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Annual Survey of Virginia Law: Taxation

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TAXATION

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This article reviews significant recent developments in the law affecting Virginia taxation. The article is divided into six sections. Each of these sections covers the recent judicial decisions and legislative changes which have occurred over the past several years for the respective category of taxation discussed in the section. The discussion of legislative activities will generally cover the 1995 and 1996 Sessions of the Virginia General Assembly. The judicial decisions reviewed in this article are primarily from the years 1995 and 1996. The overall purpose of this article is to provide Virginia tax and general practitioners with a concise overview of the recent developments in Virginia taxation most likely to have an impact on Virginia practitioners. The article is not designed to discuss or review all issues of Virginia taxation. This article will not discuss many of the numerous legislative technical changes to the State Taxation Code of Title 58.1.

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PART ONE: TAXES ADMINISTERED BY THE VIRGINIA DEPARTMENT OF TAXATION

I. INCOME TAX

A. *Recent Judicial Decisions*

1. Income Tax Credits

In *Giesecke v. Department of Taxation*,[1] the Fairfax County Circuit Court held that husband and wife shareholders in a Delaware corporation were not entitled to a credit against their Virginia income tax liability on certain corporate franchise taxes paid to the District of Columbia.[2] Hans Giesecke was a shareholder in a Delaware subchapter S corporation. The corporation was located within the District of Columbia, where it was assessed and to which it paid certain corporate franchise taxes. On their personal Virginia income tax returns for tax years 1989 and 1990, the Gieseckes treated the corporate franchise taxes paid to the District of Columbia as an income tax and claimed credits for those payments under Virginia Code section 58.1-332.[3] The Department of Taxation disallowed the credits and assessed the Gieseckes with additional taxes for the 1989 and 1990 tax years. The Gieseckes paid the taxes under protest and initiated a motion for declaratory judgment which the Fairfax County Circuit Court denied.[4]

The Gieseckes relied on the Supreme Court of Virginia decision in *King v. Forst*[5] for support of their position that the District of Columbia corporate franchise taxes should be treated as income taxes for purposes of the credit available under Virginia Code section 58.1-332. In *King*, the Supreme Court of Virginia held that the District of Columbia's unincorporated business tax was an income tax for purposes of the section 58.1-332 credit.[6] The Fairfax County Circuit Court noted that the Dis-

1. 34 Va. Cir. 455 (Fairfax County 1994).
2. *Id.* at 456.
3. *Id.* at 455.
4. *Id.* at 456.
5. 239 Va. 557, 391 S.E.2d 60 (1990).
6. *Id.* at 561, 391 S.E.2d at 62.

trict of Columbia's corporate franchise tax is not the same as an unincorporated business tax, although arguably the logic of the *King* holding would appear to apply equally to both types of taxes.[7] The Fairfax County Circuit Court did not locate any Virginia court decision or Department of Taxation ruling which treated the corporate franchise tax paid to the District of Columbia as an income tax under Virginia tax laws governing credits to be given for out-of-state tax payments.[8]

Prior to the *King* decision, the Department of Taxation had consistently taken the position that unincorporated business taxes, and other analogous taxes paid to the District of Columbia, did not qualify for the credit which was ultimately allowed by the supreme court in *King*.[9] Following the supreme court's decision in *King*, the legislature adopted a retroactive amendment to Virginia Code section 58.1-332 which explicitly incorporated the Department of Taxation's interpretation of the statute regarding the allowance and disallowance of credits to Virginia taxpayers for taxes paid to other states.[10] The amendment specifically provided that "no franchise tax, license tax, excise tax, unincorporated business tax, occupation tax or any tax characterized as such by the taxing jurisdiction, although applied to earned or business income, shall qualify for a credit under this section, ..."[11] The only exception made to the amendment's retrospective reach was for taxpayers who had paid taxes to Virginia without applying the credit, and who had filed a protective claim for refund with the Department of Taxation prior to the date of the introduction of the amending bill.[12]

The Gieseckes challenged the impact of the amendment arguing that it was an unconstitutional retroactive application of law. The Fairfax County Circuit Court stated that retroactive application of tax statutes does not necessarily make the laws unconstitutional.[13] In cases where the due process of law is infringed, the retroactive aspect of the law will be deemed in-

7. *Giesecke*, 34 Va. Cir. at 456.
8. *Id.*
9. *Id.*
10. *Id.* at 457.
11. VA. CODE ANN. § 58.1-332(A) (Repl. Vol. 1991).
12. *Giesecke*, 34 Va. Cir. at 458.
13. *Id.* at 458.

valid. The circuit court noted that there was no denial of due process.[14] The Fairfax County Circuit Court found that the amendment to Virginia Code section 58.1-332 does not impair any contractual obligations nor does it abrogate any vested rights of the taxpayers.[15] Specifically, the circuit court stated that "'[n]o one has the vested right to be free of taxation, nor does he have the constitutional right to know that a tax will be levied in such a manner that he may avoid it.'"[16]

The application of the due process analysis to taxation has two tests. First, should the taxpayer reasonably have known that the statute at issue would be amended with retroactive application as to them?[17] Second, is the period for retroactive application of a statute reasonable?[18] The Fairfax County Circuit Court held that the amendment to Virginia Code section 58.1-332 withstands constitutional challenge under both tests.[19] As to the first test, the evidence established that the Gieseckes should have known that the challenged statute would be amended and would subject them to the tax.[20] In fact, it appeared to the circuit court that the taxpayers knew of the legislative action and its probable effect on them prior to claiming the credit for tax year 1989 on their 1990 tax form, and in the subsequent year under challenge.[21] With regard to the second test, the circuit court noted that retroactive tax statutes have been upheld against due process challenge when the retroactive period is relatively short.[22] In this case, a three-year retroactive application was found to be reasonable under the facts presented by the taxpayers.[23]

The Fairfax County Circuit Court relied heavily upon the timing of the amendment by the Virginia legislature. The amendment to Virginia Code section 58.1-332 was completed at the General Assembly's first regular session after the supreme

14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.* at 459.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.* at 460.

court's decision in *King*.[24] The actual period of retroactive application of the amendment was short and reasonable given the legislature's quick action to legislatively overrule the *King* decision. The circuit court also noted that the Virginia legislature did not create "wholly new law," to which the taxpayers were subjected contrary to the legitimate expectations of finality and repose.[25] Rather, the amendment codified the position which the Department of Taxation had consistently taken with respect to all Virginia taxpayers on the issue of available credits since 1957.[26]

2. Virginia Additions and Subtractions—Individuals

In *Davenport v. Department of Taxation*,[27] the Circuit Court for the City of Richmond held that a parent's election to include his or her child's unearned income in the parent's gross income for federal income tax purposes did not make such income a part of the parent's Virginia taxable income.[28] Section 1(g) of the Internal Revenue Code of 1986,[29] as amended, is commonly known as the "Kiddie Tax," and "generally provides that the unearned income of a child under the age of [fourteen years] is taxed by the federal government at the tax rate applicable to the child's parents if the parents file jointly, at the rate of the parent with the greater income if the parents file separately, or at the rate of the custodial parent if the parents are not married to each other."[30]

For tax years 1992, 1993 and 1994, Mr. Davenport's five minor children had unearned income. The Davenports filed a joint federal tax return on which they elected to include in

24. *Id.*
25. *Id.*
26. *Id.* The Gieseckes' Petition for Appeal was denied by the supreme court in 1995. Giesecke v. Department of Taxation, No. 950166 (Va. April 13, 1995), *denying appeal from* 34 Va. Cir. 455 (Fairfax County 1994). In House Bill 2047, the 1995 General Assembly was asked to consider amending section 58.1-332(A) to broaden the income tax credit available for taxes paid to other states. H.B. 2047, Va. Gen. Assembly (Reg. Sess. 1995) House Bill 2047, Va. Gen. Assembly (Reg. Sess. 1995) was not enacted by the Virginia legislature.
27. 38 Va. Cir. 421 (Richmond City 1996).
28. *Id.* at 421.
29. 26 U.S.C. § 1(g) (1994).
30. *Davenport*, 38 Va. Cir. at 421.

their gross income the unearned income of their five minor children. When the Davenports prepared their Virginia income tax returns for those years, they subtracted their children's unearned income from their federal adjusted gross income as reported on their federal tax returns.

At trial, the Virginia Department of Taxation argued that section 58.1-322 defines "Virginia taxable income" and sets out a rather complete list of items which must be added to, or which may be deducted from, a taxpayer's federal adjusted gross income in order to arrive at the taxpayer's Virginia taxable income.[31] A deduction of the children's unearned income is not one of the items listed as an available subtraction from a taxpayer's federal adjusted gross income.[32] The Department of Taxation also argued that on two occasions the General Assembly considered, but voted against, amending section 58.1-322 to specifically provide for an exclusion of a child's unearned income from the parent's Virginia taxable income, even if such income was included on the parent's federal income tax return.[33] While the circuit court noted that both arguments were compelling and logical, it rejected both of them.[34] Section 58.1-322(A) provides that "[t]he Virginia taxable income of a resident individual means *his* federal adjusted gross income for the taxable year . . . with the modification specified in this section."[35] The circuit court stated that, "regardless of where a child's income is reported, it remains the income of the child. It simply is not the income of the parent."[36]

31. *Id.* at 422.
32. *Id.*
33. *Id.* at 423 (citing H.B. 1556, Va. Gen. Assembly, (Reg. Sess. 1991); S.B. 216, Va. Gen. Assembly, (Reg. Sess. 1992)).
34. *Id.*
35. *Id.* (emphasis added).
36. *Id.* at 424. The Tax Department's Petition for Appeal was granted by the Supreme Court of Virginia. Department of Taxation v. Davenport, No. 961270 (Va. Sept. 5, 1996), *granting appeal from* 38 Va. Cir. 421 (Richmond City 1996). Oral argument on this case will likely be held in early 1997.

3. Corporate Income Tax—Foreign Corporations

In *National Private Truck Council v. Department of Taxation*,[37] the Circuit Court of the City of Alexandria granted summary judgment to the National Private Truck Council on its claim that a Virginia corporate income tax regulation, section 630-3-401(G),[38] violates 15 U.S.C. section 381,[39] as well as the Due Process[40] and Commerce Clauses[41] of the United States Constitution. These two provisions of the Constitution, require that before a state may tax a person, property or transaction there must be some minimum "nexus" between the state and the person, property or transaction sought to be taxed.[42] To implement and amplify these protections to businesses operating in interstate commerce, Congress, in 1959, enacted Public Law 86-272.[43] This statute limits the power of states to impose net income taxes on out-of-state businesses. It provides in pertinent part:

> No state . . . shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person . . . are . . . :
>
> (1) the solicitation of orders by such person . . . in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State . . . .[44]

The National Private Truck Council, Inc.—a national trade association consisting of over 1,000 companies that manufacture, distribute, and transport their products in their own

37. 37 Va. Cir. 334 (Alexandria City 1996) (appeal granted).
38. 23 VA. ADMIN. CODE 10-120-90(G) (1996) (formerly VRR 630-3-401(G)).
39. 15 U.S.C. § 381 (1994).
40. U.S. CONST. amend XIV, § 1.
41. U.S. CONST. art. I, § 8, cl. 3.
42. *Id.*; U.S. CONST. amend XIV, § 1.
43. Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (codified as amended at 15 U.S.C. § 381 (1994)).
44. 15 U.S.C. § 381(a) (1994).

trucks—opposed the Department of Taxation's regulation which sought to implement Virginia Code section 58.1-400. Virginia Code section 58.1-400 imposes an income tax on "every corporation organized under the laws of the Commonwealth and every foreign corporation having income from Virginia sources."[45] Section 630-3-401 of the Virginia Regulations sets out certain "income from Virginia sources" which is exempted or excluded from the state income tax.[46] Subsection 630-3-401(G) provides in pertinent part:

> (G) Limitation on jurisdiction to tax.
>
> (1) Federal law prohibits any state from imposing a net income tax on a foreign corporation having no place of business within the state, whose sole activity within the state is solicitation of orders which are accepted and filled by shipment via common carrier from places outside the state. See Public Law 86-272 (15 U.S.C. §§ 381-384) for full details and definitions.[47]

In 1992, the United States Supreme Court decided *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*,[48] which discussed the parameters of "solicitation" and ancillary activities protected under 15 U.S.C. section 381. Subsequent to *Wrigley*, the Department of Taxation issued a new policy holding that "the operation of a taxpayer's trucks on Virginia highways clearly exceed[ed] 'solicitation' under P[ublic] L[aw] [No.] 86-272."[49] Furthermore, because the use of a taxpayer's own trucks will create nexus with the state, the taxpayer will now be required to file a Virginia income tax return for taxable years beginning after the date of the new policy.[50]

The National Private Truck Council directly challenged the Department of Taxation's conclusion that companies are protected from state income taxation by section 381 if they use common carriers to ship their products into Virginia, but not if they deliver those products to their Virginia customers in their

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45. VA. CODE ANN. § 58.1-400 (Repl. Vol. 1991).
46. 23 VA. ADMIN. CODE 10-120-90 (1996) (formerly VRR 630-3-401).
47. 23 VA. ADMIN. CODE 10-120-90(G) (1996) (formerly VRR 630-3-401(G)).
48. 505 U.S. 214 (1992).
49. VIRGINIA DEP'T TAXATION, PUB. DOC. 92-230 (November 9, 1992).
50. *Id.*

own vehicles. The petitioners argued that the Department's position is at odds with the plain language of the statute and its legislative history. The circuit court agreed, concluding that the clear and plain meaning of section 381 is that states may not impose a net income tax on out-of-state corporations whose only contact with the taxing state consists of soliciting orders and delivering goods in the corporation's own vehicles.[51] To hold otherwise would be contrary to Congress' intention in using the terms "shipment or delivery" and "by or on behalf of."[52]

B. *Recent Significant Legislative Activity*

1. Income Tax Credits

a. Major Business Facility Job Tax Credit Expansion

In 1995, the General Assembly amended Virginia Code section 58.1-439 to accomplish several modifications to the Major Business Facility Job Tax Credit.[53] First, the legislation eliminated the one-million dollar limitation on the maximum amount of credit which a taxpayer may cumulatively earn.[54] Second, the period during which unused credits may be carried over was increased from five to ten years.[55] In 1996, the General Assembly again amended section 58.1-439 to require the Department of Taxation to certify those companies which qualify for the Major Business Facility Job Tax Credit and determine the classification of these facilities.[56] Prior to this amendment,

51. National Private Truck Council v. Department of Taxation, 37 Va. Cir. 334, 334 (Alexandria City 1996).
52. *Id.*
53. Act of March 18, 1995, ch. 365, 1995 Va. Acts 515.
54. VA. CODE ANN. § 58.1-439(H) (Cum. Supp. 1996).
55. *Id.*
56. VA. CODE ANN. § 58.1-439(E) (Cum. Supp. 1995).

the Department of Economic Development performed these functions.[57]

b. Clean Fuel Vehicle Job Creation Tax Credit

The 1995 General Assembly created a new corporate income tax credit for the creation of full-time clean fuel vehicle jobs.[58] For taxable years commencing on or after January 1, 1996 through December 31, 2006, a corporate income tax credit will be available in the amount of $700 per new job created by a corporation engaged in certain manufacturing activities that are related to clean fuel vehicles.[59] This $700 income tax credit can also be used in each of the two succeeding years that the job is continued, for a maximum "per job" credit of $2,100.[60]

To be eligible for the credit, a corporation must create a new job for an employee whose primary work activity is the manufacture of components for clean fuel vehicles, the manufacture of components used to convert gasoline or diesel to clean fuel vehicles, the manufacture of vehicles designed to operate on clean special fuel, or the conversion of gasoline or diesel fuel vehicles to vehicles that operate on clean special fuel.[61]

Full-time employment for the purposes of the clean fuel vehicle job creation tax credit means at least forty hours per week during at least forty weeks of a calendar year.[62] The definition of "job" for purposes of the clean fuel vehicle job creation tax credit also requires that the employee's primary work activity be related to one of the specified clean fuel vehicle manufacturing or conversion activities.[63] In addition, a corporation must demonstrate that it has increased the number of eligible jobs in the tax year for which the credit is claimed in comparison to the previous taxable year.[64] "Any tax credit not used in the taxable year of job creation or continuation may be carried over

