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Annual Survey of Virginia Law: Taxation

Craig D. Bell

TAXATION

*Craig D. Bell**

This article reviews significant recent developments in the law affecting Virginia taxation. Each section covers recent judicial decisions and legislative changes over the past year. 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. This article, however, will not discuss many of the numerous legislative technical changes to the State Taxation Code of Title 58.1.

PART ONE: TAXES ADMINISTERED BY THE VIRGINIA DEPARTMENT OF TAXATION

I. INCOME TAX

A. *Recent Judicial Decisions*

1. Corporate Income-Nexus

In *Virginia Department of Taxation v. National Private Truck Council*,[1] the Supreme Court of Virginia affirmed the Alexandria Circuit Court decision granting summary judgment to the National Private Truck Council on its claim that a Virginia

* Chairman and Principal, Eure, Kincer & Bell, P.C., Richmond, Virginia. B.S., (Management, magna cum laude, with honors in Transportation and Distribution Management), 1979, Syracuse University; MBA, 1980, Syracuse University; J.D., 1983, State University of New York at Buffalo School of Law; LL.M. (Taxation), 1986, Marshall-Wythe School of Law, College of William and Mary. Mr. Bell concentrates his practice on state and local taxation, civil and criminal tax litigation, general tax planning, and business law. He is also an adjunct professor of State and Local Tax for the Virginia Commonwealth University's Masters in Taxation program. Mr. Bell serves on the Board of Governors and as chair of the Virginia State Bar's Section on Taxation.

1. 253 Va. 74, 480 S.E.2d 500 (1997).

corporate income tax regulation, Section 630-3-401(G),[2] violates 15 U.S.C. § 381,[3] as well as the Due Process[4] and Commerce Clauses[5] of the United States Constitution.[6] 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.[7]

In 1959, Congress enacted Public Law 86-272,[8] to implement and amplify the constitutional protection to businesses operating in interstate commerce. This statute 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.[9]

At trial, 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 trucks—directly challenged the Virginia Department of Taxation's regulation which only extended the immunity from state income taxation afforded under 15 U.S.C. § 381 to those instances in which the shipment or delivery of goods was accomplished by common carrier.[10] The petitioners argued, and

2. 23 VA. ADMIN. CODE 10-120-90(G) (1997) (formerly VRR 630-3-401(G)).
3. 15 U.S.C. § 381 (1994).
4. U.S. CONST. amend. XIV, § 1.
5. U.S. CONST. art. I, § 8, cl. 3.
6. *See National Private Truck Council*, 253 Va. at 77, 480 S.E.2d at 502.
7. *See* U.S. CONST. art. I, § 8, cl. 3 & amend. XIV, § 1.
8. Pub. L. No. 86-272, 73 Stat. 555, (1959) (codified as amended at 15 U.S.C. § 381 (1994)).
9. 15 U.S.C. § 381(a) (1994).
10. *See* 23 VA. ADMIN. CODE 10-120-90(G)(1)(1997) (formerly VRR 630-3-401(G)(1)).

the circuit court agreed, that the Department's regulation and position were at odds with the plain language of 15 U.S.C. § 381 and its legislative history.[11]

The supreme court held that the Virginia regulation limiting the State corporate income tax immunity to companies shipping or delivering goods to Virginia customers by common carrier, while taxing those companies using their own truck fleets, violated 15 U.S.C. § 381 because it limited conditions under which out-of-state sellers were entitled to tax immunity.[12] In reaching this result, the supreme court stated that:

> Section 381, by plain and clear language, extends immunity to a particular income-generating transaction. This transaction consists of soliciting orders, approving the orders, and shipping or delivering the goods ordered. To limit the tax immunity granted by § 381 to the activity of solicitation only, as the Department suggests, renders the protection intended by that section meaningless. Potentially taxable income is not generated within the taxing state until there has been a successful "shipment or delivery" of goods. Exempting merely "solicitation" is no exemption at all.[13]

In reaching its decision, the supreme court looked carefully at the wording of 15 U.S.C. § 381 and noted that Congress did not identify any manner of delivery necessary to qualify for the immunity.[14] The section did not specify common carrier, contract or private carrier, or any other particular method of delivery. The supreme court stated that "[i]n the absence of a qualification in the federal statute, the Department may not add conditions to, or otherwise limit, the protection afforded by 15 U.S.C. § 381."[15]

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11. *See* National Private Truck Council v. Virginia Dep't of Taxation, 37 Va. Cir. 334 (Alexandria City 1996).

