax only gross receipts attributable to a definite place of business in their locality; they cannot "throw back" receipts attributable to a locality which does not impose a BPOL tax."

**D. Procedural Aspects.**

1. Pay to play
2. Prejudgment interest
3. Cash or accrual method to determine actual gross receipts
4. Criminal sanctions for noncompliance
5. Stay of collection
6. Rulings by local officials
7. Model or mandatory?
8. Grandfathered rates
9. Statute of limitations

Definition of "Assessment"

V. The "Rodney King" Offense. Making a 1983 Suit Part of Your State and Local Tax Litigation

A. The Statute (42 U.S.C. § 1983) and Its Elements
1. Acting under color of authority
2. Deprived taxpayer of a federal right

B. Finding a Federal Right
1. Not Mere State Claims: "erroneous construction of state law is not denial of federal right"

2. Rights in the Criminal Area: First Amendment (speech), Fourth Amendment (search and seizure), Fifth Amendment (self-incrimination).

3. Rights in the Commercial/Regulation/Tax Areas:
   (a) Due Process
   (b) Equal Protection

   Query: Can only local discrimination vs. interstate commerce violate the Commerce Clause. See American Woodmark v. City of Winchester, supra.

C. Affirmative Defenses
1. Query Jurisdiction for a Federal Right in State Court
2. Qualified Immunity
   (a) ministerial act (i.e., not a decision of governance)
   (b) show no violation of "clearly established law"
D. Remedies

1. Duplicate remedy in recovery of refunds or abatement of the assessment


3. Prejudgment interest?

4. Power to enjoin collection?