57. VA. CODE ANN. § 58.1-439(E) (Cum. Supp. 1996).
58. VA. CODE ANN. § 58.1-439.1 (Cum. Supp. 1996).
59. VA. CODE ANN. § 58.1-439.1(A) (Cum. Supp. 1996).
60. *Id.*
61. *Id.*
62. VA. CODE ANN. § 58.1-439.1(C) (Cum. Supp. 1996).
63. *Id.*
64. VA. CODE ANN. § 58.1-439.1(D) (Cum. Supp. 1996).

for credit against the corporation's income tax in the five succeeding taxable years until the total credit amount is used."[65] The legislation is drafted so that a corporation will not be permitted to claim the clean fuel vehicle tax credit for jobs for which the taxpayer also claims the Major Business Facility Job Tax Credit.[66]

c. Coalfield Employment Enhancement Tax Credit

The 1995 General Assembly created a new income tax credit for Virginia producers of coal and coal methane gas by creating section 58.1-439.2.[67] Coal producers may begin earning these credits in taxable years beginning on or after January 1, 1996, but may not begin utilizing these credits until January 1, 1999.[68] The tax credits are due to expire on January 1, 2002.[69]

Virginia coal producers may claim one of two tax credits depending on the method of mining of the coal.[70] Under the 1995 legislation, coal which is mined by underground methods would permit a credit equal to sixty cents per ton if the seam thickness is under thirty-three inches, and fifty cents per ton if the seam thickness is thirty-three inches and above.[71] Seam thickness is based on the weighted average isopach mapping of actual coal thickness by mine, as certified by a professional engineer.[72] For coal mined by surface mining methods, the 1995 version of this credit was equal to twenty-five cents per ton for coal sold in 1996 and each year thereafter.[73]

In 1996, Virginia legislators made several significant amendments to the coalfield employment enhancement tax credit. The 1996 legislation increased the amount of the credit for both

65. VA. CODE ANN. § 58.1-439.1(E) (Cum. Supp. 1996).
66. VA. CODE ANN. § 58.1-439.1(G) (Cum. Supp. 1996).
67. VA. CODE ANN. § 58.1-439.2 (Cum. Supp. 1996).
68. VA. CODE ANN. § 58.1-439.2(E) (Cum. Supp. 1996).
69. VA. CODE ANN. § 58.1-439.2(A) (Cum. Supp. 1996). The original sunset provision for the credit was set to expire by January 1, 2001. The 1996 General Assembly delayed the credit's expiration date to on or before January 1, 2002. *Id.*
70. VA. CODE ANN. § 58.1-439.2(A)(1), (A)(2) (Cum. Supp. 1996).
71. *Id.*
72. *Id.*
73. VA. CODE ANN. § 58.1-439.2(A)(2) (Cum. Supp. 1995).

surface and underground mining and modified the seam thickness criteria for determining the credit for underground mining.[74] For coal mined by underground methods, a taxpayer will now be entitled to a credit equal to one dollar per ton if the seam thickness is more than thirty-six inches, and two dollars per ton if the seam thickness is thirty-six inches and under.[75] For coal mined by surface methods, the credit will now be equal to forty cents per ton for coal sold in 1996 and each year thereafter.[76]

The credit that a taxpayer may claim is calculated by multiplying the amount of credit earned by the coal producer's employment factor.[77] The employment factor is

> the percentage obtained by dividing the total number of coal mining jobs of the person filing the return, including the jobs of contract operators of such person as reflected by the annual tonnage reports filed with the Department of Mines, Minerals and Energy for the year in which the credit was earned by the total number of coal mining jobs of such persons or operators as reflected in the annual tonnage reports for the year immediately prior to the year in which the credit was earned.[78]

The credit must be claimed according to a schedule which is set forth within the coalfield employment enhancement tax credit statute.[79]

The 1996 amendment to section 58.1-439.2 also requires the Tax Commissioner to redeem unused credits for ninety percent of the credit amount.[80] The remaining ten percent of unused credit is provided for a regional economic development fund which is to be administered by the Coalfields Economic Development Authority.[81]

74. VA. CODE ANN. §§ 58.1-439.2(A)(1), (A)(2) (Cum. Supp. 1996).
75. VA. CODE ANN. § 58.1-439.2(A)(1) (Cum. Supp. 1996).
76. VA. CODE ANN. § 58.1-439.2(A)(2) (Cum. Supp. 1996).
77. VA. CODE ANN. § 58.1-439.2(F) (Repl. Vol. 1991 & Cum. Supp. 1996).
78. *Id.*
79. VA. CODE ANN. § 58.1-439.2(G) (Cum. Supp. 1996).
80. VA. CODE ANN. § 58.1-439.2(D) (Cum. Supp. 1996).
81. *Id.*

d. Qualifying Steam Producers Tax Credit

The 1995 General Assembly created Virginia Code section 58.1-439.3 which provides a tax credit for steam producers.[82] The amount of the Qualifying Steam Producers Tax Credit is three dollars per ton for each ton of coal mined in Virginia that the steam producer purchases for tax years beginning on and after January 1, 1996, but before January 1, 2001.[83] A "steam producer" is defined as a corporation that sells steam energy to a manufacturing company in Virginia or uses steam to produce manufactured goods.[84] The credit allowed may not exceed the total amount of the Steam Producer's tax liability.[85] Any tax credit not useable for the taxable year may be carried over for up to five succeeding tax years or until the full credit is used, whichever is sooner.[86]

e. Enterprise Zone Program Revamped

The 1995 General Assembly substantially revised and amended Virginia's Enterprise Zone Program.[87] A number of these changes are significant. The maximum number of enterprise zones which may be designated was doubled from twenty-five to fifty.[88] Urban localities can apply for up to three zones.[89] Rural localities with population densities of less than 150 persons per square mile can apply for two zones, one of which may be subdivided into two parts.[90] The subdivided zone will be considered one zone.[91]

Another significant change to the Virginia Enterprise Zone Program was to modify the eligibility criteria of a "qualified business firm." Under the 1995 legislation, to be eligible to

82. VA. CODE ANN. § 58.1-439.3 (Cum. Supp. 1996).
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.*
87. VA. CODE ANN. § 59.1-274(B) (Cum. Supp. 1996).
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*

receive the various tax credits and incentives, a business firm must first be designated as a qualified business firm.[92] Such entity must:

> (i) . . . establish[ ] within an enterprise zone a trade or business not previously conducted in [Virginia] by such taxpayer, and
> (ii) forty percent or more of the employees employed at the business firm's establishment or establishments located within the enterprise zone [must] either have incomes below eighty percent of the median income for the jurisdiction prior to employment or [be] residents of the [enterprise] zone.[93]

A qualified business firm also includes a taxpayer who is actively engaged in the conduct of a trade or business in an area immediately prior to that area being designated an enterprise zone and that increases the average number of full-time employees employed at the business firm's establishment or establishments located within the enterprise zone by at least ten percent over the lower of the preceding two year's employment, with no less than forty percent of such increase being employees who either have incomes below eighty percent of the median income for the jurisdiction prior to employment or are residents of the zone.[94] Current employees of the business firm that are transferred directly to the enterprise zone facility from another site within the state, resulting in a net loss of employment at that site, shall not be included in calculating the increase in the average number of full-time employees employed by the business firm within the enterprise zone.[95]

The legislation also permits any business firm to be designated as a "qualified business firm" if it is actively engaged in the conduct of a trade or business in Virginia and relocates to begin operation of a trade or business within an enterprise zone, and if it increases the average number of full-time employees employed at the business firm's establishment or establishments within the enterprise zone by at least ten percent over the

92. VA. CODE ANN. § 59.1-279(A)(1) (Cum. Supp. 1995).
93. *Id.*
94. VA. CODE ANN. § 59.1-279(A)(2) (Cum. Supp. 1996).
95. *Id.*

lower of the preceding two year's employment of the business firm prior to relocation with no less than fifty percent of such increase being employees who either have incomes below eighty percent of the median income for the jurisdiction prior to employment or are residents of the zone.[96]

Also, the 1995 legislation also substantially revamped and revised the various tax credits available to a qualifying business firm. With respect to the business income tax credit, the total amount of tax credits available to any qualified business firm and to the qualified zone residents may not exceed five million dollars for each fiscal year.[97] This limitation applies to both corporate income and individual income tax credits.[98] However, tax credits granted under section 59.1-280 to firms designated as qualified business firms prior to July 1, 1995, will not be subject to the five million dollar limitation.[99]

If a qualified business firm makes qualified zone investments[100] in excess of twenty-five million dollars and such qualified zone investments result in the creation of at least 100 full-time positions, the percentage amounts of the income tax credits available to such qualified business firms must be established by agreement between the Department of Taxation and the qualified business firm.[101] The agreement will not permit percentage amounts of tax credits to exceed the percentages allowed to other qualified business firms in section 59.1-280(A).[102] Generally, these percentages provide a business income tax credit equal to eighty percent of taxes due Virginia for year one and sixty percent of taxes due for years two through ten (up to five million dollars annually).[103]

The 1995 enterprise zone legislation repealed the credit against various taxes, including personal income, corporate income and franchise taxes, which could be taken by qualified

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96. VA. CODE ANN. § 59.1-279(A)(3) (Cum. Supp. 1996).
97. VA. CODE ANN. § 59.1-280(A) (Cum. Supp. 1996).
98. VA. CODE ANN. § 59.1-280(B) (Cum. Supp. 1996).
99. VA. CODE ANN. § 59.1-280(A) (Cum. Supp. 1996).
100. Section 59.1-280.1(K) defines "qualified zone investments." VA. CODE ANN. § 59.1-280.1(K) (Cum. Supp. 1996).
101. VA. CODE ANN. § 59.1-280(A) (Cum. Supp. 1996).
102. *Id.*
103. *Id.*

business firms for unemployment taxes paid.[104] The new law also phases out the sales and use tax exemption for qualified business firms.[105] As a compromise, those qualified business firms currently possessing an exemption for sales and use taxes are entitled to keep the exemption until the five-year period runs out.[106] "No business firm designated as a qualified business firm on or after July 1, 1995, is entitled to receive an exemption from sales and use taxes."[107]

While several of the tax credits have been eliminated or phased-out as a result of this legislation, the revamped enterprise zone program does create a real property investment tax credit, cash grants for creating permanent full-time positions, and certain other local incentives (i.e., reduced permit fees, reduction of certain taxes, etc.). Beginning on July 1, 1995, but before July 1, 2005, a taxpayer who is a qualified zone resident will be allowed a tax credit against corporate, income, and certain utility taxes, insurance license taxes, and bank franchise taxes.[108]

With regard to the enterprise zone real property investment tax credit, a refundable credit will be allowed in an amount equalling thirty percent of the qualified zone improvements for any qualified zone resident.[109] However, in no event can the cumulative credit allowed exceed $125,000 in any five-year period.[110] The total amount of tax credits granted to qualified zone residents under this statute, including qualified business firms under section 59.1-280, shall not exceed five million dollars for each fiscal year.[111]

A "qualified zone resident" means "an owner or tenant of real property located in an enterprise zone who expands or rehabilitates such real property to facilitate the conduct of a trade or business by such owner or tenant within the enterprise

104. VA. CODE ANN. § 59.1-280(B) (Cum. Supp. 1996).
105. VA. CODE ANN. § 59.1-282 (Cum. Supp. 1996).
106. *Id.*
107. *Id.*
108. VA. CODE ANN. § 59.1-280.1 (Cum. Supp. 1996).
109. VA. CODE ANN. § 59.1-280.1(B) (Cum. Supp. 1996).
110. VA. CODE ANN. § 59.1-280.1(B)(H) (Cum. Supp. 1996).
111. VA. CODE ANN. § 59.1-280.1(B) (Cum. Supp. 1996).

zone."[112] "Qualified zone improvements" means the amount properly chargeable to a capital account for improvements to rehabilitate or expand depreciable real property placed in service during the taxable year within an enterprise zone, provided that the total amount of such improvements equals or exceeds both: (i) $50,000; and (ii) the assessed value of the original facility immediately prior to the rehabilitation or expansion.[113] This statute is explicit regarding what may or may not qualify as a "qualified zone improvement." Qualified zone improvement expenditures are those expenditures associated with any exterior, structural, mechanical, or electrical improvements necessary to expand or rehabilitate a building for commercial or industrial use and for excavations, grading, paving, driveways, roads, sidewalks, landscaping, or other land improvements.[114] Qualified zone improvements also include, but are not limited to, the costs associated with demolition, carpentry, sheetrock, plaster, painting, ceilings, fixtures, doors, windows, fire suppression systems, roofing and flashing, exterior repair, cleaning, and cleanup.[115]

Qualified zone improvements will not include the cost of acquiring any real property or building.[116]

> Qualified zone improvements [will also] not include: (i) the cost of furnishings; (ii) any expenditure associated with appraisal, architectural, engineering, and interior design fees; (iii) loan fees, points, or capitalized interest; (iv) legal, accounting, realtor, sales and marketing, or other professional fees; (v) closing costs, permits, user fees, zoning fees, impact fees, and inspection fees; (vi) bids, insurance, signage, utilities, bonding, copying, rent loss, or temporary facilities incurred during construction; (vii) utility hook-up or access fees; (viii) outbuildings; or (ix) the cost of any well or septic or sewer system.[117]

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112. VA. CODE ANN. § 59.1-280.1(D) (Cum. Supp. 1996).
113. VA. CODE ANN. § 59.1-280.1(E) (Cum. Supp. 1996).
114. *Id.*
115. *Id.*
116. VA. CODE ANN. § 59.1-280.1(E)(1) (Cum. Supp. 1996).
117. VA. CODE ANN. § 59.1-280.1(E)(2) (Cum. Supp. 1996).

A number of other restrictions also apply to determine the eligibility of property or improvements to meet the definition of qualified zone improvements.[118]

For purposes of the new real property investment tax credits, the cost of any newly constructed depreciable non-residential real property is considered a qualified zone improvement eligible for the credit if the total amount of such expenditures is at least $250,000 for a single facility.[119] Land, land improvements, paving, grading, driveways, and interest shall not be considered to be qualified zone improvements.[120]

The Virginia Department of Housing and Community Development must certify the nature and amount of qualified zone improvements and investments eligible for credit in any taxable year.[121] Once properly certified, the Department of Taxation will authorize the credit when it is provided with a copy of the housing certification by the taxpayer.[122]

The 1995 legislation created additional tax credits for certain large qualified zone investments in excess of $100 million and in situations where the investments create at least 200 permanent full-time positions.[123] In these situations, a qualified zone resident is eligible for a credit of up to five percent of such qualified zone investments in lieu of the credit provided by section 59.1-281.1(B).[124] The actual percentage amount of the investment tax credit granted to a qualified zone resident will be determined by agreement between the Department of Taxation and the qualified zone resident.[125] The agreement may not provide for a percentage amount exceeding five percent.[126] The total amount of tax credit granted under these circumstances shall not exceed three million dollars.[127] In addition, the qualified investment tax credit cannot exceed the tax im-

118. *See* VA. CODE ANN. § 59.1-280.1(E)(3) (Cum. Supp. 1996).
119. VA. CODE ANN. § 59.1-280.1(F) (Cum. Supp. 1996).
120. *Id.*
121. VA. CODE ANN. § 59.1-280.1(G) (Cum. Supp. 1996).
122. *Id.*
123. VA. CODE ANN. § 59.1-280.1(J) (Cum. Supp. 1996).
124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.*

posed for such taxable year, but any such credit not usable for the taxable year generated may be carried forward until the full amount of such credit has been utilized.[128]

This new enterprise zone program, with its myriad of tax credits, requires the establishment of policies and procedures for the reservation and allocation of tax credits. All qualified business firms and qualified zone residents which are eligible to receive any tax credit provided for by either sections 59.1-280 or 59.1-280.1 must reserve the tax credit through the Department of Taxation.[129]

In order to ensure that the limited amounts of tax credits available in any year are not oversubscribed and are allocated in an orderly and equitable manner, the Virginia Board of Housing and Community Development is required to establish policies and procedures for the reservation of tax credits by qualified business firms and qualified zone residents.[130] These policies and procedures must provide:

> (i) requirements for applying for reservations of tax credits; (ii) a system for allocating available amount of tax credits among eligible applicants; (iii) for carrying forward eligibility for tax credits to subsequent periods if an applicant does not obtain a reservation of the tax credit or any portion thereof for which he is eligible in any year as the result of the over subscription of tax credits; (iv) priorities for allocating reservations to applicants whose eligibility for reservations of tax credits was carried forward from a preceding year but who did not receive a credit to which they were otherwise eligible; and (v) for the issuance of reservations to eligible applicants who did not initially receive a reservation in any year, if the [Tax] Department determines that tax credit reservations were issued to other applicants who did not use, or were determined to be wholly or partially ineligible for, a reserved tax credit.[131]

The Department of Taxation must apply these policies and procedures when approving applications for reservations of such

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128. *Id.*
129. VA. CODE ANN. § 59.1-280.2(A) (Cum. Supp. 1996).
130. VA. CODE ANN. § 59.1-280.2(B) (Cum. Supp. 1996).
131. *Id.*

tax credits to qualified business firms and qualified zone residents.[132] Actions by the Department of Taxation relating to the approval or denial of applications for reservations for tax credits under Virginia Code sections 59.1-280 or 59.1-280.1 are exempt from the provisions of the Administrative Process Act.[133]

Included within the package of legislation to revamp Virginia's enterprise zone program was the creation of several money grant programs. First, the legislation created a grant program to promote increasing full-time permanent enterprise zone employment for both business start-ups and expansions of existing firms over 110% of base employment.[134] The amount of the grant for which a business firm is eligible will be equal to "(i) $1,000 multiplied by the number of eligible positions filled by employees whose permanent place of residence is within the enterprise zone, and (ii) $500 multiplied by the number of eligible positions filled by employees whose permanent place of residence is outside of the enterprise zone."[135] In no event will a business firm be eligible for a grant under this section in excess of $100,000 for any grant year.[136]

Section 59.1-282.1 of the Virginia Code provides definitions and eligibility criteria for the grants. A business firm is eligible to receive enterprise zone incentive grants for the three calendar years commencing with the first year of grant eligibility.[137] Any business firm receiving an enterprise zone incentive grant under section 59.1-282.1 will not be eligible for the major business facility job tax credit pursuant to section 58.1-439.[138]

The second grant program created by the 1995 legislation package was the Enterprise Zone Grant Fund.[139] This new fund will be used solely for the payment of enterprise zone incentive grants to eligible business firms.[140] Appropriations to

132. VA. CODE ANN. § 59.1-280.2(C) (Cum. Supp. 1996).
133. VA. CODE ANN. § 59.1-280.2(D) (Cum. Supp. 1996).
134. VA. CODE ANN. § 59.1-282.1 (Cum. Supp. 1996).
135. VA. CODE ANN. § 59.1-282.1(C) (Cum. Supp. 1996).
136. *See id.*
137. VA. CODE ANN. § 59.1-282.1(B) (Cum. Supp. 1996).
138. VA. CODE ANN. § 59.1-282.1(G) (Cum. Supp. 1996).
139. VA. CODE ANN. § 59.1-282.2(A) (Cum. Supp. 1996).
140. *Id.*

this fund must be made by the General Assembly.[141] The appropriations will be limited to those purposes authorized under section 59.1-282.2 for the incentive grants to business firms.[142]

The Virginia Department of Housing and Community Development shall determine the amount of the grant to be allocated to each eligible business firm.[143] A business that receives an enterprise zone incentive grant may assign all or any portion of an enterprise zone incentive grant to which it is eligible to the owner of any real property within an enterprise zone occupied by the business firm as tenant.[144] A business may also assign an incentive grant to a financial institution regularly engaged in the business of lending money that has made a loan to the business firm for purposes of expanding, constructing, or rehabilitating a nonresidential building or facility for the conduct of a trade or business by the business firm within an enterprise zone, or both, as they may agree.[145] If such an assignment is made, a business firm must notify the Virginia Department of Housing and Community Development.[146]

The 1995 legislation revised the Enterprise Zone Act to authorize localities to propose local tax incentives such as permit and user fee reductions and the reduction of the business, professional and occupation license tax.[147] Specifically, the legislation enables a locality to establish eligibility criteria for local incentives to business firms that are the same as, or more stringent than, the criteria for eligibility for grants or other benefits.[148]

The legislation provides that the Virginia Department of Housing and Community Development must periodically review the effectiveness of state and local incentives in increasing investment and employment in each enterprise zone, and report annually its findings to the Senate Finance Committee, the Senate Committee on Commerce and Labor, the House Finance

141. *Id.*
142. *Id.*
143. VA. CODE ANN. § 59.1-282.2(B) (Cum. Supp. 1996).
144. VA. CODE ANN. § 59.1-282.3 (Cum. Supp. 1996).
145. *Id.*
146. *Id.*
147. VA. CODE ANN. § 59.1-283(A) (Cum. Supp. 1996).
148. VA. CODE ANN. § 59.1-283(B) (Cum. Supp. 1996).

Committee, and the House Committee on Labor and Commerce.[149] If no business firms in the enterprise zone have qualified for the benefits provided under the legislation within a five-year period, the Department shall terminate that enterprise zone designation.[150]

The revised Virginia Enterprise Zone Act will expire on July 1, 2005, unless extended by an Act of the General Assembly.[151]

In 1996, the General Assembly fine-tuned the enterprise zone program by establishing a statutory framework that will permit the Governor of Virginia to waive a portion of the employment criteria necessary to qualify for enterprise zone benefits as they apply to the pharmaceutical, health care and home care products companies which are undertaking expansions for the primary purpose of basic research or research and development.[152] The criteria that at least forty percent of new employees employed at a qualifying business either have incomes below eighty percent of the area median income of the jurisdiction prior to employment or are zone residents will be subject to waiver.[153] A waiver, if granted, would apply to a particular business and not to other businesses in the enterprise zone.[154]

f. Day-Care Facility Investment Tax Credit

The 1996 General Assembly created a new investment tax credit for any employer who establishes a licensed child day-care center for the children of employees.[155] The credit is equal to twenty-five percent of the cost of the facility, not to exceed $25,000.[156] The total amount of credits allowed in any fiscal year will be limited to $100,000.[157] Qualifying expenditures for this new tax credit include those paid or incurred by

149. VA. CODE ANN. § 59.1-284(B) (Cum. Supp. 1996).
150. *Id.*
151. VA. CODE ANN. § 59.1-284.01 (Cum. Supp. 1996).
152. VA. CODE ANN. § 59.1-279.1 (Cum. Supp. 1996).
153. *Id.*
154. *See id.*
155. VA. CODE ANN. § 58.1-439.4 (Cum. Supp. 1996).
156. VA. CODE ANN. § 58.1-439.4(B) (Cum. Supp. 1996).
157. *Id.*

the taxpayer for "planning, site preparation, construction, renovation, or acquisition of facilities for the purpose of establishing a child day-care facility . . . ."[158] Expenditures could also include equipment and kitchen appliances permanently installed in or adjacent to the facility, provided that such equipment is necessary to the functioning of the day-care facility."[159] This tax credit will be available for taxable years beginning on and after January 1, 1997.[160]

g. Tax Credit for Rent Reductions Extended

The Virginia corporate and personal income tax credits available for rent reductions granted to low-income tenants who are elderly and disabled has been extended until December 31, 1999.[161] Prior to this extension, the credit was scheduled to expire on December 31, 1996.[162] The credit, however, will only be available for units rented to qualifying tenants as of July 1, 1996, and would further be restricted to rent received from tenants in residence as of July 1, 1996.[163] Beginning July 1, 1996, the total amount of approved tax credits may not exceed $250,000 in any fiscal year.[164]

The tax credit for rent reductions is available to landlords engaged in the business of renting dwelling units and subject to the Virginia Residential Landlord and Tenant Act.[165] The Virginia Housing Development Authority certifies to the Department of Taxation the individuals or corporations providing rent reductions that qualify for the credit. If a qualifying landlord provides rentals to low-income tenants who either exceed the age of sixty-two or are disabled from a physical or mental condition, and the rent charged is at least fifteen percent less than

158. VA. CODE ANN. § 58.1-439.4(A) (Cum. Supp. 1996).
159. *Id.*
160. *Id.*
161. VA. CODE ANN. § 58.1-339 (Cum. Supp. 1996).
162. VA. CODE ANN. § 58.1-339 (Cum. Supp. 1995).
163. VA. CODE ANN. § 58.1-339 (Cum. Supp. 1996)
164. *Id.*
165. *Id.* The Virginia Residential Landlord and Tenant Act is located at Virginia Code sections 55-248.2 to -248.40. VA. CODE ANN. § 55-248.2 to -248.40 (Repl. Vol. 1995 & Cum. Supp. 1996).

market value, a credit equal to fifty percent of the rental reduction is allowed to the landlord.[166]

h. Historic Rehabilitation Tax Credit

The 1996 General Assembly enacted an income tax credit for individuals, trusts and estates, and corporations equal to a designated percentage of the eligible expenses incurred in rehabilitating certified historic structures.[167] The percentage of expenses qualifying for this new credit will be phased in as follows:

Year	*Percentage*
1997	10 percent
1998	15 percent
1999	20 percent
2000 and thereafter	25 percent[168]

In order to qualify for this tax credit, the cost of the rehabilitation must equal at least fifty percent of the assessed value of the building for local real estate tax purposes in the year prior to the rehabilitation.[169] Certification for the credit must be obtained from the Virginia Department of Historic Resources, which will determine the amount of eligible expenses and issue a certificate verifying the expenses.[170] For purposes of this tax credit, a certified historic structure is a property listed on the Virginia Landmarks Register or certified by the Director of the Virginia Department of Historic Resources as contributing to the significance of a historic district either listed on the Register or certified as meeting the criteria for listing.[171]

166. VA. CODE ANN. § 58.1-339 (Cum. Supp. 1996).
167. VA. CODE ANN. § 58.1-339.2(A) (Cum. Supp. 1996).
168. *Id.*
169. VA. CODE ANN. § 58.1-339.2(C) (Cum. Supp. 1996).
170. VA. CODE ANN. § 58.1-339.2(B) (Cum. Supp. 1996).
171. VA. CODE ANN. § 58.1-339.2(C) (Cum. Supp. 1996).

2. Foreign Sales Corporations

The 1995 General Assembly amended Virginia Code section 58.1-401 to exempt foreign sales corporations ("FSC") and any income properly attributable to an FSC under federal law from taxes levied by Virginia Code sections 58.1-400 and 58.1-400.1.[172] An FSC is an export subsidy program under federal law that allows an exporter to establish an FSC in a foreign country, and either split export profits with the FSC or pay the FSC a commission on exports.[173] The profits or commissions paid to the FSC do not have to reflect the amount actually earned by the FSC under arm's length pricing rules normally applicable to transactions between affiliated corporations. This legislation would prohibit the Department of Taxation from reassigning profits or commissions paid to an FSC back to the corporation that actually earned the income.

3. Contracts with Commercial Printers

The 1995 legislature amended section 58.1-401 to ensure that an out-of-state corporation will not be subjected to Virginia's income tax solely because it contracts with a Virginia commercial printer for printing.[174] Provided that the corporation is not otherwise subject to corporate income tax, certain activities at the Virginia commercial printer's location, by or on behalf of the corporation, will not subject the corporation to Virginia income tax. The activities specified in the legislation are:

> (i) the ownership or leasing of tangible personal property located at the printer's premises which is used solely in connection with the printing contract; (ii) the sale by the corporation at another location of any property that is printed at and shipped or distributed from the printer's premises; (iii) any activities in connection with the printing contract performed by or on behalf of that corporation at the printer's premises; and (iv) any activities in connection

172. VA. CODE ANN. § 58.1-401(8) (Cum. Supp. 1996).
173. *See* 26 U.S.C. §§ 923, 927 (1994).
174. VA. CODE ANN. § 58.1-401(7) (Cum. Supp. 1996).

> with the printing contract performed by the printer for or on behalf of the corporation.[175]

This new exemption from Virginia income tax is limited to property such as printing plates, copyrights, and printed materials, and activities like quality control monitoring that are directly related to the printing contract. Sales activity by the corporation at the commercial printer is not exempt because it may closely resemble a sales office.

C. *Department of Taxation Modifies Rules on Corporate Income Tax Factor Attribution from Limited Partnerships*

The Virginia Department of Taxation (the "Department") modified its position on corporate income tax factor attribution from limited partnerships in Public Document 95-19.[176]

The Virginia income tax rules applicable to a limited partnership with corporate, partnership or individual partners raises several Virginia income tax requirements. The rules vary depending on the type of partner (entity or individual) in the partnership. Public Document 88-165[177] provides a baseline interpretation of Virginia's income tax rules for partnerships, S corporations, C corporations and individuals. However, it has been modified by a number of rulings since.[178]

1. Prior Interpretations Involving Factor Attribution From Partnerships

The Department of Taxation ruled in Public Document 88-165[179] that

175. *Id.*

176. VIRGINIA DEP'T TAXATION, PUB. DOC. 95-19 (February 13, 1995) [hereinafter PUB. DOC. 95-19].

177. VIRGINIA DEP'T TAXATION, PUB. DOC. 88-165 (June 29, 1988) [hereinafter PUB. DOC. 88-165].

178. *See* PUB. DOC. 95-19; VIRGINIA DEP'T TAXATION, PUB. DOC. 94-240 (Aug. 5, 1994) [hereinafter PUB. DOC. 94-240]; VIRGINIA DEP'T TAXATION, PUB. DOC. 92-60 (May 1, 1992) [hereinafter PUB. DOC. 92-60]; VIRGINIA DEP'T TAXATION, PUB. DOC. 88-235 (Aug. 10, 1988) [hereinafter PUB. DOC. 88-235]; VIRGINIA DEP'T TAXATION, PUB. DOC. 88-226 (July 29, 1988) [hereinafter PUB. DOC. 88-226].

179. PUB. DOC. 88-165.

> [i]f a partnership or S corporation is carrying on business, trade, profession or occupation in Virginia *or* is receiving income as a partner in a partnership which is carrying on a business, trade, profession or occupation in Virginia, the pass-through of Virginia source income will continue until the income is passed through to a partner that is a taxable entity (an individual or C corporation).[180]

The Department modified Public Document 88-165 with its ruling in Public Document 88-226.[181] The Department ruled that a corporation holding a general partnership interest in a partnership must include its proportionate share of partnership property, payroll and sales in its own corporate factors for purposes of apportioning Virginia taxable income.[182] The same result does not apply when the corporation has only a limited partner interest in a partnership. In Public Document 88-235,[183] the Department further modified Public Document 88-165 and ruled that a corporate limited partner was not required to include its share of partnership property, payroll and sales for purposes of determining its Virginia apportionment factor.[184]

In Public Document 92-60,[185] the Department modified its position in Public Document 88-235 when it ruled that a corporation that was *both* a general and a limited partner in the same partnership must include its proportionate share (general and limited) of partnership property, payroll and sales in its own factors when apportioning Virginia taxable income.[186]

Approximately two years later, the Department again modified its earlier position in Public Document 88-235 with respect to factor attribution from a limited partnership. In Public Document 94-240,[187] the Department ruled that factor attribution attributable to a limited partnership interest held by an S cor-

180. *Id.* at 6.
181. PUB. DOC. 88-226.
182. *Id.* at 2.
183. PUB. DOC. 88-235.
184. *Id.* at 2.
185. PUB. DOC. 92-60.
186. *Id.* at 3.
187. PUB. DOC. 94-240.

poration is *required* in order to properly reflect the Virginia taxable income of non-resident S corporation shareholders.[188]

2. Newest Modification of Factor Attribution Rules From Partnerships

In Public Document 95-19,[189] the Department again found it necessary to modify its position in Public Document 88-235, although the facts in Public Document 95-19 are quite different from the earlier rulings. In Public Document 95-19, a Virginia limited partnership had two partners that were foreign corporations. Company A was the ninety-nine percent limited partner and Company B, a related party, held a one percent general partnership interest.[190] The usual scenario involving a two-partner partnership would involve an unrelated third party as the general partner.

Typically these limited partnership interests were structured as "tax shelters" or "master limited partnerships." In either scenario, the Department usually found that because the partnership interests were passive investments representing a small overall percentage ownership interest in the partnership, factor attribution would not be required.[191] Under the facts described in Public Document 95-19, however, the general partner was a related party, the partnership was an active operating company (not a passive investment), and the affiliated group held 100% of the partnership interest.[192]

The Department stated that if it did not require factor attribution from the limited partnership, Company A would be able to avoid Virginia taxation on 99% of the Virginia business activity carried on by the limited partnership.[193] To avoid this result, the Department relied on the principles contained in Virginia Code sections 58.1-445 and 58.1-446 to adjust the tax-

188. *Id.* at 3.
189. PUB. DOC. 95-19.
190. *Id.* at 1.
191. *Id.* at 2.
192. *Id.*
193. *Id.* at 3.

able income of the two companies.[194] Section 58.1-445 provides:

> In any case of two or more related trades or businesses liable to taxation under this chapter owned or controlled directly or indirectly by the same interests, the Department may, and at the request of the taxpayer shall, if necessary in order to make an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses, consolidate the accounts of such related trades or businesses.[195]

Section 58.1-446 provides that the Department may require a consolidated report by related corporations if Virginia income is not equitably reported.[196]

In holding that "[Company] A was required to include its proportionate share of the [limited partnership]'s property, payroll and sales with its own property, payroll and sales data for purposes of determining its Virginia apportionment factor," the Tax Commissioner said the result would "be the same regardless of whether [Company] A had any other business activity in addition to holding the limited partnership interest."[197] The Department indicated that if requiring Company A to include its share of the limited partnership's factors improperly reflected Virginia taxable income from business done in Virginia, the Department would seek other remedies, including consolidating Company A with the limited partnership or consolidating Company A with Company B.[198]

Although the Department of Taxation officially modified Public Document 88-235 with its ruling in Public Document 95-19, it said it will continue to follow Public Document 88-235 in situations where:

> i) a corporation holds a limited partnership interest; ii) all general partners are unrelated third parties; iii) the combined partnership interests held by the corporation and all

194. *Id.* at 2-3.
195. *Id.* (citing VA. CODE ANN. § 58.1-445 (Repl. Vol. 1991)).
196. VA. CODE ANN. § 58.1-446 (Repl. Vol. 1991).
197. PUB. DOC. 95-19 at 3.
198. *Id.*

> related parties constitute 10% or less of the profit and capital interests of the limited partnership; and iv) the structure is not a device primarily designed to avoid Virginia taxation of the limited partnership's income.[199]

The Commissioner stated that the Department will continue to examine other situations on a case-by-case basis.[200]

II. RETAIL SALES AND USE TAXES

A. *Recent Judicial Decisions*

In *Carr v. Forst*,[201] the Supreme Court of Virginia unanimously held that the Tax Commissioner's imposition of a "purpose of the publication" requirement amounts to a misinterpretation of the tax exemption language contained in the Virginia Retail Sales and Use Tax Act[202] under former section 58.1-608(A)(6)(c) of the Virginia Code.[203] The taxpayers in *Carr* compiled and distributed magazines to the general public in which real estate brokerage firms advertised residential property for sale. The magazines were published every four weeks and were distributed by the taxpayers free of charge to the cities shown on the covers of the magazines. In a declaratory judgment proceeding, the taxpayers sought a determination that they were exempt from the Virginia Retail Sales and Use Tax Act under former section 58.1-608(A)(6)(c). The Department of Taxation argued that the statutory exemption was not available to the Carrs' publication because the purpose of the publication was intended to promote the sale of goods and/or services.[204] The Department took the position that if a publication was intended to communicate ideas and information, such a publication would be entitled to the exemption.[205] However, the

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199. *Id.*
200. *Id.*
201. 249 Va. 66, 453 S.E.2d 274 (1995).
202. VA. CODE ANN. § 58.1-608(A)(6)(c) (Repl. Vol. 1991 & Cum. Supp. 1992). This exemption from Virginia sales and use tax was recodified at Virginia Code § 58.1-609.6(3) by the 1993 General Assembly and amended in 1995. VA. CODE. ANN. § 58.1-609.6(3) (Cum. Supp. 1996).
203. *Carr*, 249 Va. at 70-71, 453 S.E.2d at 276.
204. *Id.* at 70, 453 S.E.2d at 276.
205. *Id.*

Department of Taxation argued that the exemption should not apply to magazines whose purpose was to advertise the sale of real estate rather than communicate information.[206]

The Supreme Court of Virginia held that the statute exempts "any publication" without any exception or qualification.[207] Specifically, the supreme court stated that "the Commissioner reads into the statute an element (*i.e.*, the purpose of the publication) that is contrary to the statute's plain meaning."[208] The supreme court reversed the trial court's judgment and entered a final judgment for the taxpayers declaring that the costs of the printing of the magazines were exempt from the retail sales and use tax.[209]

Taxpayers also successfully recovered against the Department of Taxation in *Old Dominion Camera Shop, Inc. v. Department of Taxation*.[210] The taxpayer was a "camera shop" which sold cameras, lenses, camera bags, film, development equipment, and picture frames, and also developed film and made copies and enlargements of photographs. The Department of Taxation levied taxes on the supplies and equipment used in Old Dominion Camera Shop's photo-finishing process. These supplies consisted of chemicals, developer, fixer, bleach, and the paper used in the process. The equipment involved was a "mini lab" and a "silver recovery" unit.[211] The mini lab had two components: a film processor and a paper processor.

Undeveloped film from a customer's camera was placed in the film processor to create negatives. The negatives were then placed in the paper processor to create photographs. The silver recovery unit was used to collect the residue of the chemicals used during the developing process.[212]

The trial court held that the taxes imposed on these chemicals and equipment were improperly assessed and ordered those

206. *Id.*
207. *Id.* at 71, 453 S.E.2d at 276.
208. *Id.*
209. *Id.*, 453 S.E.2d at 277.
210. 38 Va. Cir. 374 (Richmond City 1996).
211. *Id.* at 374.
212. *Id.* at 374-75.

taxes to be refunded.[213] In reaching this decision, the Richmond Circuit Court found the photo-finishing business of the Old Dominion Camera Shop to be an industrial operation which qualified for an exemption from sales and use taxes under section 58.1-609.3(2).[214] The Tax Department argued that the photo-finishing business was similar to the processing operations conducted by the taxpayers in *Golden Skillet Corp. v. Commonwealth*[215] and *Commonwealth v. Orange-Madison Cooperative*,[216] however, the circuit court did not agree.[217]

B. *Significant Recent Legislative Activity*

The 1995 General Assembly adopted legislation that exempts from the Virginia use tax purchases from out-of-state mail order companies totalling $100 or less during any calendar year.[218] Prior to this legislation, the Department of Taxation did not require individuals to file use tax returns if their total purchases, upon which no Virginia sales tax was paid, were twenty-five dollars or less. The 1995 legislation increases the threshold filing amount by seventy-five dollars and extends the filing threshold to businesses.[219] Virginia residents who make purchases from out-of-state mail order companies totalling more than $100 during any calendar year must pay use tax on the total purchase amount, with no exemption for the first $100 in purchases.[220]

The 1995 legislature also adopted an exemption for third party gift transactions in which a nonresident, by mail or telephone purchase order, directs a Virginia business to deliver the personal property as a gift to another nonresident.[221] Gifts delivered to Virginia residents at the direction of out-of-state pur-

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213. *Id.* at 378.
214. *Id.*
215. 214 Va. 276, 199 S.E.2d 511 (1973).
216. 220 Va. 655, 261 S.E.2d 532 (1980).
217. *Old Dominion Camera*, 38 Va. Cir. at 376-77.
218. VA. CODE ANN. § 58.1-604(5) (Cum. Supp. 1996).
219. VA. CODE ANN. § 58.1-604(5) (Cum. Supp. 1995).
220. *Id.*
221. VA. CODE ANN. § 58.1-602 (Cum. Supp. 1996).

chasers and gifts purchased by Virginia residents for delivery to out-of-state recipients remain taxable.[222]

A new exemption for sales of printed materials to a Virginia advertising agency of printed materials for distribution out-of-state was also adopted by the 1995 General Assembly.[223] This legislation also exempts newspaper supplements for placement in in-state and out-of-state publications.[224] Prior to this change, printing for use out-of-state, as well as newspaper advertising supplements, were normally exempt from the tax, but were taxable to advertising agencies under a specific provision of law.[225]

Another significant piece of legislation enacted by the 1995 legislature modifies the nexus requirements for certain limited transactions involving Virginia commercial printers.[226] The statute ensures that an out-of-state person who contracts with a commercial printer in Virginia will not be subject to sales tax or registration and collection requirements solely because of their contractual relationship with the printer.[227] The legislation specifies four activities by such a person that are not to be considered in determining whether a person is required to register as a dealer for sales tax purposes. These activities include: (1) owning or leasing property at the printer's premises which is used solely in connection with the printing contract with that person;[228] (2) the sale of property printed at and shipped or distributed from the printer's premises;[229] (3) activities in connection with the printing contract with the person performed by or on behalf of that person at the printer's premises;[230] and (4) activities in connection with the printing contract with the person performed by the printer elsewhere in Virginia for or on behalf of that person.[231] Note, however, if that person conducts other activities on its own accord—for example, operating

222. *See id.*
223. VA. CODE ANN. § 58.1-609.6(4) (Cum. Supp. 1996).
224. *Id.*
225. See VA. CODE ANN. § 58.1-602, -609.6(4) (Cum. Supp. 1994).
226. VA. CODE ANN. § 58.1-612(D) (Cum. Supp. 1996).
227. *Id.*
228. VA. CODE ANN. § 58.1-612(D)(1) (Cum. Supp. 1996).
229. VA. CODE ANN. § 58.1-612(D)(2) (Cum. Supp. 1996).
230. VA. CODE ANN. § 58.1-612(D)(3) (Cum. Supp. 1996).
231. VA. CODE ANN. § 58.1-612(D)(4) (Cum. Supp. 1996).

a warehouse or office, sending sales representatives into the state to solicit sales, or advertising in newspapers or other periodicals printed and published within Virginia—this legislation will have no bearing on its tax registration and collection requirements.

The 1996 Session of the General Assembly took a considerably more stringent view of bills creating additional exemptions or exclusions from Virginia's sales and use taxes. One successful legislative effort involved the prescription medicine and drug exemption.[232] This legislation addressed the appropriate tax treatment applicable to research pharmaceutical manufacturers who provide free samples of prescription drugs and medicines to Virginia licensed physicians. Generally, the research pharmaceutical manufacturing industry considered the distribution of prescription drug and medicine samples to Virginia licensed physicians at no cost to be exempt from Virginia use tax.

Research pharmaceutical manufacturers use representatives or "detailmen" who live both in and outside of Virginia. The "detailmen" describe the company's prescription pharmaceutical products and provide prescription pharmaceutical drug samples to Virginia physicians. In connection with this activity, these representatives take prescription pharmaceutical drug samples with them. The prescription pharmaceutical samples are medicinally identical to the products obtained from a pharmacist. The primary differences between the prescription products sold by a pharmacist and the samples dispensed at no cost by Virginia physicians are the packaging size and labeling of the samples. Samples are packaged in smaller quantities than those sold by pharmacists and the packaging is clearly labeled as a "professional sample." The detailmen call upon Virginia licensed physicians to inform the physicians of new products or developments and to distribute samples of prescription pharmaceuticals. Under federal law, only prescription pharmaceutical samples requested and signed for by the physician may be left at the doctor's offices.[233]

Virginia physicians use these prescription pharmaceutical samples in conjunction with prescribing the particular pharma-

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232. VA. CODE ANN. § 58.1-609.7(1) (Cum. Supp. 1996).
233. *See* Prescription Drug Marketing Act of 1987, 21 U.S.C. § 353(d)(2) (1994).

ceutical product to a patient. The prescription pharmaceutical samples are generally passed along by physicians to patients in three situations. First, understanding that prescription pharmaceuticals are generally very expensive, physicians give samples to patients for an initial "trial period." Providing a short-term supply of a drug in the form of a sample allows the physician to evaluate whether or not a patient can tolerate a drug and whether it interacts properly with that patient before the patient spends a potentially large sum of money filling the prescription for a longer term. If the drug works and no undue side effects are noted, the patient will then purchase the prescription medicine from a pharmacist and continue to take it. If, however, the sample medication does not work, or causes unacceptable side effects, a prescription for an alternative pharmaceutical product will be provided and the patient saves the high cost of a prescription that he or she is unable to tolerate.

Second, the prescription pharmaceutical sample is a starter kit for the patient so that the patient begins taking the drug promptly. Third, prescription pharmaceutical samples are provided by physicians to patients who cannot afford to purchase the drug in the quantity necessary to treat their medical condition.

Virginia Code section 58.1-609.7(1) provides an exemption from Virginia sales and use taxes for medicines and drugs that are dispensed by or sold according to prescriptions or work orders of licensed physicians.[234] Nowhere in the Virginia Retail Sales and Use Tax Act are there definitions for the terms "dispensed by," "prescriptions," or "work orders." However, the Virginia Drug Control Act[235] provides the relevant definitions. The term "dispense" means "to deliver a drug to an ultimate user or research subject buyer pursuant to the lawful order of a practitioner, including the prescribing and administering, packaging, labeling, or compounding necessary to prepare the substance for that delivery."[236]

In 1994, the Department of Taxation released three administrative rulings that specifically addressed the application of

234. VA. CODE ANN. § 58.1-609.7(1) (Cum. Supp. 1996).
235. VA. CODE ANN. §§ 54.1-3400 to -3472 (Repl. Vol. 1994 & Cum. Supp. 1996).
236. VA. CODE ANN. § 54.1-3401 (Cum. Supp. 1996).

Virginia's use tax to the prescription drug exemption in the context of prescription pharmaceutical samples.[237] The import of the 1994 rulings is that a pharmaceutical manufacturer realizes a marketing or advertising "taxable use" benefit by providing Virginia physicians with samples.[238] In reaching this result, the Department held that the pharmaceutical manufacturer's first taxable use occurs when the prescription drug or medicine sample is withdrawn from the manufacturer's inventory with the intent to distribute the samples to licensed physicians.[239]

The 1996 General Assembly amended section 58.1-609.7(1) to specifically overrule the three Department of Taxation rulings which applied the use tax to the distribution of prescription pharmaceutical drugs and sample medicines to Virginia licensed physicians.[240]

Another important piece of legislation enacted by the 1996 General Assembly involves an exclusion from sales and use taxes for certain ships, vessels, and dredges, and repairs and alterations to these watercraft.[241] Virginia Code section 58.1-609.3(4) of the specifically provides an exemption for: (1) ships or vessels used exclusively or principally in interstate or foreign

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237. VIRGINIA DEP'T TAXATION, PUB. DOC. 94-78 (March 21, 1994); VIRGINIA DEP'T TAXATION, PUB. DOC. 94-97 (March 31, 1994); VIRGINIA DEP'T TAXATION, PUB. DOC. 94-122 (April 20, 1994).

238. *See* documents cited *supra* note 238.

239. *Id.*

240. VA. CODE ANN. § 58.1-609.7(1) (Cum. Supp. 1996). In a dialogue between members of the House Finance Committee and representatives of the Department, the Committee specifically stated that all prescription pharmaceutical products are not to be taxed. *Hearings on H.B. 224 Before the House Finance Comm.*, Va. Gen. Assembly, (Reg. Sess. 1996) (unpublished). In particular, Delegate Rhodes argued vociferously that the Department of Taxation should not tax any prescription pharmaceutical drugs and medicines. *Hearings on H.B. 224 Before the House Finance Comm.*, Va. Gen. Assembly, (Reg. Sess. 1996) (statement of Delegate Rhodes) (unpublished). From hearings before both the House Finance Committee and the Senate Finance Committee, it was clearly evident that Virginia legislators do not want any tax imposed on prescription pharmaceutical products. *Hearings on H.B. 224 Before the House Finance Committee and the Senate Finance Comm.*, Va. Gen. Assembly, (Reg. Sess. 1996) (unpublished). In other words, the Virginia General Assembly's legislative intent behind the prescription pharmaceutical drug and medicine exemption is that "as a class these prescription drug products are exempt from Virginia sales and use taxes." *Hearings on H.B. 224 Before the House Finance Comm.*, Va. Gen. Assembly, (Reg. Sess. 1996) (statement of Delegate Rhodes) (unpublished)

241. VA. CODE ANN. § 58.1-609.3(4) (Cum. Supp. 1996).

commerce and repairs and alterations to such vehicles; (2) fuel and supplies for use or consumption on vessels plying the high seas; and (3) materials used in the building, conversion or repair of any of the vessels in either (1) or (2).[242]

This legislation codifies the Department of Taxation's policy of exempting dredges and attendant vessels used directly in the dredging of interstate waterways, and expands the exemption for ships and vessels to include supporting equipment and other attendant vessels used or to be used in dredging operations exclusively or principally in interstate commerce. The newly expanded exemption will apply to vessels used to transport employees or equipment to and from the dredge site. Vessels used to survey and mark the dredge area, repair parts for such vehicles, buoys, fuel used to power equipment aboard the dredge and other vessels, ropes, chains, and other tangible personal property used in dredging operations exclusively or principally in interstate commerce are also exempt.[243]

On a procedural note, another important piece of legislation in the sales and use tax area establishes new requirements for the introduction of exemptions or exclusions from sales and use tax. The 1996 General Assembly adopted legislation, effective beginning July 1, 1998, that requires sales and use tax exemption bills to be introduced in the General Assembly *only* in regular sessions of even-numbered years.[244] The legislation will not apply to any bill extending the expiration date or delaying the effective date of any sales and use tax exemptions.[245]

III. TAXPAYER BILL OF RIGHTS ENACTED

The 1996 General Assembly enacted a Virginia Taxpayer Bill of Rights which will take effect on July 1, 1997.[246] This legislation is intended to protect the "rights, privacy, and property of Virginia taxpayers" with respect to taxes administrated by

242. *Id.*
243. *Id.*
244. VA. CODE ANN. §§ 30-19.05(A), -19.1:3 (Repl. Vol. 1992 & Cum. Supp. 1996).
245. VA. CODE ANN. § 30-19.1:3 (Repl. Vol. 1992 & Cum. Supp. 1996).
246. VA. CODE ANN. § 58.1-1845 (Cum. Supp. 1996).

the Department of Taxation.[247] Generally, the legislation summarizes the rights and obligations of taxpayers and the Department of Taxation during the initial tax assessment through the collection and enforcement processes.[248] The legislation package also amends a number of statutes governing the powers and authorities granted to the Tax Commissioner for enforcement and administration of the State Tax Code and codifies specific rights for taxpayers.[249] Generally, the legislative package performs the following functions: (1) allows taxpayers fourteen days in which to contest jeopardy assessments and requires a response by the Department of Taxation within twenty days of a meeting;[250] (2) creates a statutory framework for allowing installment payment plans for outstanding tax liabilities;[251] (3) creates a taxpayer resolution program and provides for a taxpayer rights advocate and adequate staff to administer the program;[252] (4) requires the Department of Taxation to provide a written explanation of the audit and collection process; allows a taxpayer to be represented at meetings and to suspend meetings to consult with the representative; and allows taxpayers and the Department to make audio recordings of meetings;[253] and (5) creates the right of abatement of penalty, interest or tax attributable to erroneous advice from the Department of Taxation.[254]

Contained within the main body of the Virginia Taxpayer Bill of Rights statutory scheme is a list of sixteen rights specifically guaranteed to Virginia taxpayers. Effective July 1, 1997, Virginia taxpayers will specifically enjoy the following rights:

> 1. The right to available information and prompt, courteous, accurate responses to questions and requests for tax assistance.
> 2. The right to request assistance from a taxpayers' rights advocate, . . . [an employee within the Department

247. *Id.*
248. *Id.*
249. *See* VA. CODE ANN. §§ 58.1-202, -307, -313, -1805, -1817, -1818, -1834, -1835, -1845 (Cum. Supp. 1996).
250. VA. CODE ANN. § 58.1-313(C) (Cum. Supp. 1996).
251. VA. CODE ANN. § 58.1-1817 (Cum. Supp. 1996).
252. VA. CODE ANN. § 58.1-1818 (Cum. Supp. 1996).
253. VA. CODE ANN. § 58.1-1834 (Cum. Supp. 1996).
254. VA. CODE ANN. §§ 58.1-1835, -1845(4) (Cum. Supp. 1996).

of Taxation] responsible for facilitating the resolution of taxpayer complaints and problems not resolved through normal administrative channels within the Department.

3. The right to be represented or advised by counsel or other qualified representative . . . in . . . administrative interactions with the Department [of Taxation]; the right to procedural safeguards with respect to recording of meetings during tax determination or collection processes conducted by the Department [of Taxation]; . . . and [t]he right to have audits, inspections of records, and meetings conducted at a reasonable time and place except in criminal or internal investigations . . . .

4. The right to abatement of tax, interest, and penalties . . . when the taxpayer reasonably relies upon binding written advice furnished [by an authorized departmental representative] in response to the taxpayer's specific written request which provided adequate and accurate information.

5. The right to obtain simple, nontechnical statements which explain the procedures, remedies, and rights available during audit, appeals, and collection proceedings . . . and the right to be provided with an explanation for details of refunds as well as the basis of the audit, assessments, or denials of refunds which identify any amount of tax, interest or penalty due and which explain the consequences of the taxpayer's failure to comply with the notice . . . .

6. The right to be informed of impending collection actions which require sale or seizure of property or freezing of assets, except jeopardy assessments, and the right to at least fourteen days' notice in which to pay the liability or seek further review.

7. [T]he right to have an immediate review of [a] jeopardy assessment . . . .

8. The right to seek review, through formal or informal proceedings, of any adverse decisions relating to determinations in the audit or collections processes.

9. The right to have the taxpayer's tax information kept confidential, unless otherwise specified by law . . . .

10. The right to procedures for retirement of tax obligations by installment payment agreements . . . .

11. The right to procedures . . . for requesting for release of liens filed by the Department [of Taxation] and for requesting that any lein which is filed in error be so noted on the lien cancellation filed by the Department . . . .

12. The right to procedures which assure that the individual employees of the Department [of Taxation] are not paid, evaluated, or promoted on the basis of the amount of assessments or collections from taxpayers . . . .

> 13. The right to have the Department [of Taxation] begin and complete its audits in a timely and expeditious manner after notification of intent to audit.[255]

PART TWO: TAXES ADMINISTERED BY LOCALITIES

IV. CLASSIFICATION OF INTANGIBLE AND TANGIBLE PERSONAL PROPERTY

A. *Recent Judicial Decision:* City of Winchester v. American Woodmark Corp.[256]

In a widely anticipated decision, the Supreme Court of Virginia unanimously held in *City of Winchester v. American Woodmark Corp.*[257] that a manufacturer's furniture, fixtures, office equipment and computer equipment located in its corporate headquarters are "used in" its manufacturing business, even though no products are specifically manufactured within the taxing jurisdiction.[258] This case required the supreme court to interpret the interplay between Virginia's intangible personal property and tangible personal property statutory tax schemes.

1. Virginia's Intangible Personal Property Tax

Virginia Code section 58.1-1100 segregates intangible personal property and the capital of a trade or business (except merchants' capital as defined in Virginia Code section 58.1-3510) for state taxation only, not for local taxation.[259] Section 58.1-1101(A)(2) defines intangible personal property as capital that is personal property, tangible in fact, and used in a manufacturing business.[260]

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255. VA. CODE ANN. § 58.1-1845 (Cum. Supp. 1996).
256. 250 Va. 451, 464 S.E.2d 148 (1995).
257. *Id.*
258. *Id.* at 457, 464 S.E.2d at 152.
259. VA. CODE ANN. § 58.1-1100 (Repl. Vol. 1991).
260. VA. CODE ANN. § 58.1-1101(A)(2) (Repl. Vol. 1991 & Cum. Supp. 1996).

By virtue of the intangible personal property tax classification statutes, a taxpayer could easily owe tax on a number of tangible personal property items used in a manufacturing business which are now treated as if they were intangible personal property assets. With this classification, only the Commonwealth of Virginia can impose a tax on the property, even though such property is physically "touchable or grabable" as tangible in fact property.[261] Currently, Virginia does not impose an intangible personal property tax.[262] By virtue of this lack of taxation on intangible personal property, taxpayers frequently take the position that if they are a manufacturer then all of their tangible in fact personal property items are intangible property, and thus not subject to taxation by the local taxing jurisdiction.

This awkward conclusion was approved by the Supreme Court of Virginia in *Roanoke v. James W. Michael's Bakery Corp.*[263] The taxpayer, *Michael's Bakery*, was engaged in the bakery business in the City of Roanoke and owned a number of delivery trucks. The case is unique because the Commonwealth of Virginia and the City of Roanoke were at odds as to which entity was the appropriate taxing authority. Roanoke maintained that under section 171 of the 1902 Constitution[264] (predecessor to Article X, Section 4 of the 1971 Virginia Constitution),[265] the Commonwealth lacked jurisdiction to tax tangible personal property. The City maintained that such property was segregated for local taxation only. Roanoke also argued that under section 168 of the 1902 Constitution[266] (predecessor to Article X, Section 1),[267] the General Assembly's power to define and classify taxable property is subject to such segregation.[268] The Commonwealth argued that the last sentence of section 168 of the 1902 Constitution provided the General Assembly with a broad power to define and classify taxable sub-

261. *Id.*
262. VA. CONST. art. X, § 6(a)(5).
263. 180 Va. 132, 21 S.E.2d 788 (1942).
264. VA. CONST. § 171 (1902).
265. VA. CONST. art. X, § 4.
266. VA. CONST. § 168 (1902).
267. VA. CONST. art. X, § 1.
268. *Michael's Bakery*, 180 Va. at 138-41, 21 S.E.2d at 791-92.

jects, including classifying intangible personal property as tangible personal property.[269]

The Roanoke Circuit Court concluded that the Commonwealth of Virginia was the appropriate taxing authority.[270] In upholding the trial court, the Supreme Court of Virginia looked at the long standing practice of classifying capital used in a business as intangible personal property. The supreme court noted that at the time the Constitution of 1902 became effective, the General Assembly met in an extra session to adjust the statutory law to the changes made in the new 1902 Constitution.[271] The General Assembly continued to classify and define capital, as a composite whole, as intangible personal property, although it includes items which were tangible in fact.[272] The supreme court noted a continuation of the practice of treating tangible in fact property as intangible personal property when such property was used as capital in a business.[273]

The supreme court stated that when the General Assembly segregated "tangible personal property" for local taxation, it did not intend to include in that term capital employed in business, for this was expressly classified as "intangible personal property" and was segregated for taxation by the State although the definition of capital included some items of personal property which were tangible in fact.[274] The supreme court stated that when the statutes were revised in 1928, the General Assembly and the Commission for the Revision, Simplification and Codification of the general tax laws of Virginia were cognizant of the constitutional segregation in existence at that time.[275]

The Virginia Tax Commissioner testified that since assuming office in 1926, he had uniformly enforced the statute requiring that inventory or stock on hand, furniture and fixtures and delivery equipment of mining and manufacturing concerns be reported as capital to the State for taxation purposes.[276] The

269. *Id.* at 141-42, 21 S.E.2d at 792.
270. *Id.* at 137, 21 S.E.2d at 789.
271. *Id.* at 144, 21 S.E.2d at 793.
272. *Id.* at 145, 21 S.E.2d at 793.
273. *Id.* at 146, 21 S.E.2d at 794.
274. *Id.* at 149, 21 S.E.2d at 795.
275. *Id.* at 149-50, 21 S.E.2d at 796.
276. *Id.* at 151, 21 S.E.2d at 796.

Tax Commissioner also testified that local tax officials had acquiesced in this practice.[277] His testimony indicated that this practice was so deeply rooted in the Virginia scheme of taxation that adopting the argument of the City of Roanoke would result in a heavy loss of revenue to Virginia, with a corresponding gain to localities.[278]

The supreme court concluded that section 171 of the 1902 Constitution made no specific allocation of intangible personal property, including capital, to the State for taxation.[279] The supreme court noted that segregation was merely the result of the statute.[280] The supreme court opined that "if the General Assembly, as a matter of policy, deems it proper to exclude from its definition of capital certain property of a few businesses . . . which the State [may] otherwise tax, and sees fit to segregate such property to the localit[y] for taxation, there is nothing in the [Virginia] Constitution to prohibit [the General Assembly] from doing so."[281]

Commentators have criticized *Michael's Bakery* and believe that Judge Eggleston was understandably hard pressed to reach the conclusion which the General Assembly doubtlessly intended. One author called for the end of the fiction that permits a State statute to provide that property which is tangible in fact must be considered intangible in order to circumvent the clear mandate of the Virginia Constitution.[282] In a strongly worded

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277. *Id.*
278. *Id.*
279. *Id.* at 154, 21 S.E.2d at 798.
280. *Id.*
281. *Id.*
282. *See* Alan J. Hofheimer, *Taxation of Personal Property in Virginia: A Plea for Clarification*, 44 VA. L. REV. 127, 133 (1958). Hofheimer added that:

> [i]t would seem that the General Assembly does not have the inherent power in classifying subjects for taxation to disregard the segregation provision of the State Constitution. It, therefore, has not the authority to accomplish its purpose by calling black white, by calling a truck an intangible asset, or by any other method of indirection. The argument advanced by the Virginia Supreme Court of Appeals from time to time, that this has been going on for many years, is unimpressive. If the Tax Department of the State of Virginia cannot find sufficient taxable subjects under the State Constitution to meets its revenue requirements, and it is unable to obtain a constitutional amendment which will increase its taxable subjects, then it should endeavor to have the rate of tax raised on subjects available to it. The State should not tax property which the

dissent to *Michael's Bakery*, Justice Holt closed his opinion by stating that "one must travel far to prove that a truck is not a truck."[283]

The supreme court's decision in *Michael's Bakery* precludes a realistic opportunity to directly challenge the constitutionality of Virginia's intangible personal property tax scheme. Subsequent challenges by local tax authorities have taken the form of narrowly interpreting the definition of intangible personal property in an attempt to "carve out" items of tangible in fact business property. The City of Winchester recently attempted just such an opportunity in *City of Winchester v. American Woodmark Corp.*[284]

2. American Woodmark Corporation Seeks Refund

American Woodmark Corporation ("American Woodmark") is a publicly traded Virginia corporation with its corporate headquarters located in the City of Winchester, Virginia. American Woodmark was engaged in the manufacture and sale of wooden kitchen cabinets and vanities. Component parts were manufactured at four locations, all of which were outside the geographical boundaries of the City of Winchester. In addition, American Woodmark had a number of assembly plants, distribution centers, sales and service centers, and manufacturing facilities located outside Virginia. American Woodmark did have an assembly facility and a component manufacturing plant located within Virginia, but outside the City of Winchester.[285]

The functions performed at the corporate headquarters included establishing and monitoring overall corporate direction and strategy, overall management of American Woodmark's business, consolidated reporting of its financial information, approving extensions of credit to prospective customers, selling and marketing of cabinets and vanities produced by other American Woodmark facilities, invoicing sales, collecting ac-

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> State Constitution declares only can be taxed by cities or counties . . . . This is not good judicial reasoning.

Id.

283. *Michael's Bakery*, 180 Va. at 158, 21 S.E.2d at 800 (Holt, J., dissenting).

284. 250 Va. 451, 464 S.E.2d 148 (1995).

285. *Id.* at 454-55, 464 S.E.2d at 150-51.

counts receivable, paying purchase invoices, maintaining a company-wide computer network, and fulfilling the accounting, tax and regulatory compliance functions required to manage and operate the company's business activities. American Woodmark did not engage in the actual production of cabinets and vanities at its corporate headquarters in the City of Winchester, nor any other location within the geographical boundaries of the City of Winchester.

For the tax years 1989-1992, American Woodmark filed the appropriate business schedules for the City of Winchester with Commissioner of the Revenue Lacky G. Sempeles.[286] These business schedules reported personal property of American Woodmark located within the City of Winchester. On the basis of the information supplied on each business schedule, Commissioner Sempeles billed American Woodmark for personal property taxes for each of the years at issue on all of the items of property listed on the business schedules by American Woodmark.[287] American Woodmark then paid to the City of Winchester the personal property taxes assessed against it.[288]

Subsequently, American Woodmark timely filed a request for refund with Commissioner Sempels, including amended returns for each of the years 1989-1992.[289] The refund request was based on American Woodmark's contention that no tangible personal property tax is properly assessed by the City of Winchester on any tangible property used by American Woodmark in its facilities in the City of Winchester, other than machinery and tools, motor vehicles and delivery equipment.[290] The amount of American Woodmark's refund request totalled $464,637.[291] Commissioner Sempeles, acting in his capacity as Commissioner of Revenue for the City of Winchester, denied American Woodmark's refund request for the tax years at issue.

286. American Woodmark Corp. v. City of Winchester, 34 Va. Cir. 421, 430 (Winchester City 1994).
287. *Id.*
288. *Id.*
289. *Id.* at 430-31.
290. *Id.* at 431.
291. *Id.*

The primary issue in *American Woodmark* was whether the taxpayer's computers, office fixtures and office equipment located in its corporate headquarters constituted capital that was personal property, tangible in fact, used in a manufacturing business and more properly classified as intangible personal property under Virginia Code section 58.1-1101(A)(2). The City of Winchester contended that since American Woodmark did not perform any actual manufacturing within the City, then the tangible personal property in question could not be "personal property, tangible in fact, [and] used in a manufacturing" business.[292] American Woodmark argued that as a manufacturer of wood cabinets and vanities, all of its tangible in fact personal property should be classified as intangible personal property under section 58.1-1101(A)(2) unless such property is otherwise classified as machinery and tools, motor vehicles and delivery equipment.[293] These latter classifications of property are carved out of the intangible personal property definition and segregated for local taxation as tangible personal property.

3. Trial Court Orders Tax Refund

Winchester Circuit Court Judge Wetsel, in an extensive twenty-five page opinion, held that American Woodmark was entitled to a full refund of the personal property taxes paid that were allocable to the computer equipment, office fixtures, and office furniture located within the City of Winchester.[294] Judge Wetsel's opinion provides a valuable review of the intangible personal property tax scheme as it relates to tangible business property and machinery and tools. In his decision, Judge Wetsel stated that the propositions relied on by the City of Winchester—that tax exemptions are to be construed strictly against the taxpayer and that the taxpayer has the burden of establishing entitlement of an exemption—were not applicable.[295] Specifically, Judge Wetsel stated:

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292. City of Winchester v. American Woodmark Corp., 250 Va. 451, 455, 464 S.E.2d 148, 151 (1995).

293. *Id.* at 455-56, 464 S.E.2d at 151.

294. American Woodmark Corp. v. City of Winchester, 34 Va. Cir. 421, 445-46 (Winchester City 1994).

295. *Id.* at 433.

> Sections 58.1-1100 and 58.1-1102(A)(2) do not exempt from tax property which would otherwise be subject to taxation. Rather, they classify and define what property is to be segregated for taxation solely by the Commonwealth. Therefore, this is not about an exemption but rather a limitation on the City's authority to tax and the standards of strict construction is applied against the City and not the taxpayer.[296]

The trial court relied on the longstanding and established rule that statutes imposing taxes are to be construed most strongly against the government, and in favor of the citizens. The circuit court stated, "[w]henever there is doubt concerning such a statute, that doubt should absolve the taxpayer from his burden."[297] In reaching this conclusion, Judge Wetsel stated that the court should be cognizant of the policy in Virginia of promoting manufacturing, and should therefore construe its definition broadly.[298]

The City of Winchester claimed that American Woodmark's business in the City was not part of a manufacturing business, but rather American Woodmark was engaged in four different businesses—manufacturing, assembling, distribution, and sales.[299] The City cited specific authorities which stand for the proposition that manufacturing is an activity which transforms new material into an article or product which is substantially different in character.[300] The Winchester Circuit Court stated that the term "manufacturing" should 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 nonetheless be classified as a manufacturer for tax purposes if the manufacturing portion of its business is substantial.'"[301]

296. *Id.* (citations omitted).

297. *Id.* at 434 (citing Commonwealth Natural Resources, Inc. v. Commonwealth, 219 Va. 529, 537-38, 248 S.E.2d 791, 796 (1978) (holding that franchise tax on gross receipts and special taxes were improperly assessed on public service corporation since there was no clear legislative intent to impose franchise tax on gross receipts).

298. *Id.* (citing County of Chesterfield v. BBC Brown Boveri, Inc., 238 Va. 64, 69, 380 S.E.2d 890, 893 (1989)).

299. *Id.*

300. *Id.* (citing Solite Corp. v. King George County, 220 Va. 661, 663, 261 S.E.2d 535, 536 (1980)).

301. *Id.* at 434-35 (quoting County of Chesterfield v. BBC Brown Boveri, Inc., 238

Judge Wetsel stated that the Commissioner of Revenue should not subdivide a Virginia business into its component activities in order to maximize taxes.[302] The Winchester Circuit Court held that American Woodmark was engaged in an integrated manufacturing business, because it transforms raw materials into cabinets, and cabinets are articles of "substantially different character" from the original raw wood and other materials.[303]

In specifically addressing the issue of the situs of the actual physical manufacturing activities, Judge Wetsel stated:

> The fact that American Woodmark does not engage in any production activities at its headquarter facility in the City of Winchester does not alter American Woodmark's status as a manufacturing business. The corporate headquarter facility is clearly part of that manufacturing business. The functions of the headquarters include overall management of American Woodmark's manufacturing and business, consolidation and reporting of its manufacturing financial information, collection of accounts receivable, credit approval, payment of purchase invoices, filing of all federal, state and local taxes, and operation and maintenance of the mainframe computer operations utilized by all American Woodmark facilities nationwide. These activities are all integral to any manufacturing business.[304]

The trial court also ruled that American Woodmark's computer equipment would not be classified as machinery and tools that are specifically excluded from the definition of intangible personal property under Virginia Code section 58.1-1101(A)(2).[305] Judge Wetsel stated that "machinery and tools," as used in the statute, refers to items that are used in connection with the operation of the machinery and that are actually and directly used in the manufacturing process.[306] Judge Wetsel concluded that American Woodmark's computers at its headquarters essentially do the work that clerks would have

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Va. 64, 69, 70, 380 S.E.2d 890, 893 (1989)).

302. *Id.* at 435.

303. *Id.*

304. *Id.*

305. *Id.* at 438-39.

306. *Id.* at 436.

done at the time when the tax statutes first began using the classification of "machinery and tools."[307] The circuit court noted that from 1918 to the present, the use of office equipment had increased geometrically, but the General Assembly had yet to add the designation of "office equipment" to the class of tangible personal property of a manufacturing business, which may be taxed only by local government units.[308]

4. Arguments Before the Supreme Court of Virginia

The City of Winchester argued to the Supreme Court of Virginia that American Woodmark's personal property located at the corporate office was subject to local taxation because American Woodmark's headquarters was not a manufacturing business under the provisions of Virginia Code section 58.1-1101(A).[309] The City argued that such personal property was not "used in" a manufacturing business.[310] In the alternative, the City of Winchester argued that if the property is used in a manufacturing business within the City, such property is part of the "machinery and tools of" that manufacturing business and thus taxable locally by the City under the provisions of section 58.1-1101(A)(2).[311] In support of its position, the City of Winchester argued that the intangible property located in American Woodmark's corporate headquarters cannot be deemed capital used in a manufacturing business because American Woodmark does not manufacture any products within Winchester's geographical boundaries.[312] The City also argued that the intangible personal property tax statutes located at Virginia Code sections 58.1-1100 and 58.1-1101 are tax exemptions and not tax classifications.[313] According to the City, under long standing rules of statutory construction for tax exemp-

307. *Id.* at 438-39.
308. *Id.* at 439.
309. City of Winchester v. American Woodmark Corp., 250 Va. 451, 455, 464 S.E.2d 148, 151 (1995).
310. *Id.*
311. *Id.*
312. *Id.*
313. *Id.*

tions, such exemptions are to be strictly construed against the taxpayer.[314]

American Woodmark argued that it was a manufacturing business within the "plain meaning" of Virginia Code sections 58.1-1100 and 58.1-1101 and that the furniture, fixtures, office equipment and computer equipment in its corporate headquarters are "used in" its manufacturing business, even though no products are specifically manufactured in Winchester.[315] The supreme court agreed with American Woodmark's contention.[316]

5. Exemption or Classification?

In reaching its decision, the Supreme Court of Virginia specifically held that Virginia Code sections 58.1-1100 and 58.1-1101(A)(2) are not tax exemptions, but rather classify certain personal property, tangible in fact, as intangible personal property and segregate that property for state taxation purposes only.[317] The supreme court stated that the plain meaning of these statutes prohibits the City of Winchester from assessing a personal property tax upon property that falls within the intangible personal property classification.[318]

The critical decision by the supreme court that the intangible personal property statutes represent a "classification" system as opposed to tax exemptions, brings into play another statutory rule of construction. It is a long-standing rule in Virginia that a municipal corporation, such as the City of Winchester, can only derive its taxing power through positive grants of authority from the General Assembly.[319] The supreme court stated that Virginia Code sections 58.1-1100 and 58.1-1101(A)(2) reflect the General Assembly's decision not to grant a specific taxing power

314. *Id.*
315. *Id.*
316. *Id.*
317. *Id.* (citing City of Roanoke v. James W. Michael's Bakery Corp., 180 Va. 132, 143-54, 21 S.E.2d 788, 793-98 (1942) (discussing history of segregation and classification of personal property for taxation)).
318. *Id.* at 456, 464 S.E.2d at 152.
319. *Id.*, 464 S.E.2d at 151 (citing Whiting v. Town of West Point, 89 Va. 741, 743 (1893)).

to the City, and these statutes must be treated as general tax statutes.[320]

Viewing the intangible personal property taxation classification statutes as general tax statutes, as opposed to tax exemptions, involves a different rule of statutory construction. The supreme court previously stated that "statutes imposing taxes are to be construed most strongly against the government, and in favor of the citizens, and are not to be extended by implication beyond the clear import of the language used. Whenever there is a just doubt, 'that doubt should absolve the taxpayer from his burden.'"[321]

In *American Woodmark*, the supreme court indicated that the intangible personal property tax statutes are unambiguous.[322] The supreme court stated that it found no language in sections 58.1-1100 or 58.1-1101(A)(2) requiring that "capital be used in a manufacturing facility *physically* located within the geographical boundaries of Winchester."[323] The supreme court specifically declined the City of Winchester's request to construe Virginia Code section 58.1-1101(A)(2) as requiring that a manufacturer maintain a manufacturing facility within the City's geographical boundaries, or that the manufacturer's capital, which is personal property, tangible in fact, be used "directly" in the manufacturing process.[324] The supreme court noted that the limitations which the City of Winchester sought to govern the case do not appear in section 58.1-1101(A)(2).[325]

6. Machinery and Tools of Manufacturers

As a fall-back argument, the City of Winchester argued that even if American Woodmark's personal property is "used in" a manufacturing business, its computer system and office equipment are "machinery and tools . . . of such business" and not

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320. *Id.*, 464 S.E.2d at 151-52.
321. *Id.*, 464 S.E.2d at 152 (citing Commonwealth Natural Resources, Inc. v. Commonwealth, 219 Va. 529, 537-38, 248 S.E.2d 791, 796 (1978)).
322. *Id.* at 457, 464 S.E.2d at 152.
323. *Id.*
324. *Id.*
325. *Id.*, 464 S.E.2d at 152.

exempt from personal property tax.[326] The City of Winchester relied upon a portion of section 58.1-1101(A)(2) which states that "[m]achinery and tools . . . of [manufacturing] businesses shall not be defined as intangible personal property for purposes of this chapter and shall be taxed locally as tangible personal property according to the applicable provisions of law relative to such property."[327] American Woodmark countered this argument by asserting that its computer system and office equipment located at the corporate headquarters were not "machinery and tools" within the meaning of section 58.1-1101(A)(2).[328]

The supreme court held that American Woodmark's furniture, fixtures, office equipment and computer equipment are not "machinery and tools" within the meaning of section 58.1-1101(A)(2) because these items are not used in connection with the operation of machinery, which is actually and directly used in the manufacturing process.[329] To reach this decision, the supreme court noted that since 1950, Virginia's Tax Commissioner has opined that the phrase "machinery and tools" contained in section 58.1-1101(A)(2) and its precursors means machinery used in the actual process of manufacturing.[330] The supreme court also noted that the Virginia Attorney General has consistently opined that "'machinery and tools used in a particular manufacturing business' are the machinery and tools which are necessary in the particular manufacturing business and which are used in connection with the operation of machinery which is actually and directly used in the manufacturing process."[331] The supreme court also found it persuasive that the Virginia General Assembly had taken no action to modify the Attorney General's opinions concerning the definition of "machinery and tools" for purposes of tangible personal property

326. *Id.*
327. *Id.* at 458, 464 S.E.2d at 152.
328. *Id.*
329. *Id.* at 458-59, 464 S.E.2d at 153.
330. *Id.* at 458, 464 S.E.2d at 152 (citing Commonwealth v. Carter, 198 Va. 141, 146-47, 92 S.E.2d 369, 373 (1956) (construction of taxation statute by Tax Commissioner charged with its enforcement is entitled to great weight)).
331. *Id.* (citing 1985-1986 Att'y Gen. Ann. Rep. 316, 317); *see also* 1987-1988 Atty. Gen. Ann. Rep. 590.

taxation.[332] The supreme court noted that the General Assembly is presumed to have knowledge of the Attorney General's interpretation of statutes, and the General Assembly's failure to make corrective amendments evinces legislative acquiescence in the Attorney General's interpretation.[333]

B. *Recent Significant Legislation*

The 1996 General Assembly moved quickly after the decision in *City of Winchester v. American Woodmark Corp.* to adopt legislation that specifically provides that certain tangible personal property used in the headquarters of a manufacturing business be classified as intangible personal property.[334]

The 1996 legislature also expanded the local tangible personal property tax classification for computer hardware used by data processing businesses to include programmable computer equipment owned by all businesses.[335] Tangible personal property classified in this category will be valued as a percentage of original cost to the taxpayer or actual fair market value.[336]

V. BUSINESS, PROFESSIONAL AND OCCUPATIONAL LICENSE TAX

A. *Recent Judicial Decisions*

At the same time it was litigating the classification of office furniture, fixtures, equipment and computers used at its corporate headquarters for Virginia property tax purposes, American Woodmark was also actively involved in litigation challenging the City of Winchester's assessments of a local business, professional and occupational license tax ("BPOL"), which had been levied against the corporation.[337] American Woodmark Corpo-

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332. *American Woodmark*, 250 Va. at 458, 464 S.E.2d at 153.

333. *Id.* (citing Browning-Ferris, Inc. v. Commonwealth, 225 Va. 157, 161-62 (1983)); Richard L. Deal & Assoc. v. Commonwealth, 224 Va. 618, 622 (1983); Albemarle County v. Marshall, 215 Va. 756, 762 (1975)).

334. VA. CODE ANN. § 58.1-1101(A)(2) (Cum. Supp. 1996).

335. VA. CODE ANN. § 58.1-3503(A)(16) (Cum. Supp. 1996).

336. *Id.*

337. City of Winchester v. American Woodmark Corp, 252 Va. 98, 471 S.E.2d 495 (1996).

ration argued that Winchester's BPOL license tax violated the Commerce Clause of the United States Constitution because the City of Winchester did not fairly apportion the assessments to tax only those gross receipts attributable to the corporation's business activities in the City.[338] The Supreme Court of Virginia held that the Winchester tax assessments failed the Commerce Clause's external consistency test—which requires that an assessment apply only to the portion of the revenues from interstate activity that reasonably reflects the in-state component of the activity—because the assessments included revenues realized from value produced in locations other than the taxing jurisdiction.[339]

The Winchester Commissioner of Revenue assessed BPOL taxes against American Woodmark for the years 1990 and 1991 in the amount of $374,636.91 and $343,918.42, respectively. American Woodmark refused to make payment on these assessments and initiated an application to correct the local BPOL tax assessments. The issue was whether the City of Winchester's assessment of BPOL tax based on American Woodmark's nationwide receipts was valid under the Commerce Clause of the United States Constitution.[340]

The Commerce Clause grants to Congress the exclusive power to "regulate Commerce . . . among the several States."[341] In particular, the United States Supreme Court has held that a state or local tax on a business engaged in interstate commerce violates the Commerce Clause unless the tax: (i) is applied to an activity with a substantial nexus to the taxing jurisdiction; (ii) is fairly apportioned; (iii) does not discriminate against interstate commerce; and (iv) is fairly related to the services provided by the taxing jurisdiction.[342] The issue presented by American Woodmark in its challenge to Winchester's BPOL tax assessments was the second prong of the *Complete Auto Transit*

338. *Id.* at 101, 471 S.E.2d at 497.
339. *Id.* at 103-04, 471 S.E.2d at 498.
340. *Id.* at 100, 471 S.E.2d at 496.
341. U.S. CONST. art. I, § 8, cl. 3.
342. *American Woodmark*, 252 Va. at 101, 471 S.E.2d at 497 (citing Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 278 (1977)); *see also* Ryder Truck Rental, Inc. v. County of Chesterfield, 248 Va. 575, 449 S.E.2d 813 (1994); Short Bros. (USA), Inc. v. Arlington County, 244 Va. 520, 423 S.E.2d 172 (1992).

test which requires assessments to satisfy the "fairly apportioned" prong.[343] This prong requires that an assessment be both internally and externally consistent.[344] The United States Supreme Court stated that an assessment is internally consistent if applying the text of the taxing statute, and assuming that every other jurisdiction applied the same statute, the taxpayer would not be subjected to a risk of double taxation.[345] The Supreme Court of Virginia also noted that an assessment is externally consistent if the assessment applies only to the "'portion of the revenue from the interstate activity which reasonably reflects the in-state component of the activity being taxed.'"[346]

The supreme court affirmed the trial court's decision which held that the assessments were internally consistent because if every taxing jurisdiction applied the taxes set out in the City of Winchester's ordinance, the taxpayer would be allowed to deduct amounts paid to other taxing jurisdictions and therefore would not be subject to multiple taxation.[347] The supreme court, however, held that the City of Winchester ordinance failed to pass the external consistency test.[348] The supreme court stated that "[t]o prevail in a claim that a tax assessment fails the external consistency test, a taxpayer must 'demonstrate that there is no rational relationship between the income attributable to the state and the interstate values of the enterprise.'"[349]

The City of Winchester argued that the trial court's determination that the assessments were not externally consistent was erroneous because American Woodmark failed to meet its burden of proof.[350] Winchester argued that the record demonstrated that American Woodmark was a highly centralized, unitary business and its corporate headquarters contributed value to its

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343. *American Woodmark*, 252 Va. at 102, 471 S.E.2d at 497.
344. *Id.*
345. *Id.*, 471 S.E.2d at 497 (citing Goldberg v. Sweet, 488 U.S. 252, 261 (1989)).
346. *Id.* (citing *Goldberg*, 488 U.S. at 262).
347. *Id.* at 103-04, 471 S.E.2d at 498.
348. *Id.*
349. *Id.* at 102, 471 S.E.2d at 498 (quoting Amerada Hess Corp. v. Director, Div. of Taxation, N.J. Dep't of the Treasury, 490 U.S. 66, 75 (1989) (quoting Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 180 (1983))).
350. *Id.* at 103, 471 S.E.2d at 498.

business.[351] Winchester asserted that all of the taxpayer's gross receipts were in some way attributable to the headquarters office and, presumably, could all be used as the basis for the BPOL assessments.[352] The supreme court disagreed.[353]

The supreme court stated that American Woodmark was not required to produce evidence of a specific level of value attributable to its Winchester operation to prevail in its assertion that the BPOL assessments were not externally consistent.[354] The taxpayer did present uncontested evidence that, during the years in question, it operated twenty-four facilities in thirteen different states. These facilities included manufacturing and distribution centers, as well as service and sales offices. The supreme court stated that common sense compels the conclusion that these operations added value to American Woodmark's business product and were revenue producing activities.[355] The supreme court concluded that the BPOL assessments were based on 100% of American Woodmark's revenues, including revenues realized from value produced in locations other than in the taxing jurisdiction.[356] Given the number of facilities in operation outside the City of Winchester, the supreme court stated that the value added to the product by the Winchester operations could not possibly produce 100% of the revenues.[357] In affirming the circuit court decision, the supreme court held that under the specific facts of this case, Winchester failed to apportion the BPOL tax assessments as required by the Commerce Clause.[358]

In *Fairfax County v. DataComp Corp.*,[359] the Fairfax County Circuit Court held that a company which assembles and integrates various pre-made computer parts into completed computers that are subsequently sold to various governmental agencies and institutional purchasers qualifies for the exemption from business, professional and occupational license taxes under

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351. *Id.*
352. *Id.*
353. *Id.*
354. *Id.*
355. *Id.*
356. *Id.*
357. *Id.*
358. *Id.*
359. 36 Va. Cir. 60 (Fairfax County 1995).

former section 58.1-3703(B)(4)[360] of the Virginia Code.[361]

DataComp was in the business of producing and selling personal computers, file servers and computer parts. In 1988, DataComp opened a "manufacturing plant" in Fairfax County to fulfill its obligation under a contract with the United States Department of Labor. DataComp contracted and provided computer networks to various government agencies, labor unions, law firms, and "re-sellers."[362] In producing its computers, DataComp acquired various component parts such as motherboards, power switches, cabling and brackets from original equipment manufacturers. These individual parts were tested to insure quality and compatibility with FCC standards. DataComp technicians then assembled and integrated these parts into a final product in accordance with contract specifications. This process included the soldering, taping and connecting of these materials by trained DataComp employees.[363]

Fairfax County initiated a lawsuit demanding payment of taxes, penalties and interest allegedly owed by DataComp on delinquent BPOL taxes for the years 1989 through 1993. DataComp responded that it qualified for the exemption under Virginia Code section 58.1-3703(B)(4), which provides that no county shall levy any license tax "[o]n a manufacturer for the privilege of manufacturing and selling goods, wares and merchandise at wholesale at the place of manufacture."[364]

Fairfax County alleged that DataComp's business activity did not constitute manufacturing for purposes of this exemption but consisted merely of assembly of ready made parts. The County also argued that DataComp did not sell its computers "at wholesale" as required by the statutory exemption.

The first issue presented to the circuit court was to determine whether DataComp qualified as a "manufacturer" for purposes of section 58.1-3703(B)(4). This requires a two-step analysis. First, the court must consider whether some of DataComp's business activities constituted "manufacturing," as

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360. VA. CODE ANN. § 58.1-3703(B)(4) (Repl. Vol. 1991).
361. *Datacomp*, 36 Va. Cir. at 67.
362. *Id.* at 61.
363. *Id.*
364. VA. CODE ANN. § 58.1-3703(B)(4) (Repl. Vol. 1991).

defined by the Supreme Court of Virginia.[365] Second, the court must decide whether these activities, if deemed to be manufacturing, meet the test of substantiality.[366]

The circuit court held that DataComp's activities did constitute manufacturing.[367] The evidence at trial showed that "DataComp's production of its computers involved the transformation and integration of various components into a final product of substantially different character."[368] The processes involved many steps, including integrating parts into a motherboard and soldering and wiring materials into the system. This process also involved integrating control panel switches, disk drives, controller cards, wires and cables, and other computer parts which could not function as a computer without the technical expertise of DataComp's employees, who transformed these computer "raw materials" into an integrated system which performs the desired tasks.[369]

Having decided that DataComp performed manufacturing activities, the circuit court next considered whether such manufacturing activities met the test of substantiality set forth in the *County of Chesterfield v. BBC Brown Boveri*.[370] In determining whether the manufacturing portion of a business is substantial, a court must examine a number of factors, including:

> [1] the manufacturing component's financial receipts, [2] its proportion of the total corporate income, [3] the percentage it comprises of the total capital investment, [4] the number of employees working in the manufacturing component as compared with the total number of employees, or [5] the ratio of manufacturing activities to the entire business.[371]

365. *DataComp*, 36 Va. Cir. at 63 (citing County of Chesterfield v. BBC Brown Boveri, 238 Va. 64, 69, 389 S.E.2d 890, 892-93 (1989)).
366. *Id.*
367. *Id.* at 65.
368. *Id.* at 64.
369. *Id.*
370. 238 Va. 64, 380 S.E.2d 890 (1989).
371. *DataComp*, 36 Va. Cir. at 65 (quoting *Brown Boveri*, 238 Va. at 71, 380 S.E.2d at 894).

The evidence presented to the circuit court demonstrated that greater than one-half of DataComp's business activity during the relevant years consisted of the production of computers and monitors pursuant to government contracts. Approximately eighty to ninety percent of DataComp's revenue between 1989 and 1990 came from its government contracts. As a result of this evidence, the circuit court held that DataComp met the test of substantiality.[372]

The circuit court next had to decide whether DataComp's selling activities were "at wholesale." Fairfax County argued that DataComp sold the computers and monitors to end-users which essentially amounted to sales at retail and not at wholesale. DataComp responded by asserting that Fairfax County had assessed its gross receipts tax on DataComp as a "wholesale merchant." The circuit court stated that the fact that DataComp was assessed as a wholesale merchant was some evidence that its operations involved wholesale sales, but was not conclusive.[373] However, the circuit court stated that the majority of DataComp's sales were to government agencies under government contracts.[374] In addition, the remaining sales to labor unions, law firms, and other organizations were essentially institutional sales.[375]

The statutory exemption from BPOL license taxes for manufacturers who sell from the place of manufacture treats governmental sales and sales to institutions as being "wholesale in nature."[376] As a result, the circuit court held that DataComp was entitled to the statutory exemption of Virginia Code section 58.1-3703(B)(4) for its sales to government agencies and institutions.[377]

In *Hampton Nissan Limited Partnership v. City of Hampton*,[378] the Supreme Court of Virginia held that the City of Hampton could not retain, as license taxes, payments that a motor vehicle dealer had collected improperly from motor vehi-

372. *Id.*
373. *Id.* at 66.
374. *Id.*
375. *Id.* at 67.
376. VA. CODE ANN. § 58.1-3703(B)(4) (Repl. Vol. 1991).
377. *DataComp*, 36 Va. Cir. at 67.
378. 251 Va. 100, 466 S.E.2d 95 (1996).

cle purchasers in excess of the rate prescribed by law.[379] Hampton Nissan had improperly charged its customers an amount in excess of the imposed license tax rate. The Hampton Commissioner of Revenue requested the motor vehicle dealer to remit to the City of Hampton the full amount of overpayments. Hampton Nissan offered to refund the overpayments to its customers and placed a notice in the local newspaper containing the offer. The trial court held that Hampton Nissan must pay over the excess license taxes collected and awarded summary judgment to the City of Hampton.[380] Hampton Nissan argued in its appeal that the City did not have the statutory authority to collect, under the guise of a tax, the overpayment that Hampton Nissan had improperly received from its customers. The motor vehicle dealer asserted that the City may not collect a tax unless it has specific statutory authority to do so, and that no such authority existed in this case.[381] The City of Hampton argued that Virginia Code section 58.1-16 and certain provisions contained in the City's Code provided it with the express authority to collect the overpayments as license taxes.[382]

The Supreme Court of Virginia rejected the City's assertion that section 58.1-16 was applicable.[383] The BPOL tax at issue in this case is administered solely by the City, not the Department of Taxation or the Division of Motor Vehicles. Accordingly, the supreme court held that section 58.1-16 had no relevance.[384] The supreme court also found no support in the City of Hampton's ordinances providing express authority to the City to seek overcollected taxes.[385] In reaching this decision, the supreme court stated that "a city can derive its taxing power only through positive grants of authority from the General Assembly, and the City must be able to put its finger on the statute which confers upon the City the power to tax."[386]

379. *Id.* at 103-04, 466 S.E.2d at 97.
380. *Id.* at 102, 466 S.E.2d at 96.
381. *Id.*
382. *Id.*
383. *Id.* at 102-03, 466 S.E.2d at 96-97.
384. *Id.*
385. *Id.* at 103-04, 466 S.E.2d at 97.
386. *Id.* at 105, 466 S.E.2d at 98.

Hampton Nissan is very important because the supreme court provided an analytical framework in which a local tax jurisdiction must operate. Commissioners of Revenue do not have any implied authority. They must follow their statutory authority exactly.

B. *Significant Legislative Activity*

In 1996, the Virginia General Assembly was able to produce and pass a major bill to reform the local business, professional and occupational license ("BPOL") tax. This significant legislation was based on over three years of spirited cooperation between Virginia's business community and their legislators. The legislative package will bring substantial relief and reform when the legislation takes effect on January 1, 1997.[387]

The new statutory scheme calls for the adoption of guidelines and regulations which ultimately will be published by the Department of Taxation. This process of developing guidelines and regulations is underway with an expected release in early 1997.

1. Procedural Reforms

The legislation creates a number of administrative procedures and remedies for taxpayers to contest BPOL assessments. Under the legislation, local governments will be able to retain a great deal of flexibility including the ability to tax or not tax particular businesses and to tax at rates less than the statutory ceilings. For the first time, however, there will be uniform administration of this tax throughout the Commonwealth. This should eliminate complaints about inconsistent and arbitrary administration of the BPOL tax in certain localities. The key features producing this uniformity of administration are as follows:

(1) Guidelines or regulations and advisory written opinions by the Virginia Department of Taxation;[388]

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387. *See, e.g.*, VA. CODE ANN. §§ 58.1-3700, -3700.1, -3701, -3703, -3703.1, -3706, -3708, -3732 (Repl. Vol. 1991 & Cum. Supp. 1996). The BPOL legislation package also repealed §§ 58.1-3707. Act of April 6, 1996, chs. 715, 720 1996 Va. Acts 1233, 1247.

388. VA. CODE ANN. § 58.1-3701 (Cum. Supp. 1996).

(2) Administrative appeals to the Virginia Department of Taxation from adverse decisions by the local Commissioner of Revenue;[389]

(3) No collection of tax pending final administrative determination;[390]

(4) Interest on refunds;[391]

(5) Single ten percent penalty for late filing of return and late payment of tax;[392]

(6) Procedures to extend filing date and to extend statute of limitations for assessments and payments;[393]

(7) Procedure for obtaining advance rulings.[394]

2. Substantive Reforms

The substantive reforms of the 1996 BPOL legislation seek to retain the basic theory of the BPOL tax and provide specific rules as to where gross receipts are deemed taxable.

One of the most frequent criticisms of the BPOL tax was the way in which localities administered the tax. Many localities applied the BPOL tax as a gross income tax. Certain localities treated the existence of any local office or other tax nexus as giving rise to a presumption of taxability with respect to worldwide gross income.[395] An underlying principle of the legislation is to destroy such overreaching applications by certain localities. This concept is found in section 58.1-3703.1(A)(3)(a):

> General Rule: Whenever the tax imposed by this ordinance is measured by gross receipts, the gross receipts included in the taxable measure shall be only those gross receipts at-

389. VA. CODE ANN. § 58.1-3703.1(A)(5)(c) (Cum. Supp. 1996).
390. VA. CODE ANN. § 58.1-3703.1(A)(5)(b), (d) (Cum. Supp. 1996).
391. VA. CODE ANN. § 58.1-3703.1(A)(2)(e) (Cum. Supp. 1996).
392. VA. CODE ANN. § 58.1-3703.1(A)(2)(d) (Cum. Supp. 1996).
393. VA. CODE ANN. § 58.1-3703.1(A)(2)(c), (4) (Cum. Supp. 1996).
394. VA. CODE ANN. § 58.1-3703.1(A)(5)(e) (Cum. Supp. 1996).
395. *See* City of Winchester v. American Woodmark Corp., 252 Va. 98, 471 S.E.2d (1996); *supra* notes 208-16 and accompanying text.

> tributed to the exercise of a *privilege* subject to licensure at a definite place of business within this jurisdiction . . . .[396]

The BPOL legislative reform package makes it clear that the BPOL tax is a privilege tax, not an income tax, and that items of income unrelated to the taxed privilege are not included in the tax base.[397] Section 58.1-3703.1(A)(6) provides that the assessor's burden is to establish that "a particular receipt is directly attributable to the taxable privilege exercised within this jurisdiction."[398] Income attributable to a definite place of business in another jurisdiction cannot be taxed even if that other jurisdiction does not tax them.[399] Items of income unrelated to the taxable privilege cannot be taxed. The most obvious example should be investment income in the case of businesses other than brokerages, banks, savings and loan institutions, and other financial service organizations.[400]

Another area of concern to the business community involves the tax status of business locations that do not generate gross receipts from dealing with the general public. Comments by the Virginia Department of Taxation during the legislative process indicate that such "administrative facilities" will not be deemed to be engaged in a taxable privilege.[401] Thus, corporate headquarters, training centers, administrative facilities and other offices that do not directly generate gross receipts from transactions with the general public should be exempt from the BPOL tax.[402]

The BPOL reform legislation will change the entire audit approach of local tax authorities. Where previously some Commissioners of Revenue audited on a "prove it is not taxable" basis, the statutory burden now will require the assessor to

396. VA. CODE ANN. § 58.1-3703.1(A)(3)(a) (Cum. Supp. 1996) (emphasis added).
397. *See id.*
398. VA. CODE ANN. § 58.1-3703(A)(6) (Cum. Supp. 1996).
399. VA. CODE ANN. § 58.1-3703.1(A)(3)(b) (Cum. Supp. 1996).
400. *See* VA. CODE ANN. § 58.1-3732(A)(8) ((Cum. Supp. 1996) (exclusion for investment income).
401. *Hearings on H.B. 293 Before House Finance Comm. and Senate Finance Comm.*, Va. Gen. Assembly, (Reg. Sess. 1996) (unpublished).
402. *See, e.g.*, BPOL Guidelines § 2.2(A)(4) (Va. Dept. Tax., July 1, 1995).

demonstrate that particular receipts are related to business activities conducted locally.[403]

3. Situs Rules

In determining where receipts are taxable, the "uniform ordinance" provisions contained in the new legislation set forth specific rules and, in appropriate situations, apportionment procedures. The basic rules under new Virginia Code section 58.1-3703.1(A)(3)(a) include the following:

(1) Construction contractor gross receipts will be taxable at the job site;[404]

(2) Retail merchant gross receipts will be taxable where sales solicitation activities occur;[405]

(3) Wholesale merchant gross receipts will be taxable where the goods are delivered to customers;[406]

(4) Tangible personal property rentals will be taxable at the lessor's office;[407]

(5) Services will be taxable at the office or definite place of business of the taxpayer at which the services are performed or are directed.[408]

When a taxpayer has multiple offices, the statutory rule clearly provides the opportunity to trace receipts to a particular office.[409] If adequate records are not available to permit that, the statute also permits the gross receipts to be apportioned based on a payroll factor reflecting the involvement of all the taxpayer's offices working on the contract.[410]

403. *See id.*
404. VA. CODE ANN. § 58.1-3703.1(A)(3)(a)(1) (Cum. Supp. 1996).
405. VA. CODE ANN. § 58.1-3703.1(A)(3)(a)(2) (Cum. Supp. 1996).
406. *Id.*
407. VA. CODE ANN. § 58.1-3703.1(A)(3)(a)(3) (Cum. Supp. 1996).
408. VA. CODE ANN. § 58.1-3703.1(A)(3)(a)(4) (Cum. Supp. 1996).
409. VA. CODE ANN. § 58.1-3703.1(A)(3)(b) (Cum. Supp. 1996).
410. *Id.*

4. Exemptions

The legislation provides for various exemptions from the BPOL tax and, in certain circumstances, places restrictions on localities' authority to impose the tax. Several of these exemptions or exclusions are duplicative of other provisions of the law or reflect current practice in some localities. However, the exemptions or exclusions listed in the statute should facilitate taxpayer understanding and compliance by the localities. Several of the more critical new statutory BPOL exemptions include the following:

(1) Certain charities exempt from income tax under section 501(c)(3) of the Internal Revenue Code[411] except for "unrelated trade or business income;"[412]

(2) Gifts, contributions and membership dues of nonprofit organizations;[413]

(3) Venture capital funds (but commissions and fees of fund managers are taxable);[414]

(4) Receipts from the conversion of one asset to another to the extent the amount has previously been taxed (for example, factoring of accounts receivable);[415]

(5) Proceeds received by the obligor from loan transactions;[416]

(6) Returns of principal or basis upon the sale of a capital asset;[417]

(7) Rebates, discounts and other reductions in purchase price;[418]

(8) Withdrawals from inventory and occasional sales;[419]

411. 26 U.S.C. § 501(c)(3) (1994).
412. VA. CODE ANN. § 58.1-3703(C)(18)(a) (Repl. Vol. 1991 & Cum. Supp. 1996).
413. VA. CODE ANN. § 58.1-3703(C)(18)(b) (Cum. Supp. 1996).
414. VA. CODE ANN. § 58.1-3703(C)(19) (Cum. Supp. 1996).
415. VA. CODE ANN. § 58.1-3732(A)(2) (Cum. Supp. 1996).
416. VA. CODE ANN. § 58.1-3732(A)(4) (Cum. Supp. 1996).
417. VA. CODE ANN. § 58.1-3732(A)(5) (Cum. Supp. 1996).
418. VA. CODE ANN. § 58.1-3732(A)(16) (Cum. Supp. 1996).
419. VA. CODE ANN. § 58.1-3732(A)(7) (Cum. Supp. 1996).

(9) Investment income from taxpayers not engaged in a financial service business.[420]

For multi-state businesses, the most important exemption may be that provided by section 58.1-3732(B)(2), which allows a deduction for "[a]ny receipts attributable to business conducted in another state or foreign country in which the taxpayer is liable for an income or other tax based upon income."[421]

4. Small Business Exemption

A concerted effort was made by the Virginia business community and the legislature to eliminate the BPOL tax that may be imposed by localities for small businesses. The result was the establishment of statutory thresholds geared to the annual gross receipts of the business.

The BPOL tax may be imposed by localities if annual gross receipts exceed the threshold amounts for the population ranges indicated in the table below:

Threshold Amount	*Population*
No threshold	Below 25,000
$50,000	Between 25,000 and 50,000
$100,000	Over 50,000[422]

The BPOL reform legislation also establishes an annual license fee schedule. A license fee may be charged to all businesses, including those with gross receipts less than the threshold, as follows:

Maximum Fee	*Population*
$30	Below 25,000
$50	Between 25,000 and 50,000
$100 ($50 by 1/1/2000)	Over 50,000[423]

420. VA. CODE ANN. § 58.1-3732(A)(8) (Cum. Supp. 1996).
421. VA. CODE ANN. § 58.1-3732(B)(2) (Cum. Supp. 996).
422. VA. CODE ANN. § 58.1-3706(A) (Cum. Supp. 1996).
423. VA. CODE ANN. § 58.1-3703(A) (Cum. Supp. 1996).

VI. REAL PROPERTY TAX

A. *Recent Judicial Decisions*

In *DKM Richmond Associates, L.P. v. City of Richmond*,[424] the Supreme Court of Virginia held that the City of Richmond could reduce the amount of a tax credit granted for property which was substantially rehabilitated by the taxpayer where the building's value decreased when it was subsequently reassessed.[425] During the third year of the five-year tax credit period, the value of the building decreased while the value of the land remained the same. The City of Richmond decreased the amount of tax credit to reflect the decline in the building's value. DKM, the taxpayer, objected to the reduced tax credit, arguing that the credit could not be altered during the five-year credit time period.[426] The taxpayer argued that the "plain language of the [o]rdinance demonstrates that the legislative intent was to grant the taxpayer a credit based on the improvements that he added to his property, and the value of these improvements to the taxpayer is fixed at the time of making the improvements."[427]

The supreme court upheld the City of Richmond's reduction of the tax credit.[428] The supreme court noted that the rehabilitation tax credit was a partial exemption from taxation and was not intended to apply to the value of the land or to the improvements that existed before the rehabilitation effort.[429] The tax credit was held to be available for the limited purpose of offsetting a specific portion of the total assessment on the property, to-wit: the portion resulting from the rehabilitation.[430]

In *Seaone v. Board of Supervisors*,[431] the Fairfax County Circuit Court held that the owner of a shopping center plaza

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424. 249 Va. 401, 457 S.E.2d 76 (1995).
425. *Id.* at 407-08, 457 S.E.2d at 80.
426. *Id.* at 406, 457 S.E.2d at 79.
427. *Id.* at 407, 457 S.E.2d at 79.
428. *Id.* at 407-08, 457 S.E.2d at 80.
429. *Id.*
430. *Id.* at 408-09, 457 S.E.2d at 80.
431. 35 Va. Cir. 351 (Fairfax County 1995).

met his burden of proof in demonstrating that Fairfax County did not take into consideration the actual rents from the shopping center when it determined the "economic rent" for purposes of real estate tax assessments of the shopping center for the years 1989 through 1992.[432] Unfortunately for the landowner, the circuit court also held that the landowner did not present sufficient evidence to enable the court to correct the real estate assessments.[433] Therefore, the circuit court was not able to provide the landowner any relief.[434]

The taxpayer owned a strip shopping center which housed two "anchor" tenants and approximately sixteen smaller tenants in Fairfax County. In 1969, anticipating the construction of the shopping center, the taxpayer entered into two anchor leases with two large tenants, each covering a base period of twenty years. Both leases contained several five-year extension option periods. In exchange for receiving long-term leases on the new strip shopping center from the anchor tenants, the taxpayer agreed to a reasonable annual rent fee which ultimately became below fair market value rent in the later years of the lease agreements.[435]

For the years 1989 through 1992, Fairfax County assessed the strip shopping center plaza. The landowner was particularly upset that the assessed value of the strip shopping center was increased by forty-three percent between 1989 and 1990. Fairfax County used the capitalization of income approach to appraise the income-producing strip shopping center property.[436] The landowner challenged Fairfax County's tax assessments, contending that the County failed to take the shopping center's actual rents into account when determining economic rent for purposes of assessing the shopping center for the relevant tax years. Both the taxpayer and the County agreed that the County's appraisers used a proper methodology to value the shopping center.[437] The taxpayer challenged; however, the County's appraiser used the amount of rent for which space in

432. *Id.* at 363.
433. *Id.* at 365-66.
434. *Id.*
435. *Id.* at 353-54.
436. *Id.* at 354.
437. *Id.* at 352.

the income-producing property could have been leased for in the years 1989-1992. This potential rent is referred to as "economic rent."

The Fairfax County assessments were based upon an independent appraisal prepared by use of the capitalization of income method. The County's appraiser used summarized information contained in the County Assessor's Office and looked at "comparable" shopping centers to determine what the appropriate "gross economic rent" would be for the subject strip shopping center. The Fairfax County Circuit Court looked at the County's field data cards for the subject property and noticed that actual rent figures only appeared on the 1991 and 1992 field data cards.[438] No actual rent information was in Fairfax County's possession for the 1989 and 1990 tax years. No such actual rent information was ever relied upon by the County's appraisers.[439]

The circuit court held that the shopping center landowner sustained his burden of demonstrating that Fairfax County did not take actual rents into account in appraising the shopping center for the 1989, 1990, 1991 and 1992 tax years.[440] The evidence presented during the trial showed that the Fairfax County appraisers did not have information as to actual rents for the 1989 and 1990 tax years, and therefore could not have taken actual rents into account when making their appraisals. Fairfax County also did not use actual rents for 1991 and 1992 but instead used assumed economic rents for those latter two years. Fairfax County did have actual rent information for 1991 and 1992.

The County's 1990 appraisal for the shopping center was forty-three percent higher than the appraisal for the previous year, an increase of over three million dollars. The evidence introduced at trial showed that this jump occurred because of the County's assumption that economic rents jumped by forty-three percent between 1989 and 1990, despite the fact that: (1) commercial real estate in the region was suffering an unprecedented decline; and (2) the County had no actual rent and

438. *Id.* at 355.
439. *Id.*
440. *Id.* at 362.

expense information for the two years involved.[441] Testimony at trial did show that rents for the shopping center were approximately the same for 1989, 1990 and 1991.

Once the trial court held that the assessments were improper, it noted that Virginia Code section 58.1-3987 authorizes a circuit court to correct an assessment in the event a taxing authority has erroneously assessed real estate.[442] In granting such relief, the circuit court does not have authority to remand the case to the taxing authorities for a new assessment, but must "grant appropriate relief based upon the evidence before it."[443]

The taxpayer argued that the testimony of its appraisers constituted sufficient evidence. The circuit court disagreed holding that one of the shopping center landowner's appraisers only testified as to value for the 1992 tax year.[444] In addition, this appraisal was made for purposes of a bank. The circuit court stated the other appraiser's testimony was not persuasive.[445] As a result, the Fairfax County Circuit Court reluctantly concluded that it was unable to afford the taxpayer any relief.[446] In reaching this unfortunate decision, the circuit court stated that

> [n]either the Code of Virginia, nor any precedent presented by the parties, suggests that this Court is authorized to assess the value of the [shopping c]enter on any basis other than the evidence presented at trial. Since I find [taxpayer's] evidence insufficient to correct the County's assessments, he has failed to sustain his ultimate burden of proof.[447]

441. *Id.* at 363.
442. *Id.* at 365.
443. *Id.* (citing Smith v. Board of Supervisors, 234 Va. 250, 255, 361 S.E.2d 351, 353 (1987)).
444. *Id.*
445. *Id.*
446. *Id.*
447. *Id.* at 365-66.

B. *Recent Significant Legislation: Exemption for Substantially Renovated or Rehabilitated Property and Tax Credit*

In 1978, the Virginia Constitution was amended to include a new authorization for localities to provide for the partial exemption from real estate taxes for real property that has been substantially renovated, rehabilitated, or replaced because of age or use.[448] Virginia Code section 58.1-3220 deals with rehabilitated residential real estate[449] and section 58.1-3221 covers rehabilitated commercial and industrial real estate.[450]

By local option, localities may exempt certain rehabilitated residential and commercial real estate.[451] Prior to July 1, 1995, any residential, commercial or industrial structure which is less than twenty-five years of age and undergoes any substantial rehabilitation, renovation or replacement may receive a partial exemption from real estate taxes by the local taxing jurisdiction.[452] The partial exemption to be provided by the local governing body "may be an amount equal to the increase in assessed value or a percentage of such increase resulting from the rehabilitation, renovation or replacement of the structure, as determined by the Commissioner of Revenue or other assessing officer . . . ."[453] The amount of exemption may be up to fifty percent of the cost of the rehabilitation, renovation or replacement as established by local ordinance.[454] The partial exemption is available upon the completion of the rehabilitation, renovation or replacement or on January 1 of the year following the completion of such rehabilitation, renovation or replacement.[455] The partial exemption was available for a period of ten years.[456]

The 1995 General Assembly amended sections 58.1-3220 and

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448. VA. CODE ANN. §§ 58.1-3220, -3221 (Repl. Vol. 1991) (implementing VA. CONST. art. X, § 6(h)).
449. VA. CODE ANN. § 58.1-3220 (Cum. Supp. 1996).
450. VA. CODE ANN. § 58.1-3221 (Cum. Supp. 1996).
451. VA. CODE ANN. § 58.1-3221(A) (Cum. Supp. 1996).
452. VA. CODE ANN. §§ 58.1-3220(A), -3221(A) (Cum. Supp. 1994).
453. VA. CODE ANN. §§ 58.1-3220(B), -3221(B) (Cum. Supp. 1994).
454. *Id.*
455. *Id.*
456. *Id.*

58.1-3221 to make two significant changes to these partial exemption real estate tax statutes. The first change revises the age of a structure or improvement in order to be eligible for the partial exemption from real estate taxes. For residential structures, a building that is fifteen years of age or older and undergoes substantial rehabilitation, renovation or replacement would be eligible for the partial exemption.[457] Commercial industrial structures of at least twenty years of age, or fifteen years of age if the structure is located in an area designated as a Virginia enterprise zone, would be eligible for the partial exemption from real estate taxes once the substantial rehabilitation, renovation or replacement is completed.[458]

The second significant change concerns the length of time for which the partial exemption is available. For residential, commercial or industrial structures, the partial exemption from real estate taxes would be available for fifteen years.[459] This represents an additional five years of partial exemption eligibility.[460]

The 1996 General Assembly added a new section to the tax credit scheme for certain rehabilitated, renovated or replacement of residential structures.[461] Virginia Code section 58.1-3220.01 permits localities, by ordinance, to provide for local real property tax credits equal to property tax liens which do not exceed fifty percent of the assessed value of the applicant's property at the time of purchase.[462] The credit is available only to owners of rehabilitated, renovated or replacement residential structures at least fifteen years old and may be used by the owner to offset real property taxes assessed against such property.[463] The local tax credit will only be available to property owners who purchase a structure which at the time of purchase contains property tax liens exceeding fifty percent of the property's assessed value.[464] The locality may also include in

457. VA. CODE ANN. § 58.1-3220(A) (Cum. Supp. 1996).
458. VA. CODE ANN. § 58.1-3221(A) (Cum. Supp. 1996).
459. VA. CODE ANN. §§ 58.1-3220(B) (Cum. Supp. 1996).
460. *Id.*
461. VA. CODE ANN. § 58.1-3220.01 (Cum. Supp. 1996).
462. *Id.*
463. *Id.*
464. *Id.*

its ordinance multi-family residential units which have been substantially rehabilitated by replacement for multi-family use.[465]

465. *Id.*