12. *See* Virginia Dep't of Taxation v. National Private Truck Council, 253 Va. 74, 77, 480 S.E.2d 500, 502 (1997).

13. *Id.* at 76, 480 S.E.2d at 502.

14. *See id.* at 77, 480 S.E.2d at 502.

15. *Id.*

In *McWane, Inc. v. Virginia Department of Taxation*,[16] the Richmond Circuit Court had the opportunity to apply the activities performed by a valve and hydrant salesman to the protected solicitation activities of 15 U.S.C. § 381. In *McWane*, the circuit court looked carefully at the activities of a valve and hydrant salesman who had assisted Virginia customers in his sales territory on five or six occasions to repair fire hydrants. Specifically, the salesman would remove a few bolts and replace a gasket in a fire hydrant.[17] The issue before the court was whether the repair of five or six hydrants went beyond the solicitation of sales or was an activity ancillary to such solicitation, or, if not, whether such activity was de minimis.[18] The Richmond Circuit Court held that the salesman's repair activities were not the solicitation of sales or an activity which was ancillary to the solicitation of sales.[19] In its conclusion, the circuit court cited the United States Supreme Court decision in *Wisconsin Department of Revenue v. Wrigley Co.*,[20] in which the Supreme Court stated that "[r]epair and servicing may help to *increase* purchases; but it is not ancillary to *requesting purchases*, and cannot be converted into 'solicitation' by merely being assigned to salesmen."[21]

Despite this finding, the circuit court held that the repair activities performed by McWane's salesman were de minimis.[22] The court noted that McWane's total repair activity in Virginia consisted of the removal of "a few bolts" to replace a fire hydrant gasket five or six times a year.[23] The court stated that McWane's repair activity was nothing more than an accommodation to its customers and that such activity failed to establish a "nontrivial additional connection with Virginia."[24] As a result of this holding, all of McWane's activities in Virginia were pro-

16. No. LB-1623-1 (Richmond City Cir. Ct. May 23, 1997).
17. *See id.*
18. *See id.* at 3.
19. *See id.*
20. 505 U.S. 214 (1992).
21. *Id.* at 229 (emphasis added).
22. *See McWayne*, No. LB-1623-1 at 3.
23. *See id.* at 4.
24. *Id.* at 5.

tected by 15 U.S.C. § 381, and the Virginia Department of Taxation's assessment and the taxes at issue were set aside.[25]

2. Income Tax Credits

In *Mathy v. Virginia Department of Taxation*,[26] the Supreme Court of Virginia held that two Virginia taxpayers were not entitled to a credit under Virginia Code section 58.1-332(A) for taxes paid to the District of Columbia on income received from a partnership conducted in the District of Columbia.[27]

Mr. and Mrs. Mathy were residents of northern Virginia; however, Mr. Mathy was a general partner in a District of Columbia general partnership.[28] The partnership's sole source of income during the relevant tax years was rental income earned from the operation of an office building in the District of Columbia.[29] The partnership filed District of Columbia tax returns for 1991, 1992, and 1993, and paid the taxes due on income received from the commercial office rental pursuant to D.C. Code Ann. No. 47-1808.1 to -1808.6.[30] This portion of the District of Columbia Code involves the appropriate taxes on unincorporated businesses. Specifically, the tax applies to the "privilege of carrying on or engaging in any trade or business within the District and of receiving income from sources within the District."[31] The tax is levied at a rate of 10% upon the taxable income of every unincorporated business, plus a surtax of between 2.5% and 5% of taxes due.[32] The taxes may be assessed in the name of the unincorporated business but are payable by the persons conducting the business.[33] As a general partner, Mr. Mathy was personally liable for the payment of these unincorporated business taxes.[34]

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25. *See id.*
26. 253 Va. 356, 483 S.E.2d 802 (1997).
27. *See id.* at 362, 483 S.E.2d at 805.
28. *See id.* at 358, 483 S.E.2d at 802.
29. *See id.*
30. *See id.*
31. D.C. CODE ANN. § 47-1808.3 (1997).
32. *See id.* At the time of *Mathy*, the statute required the tax to be 10%. After December 31, 1994, the tax changed to its current rate of 9.5%.
33. *See* D.C. CODE ANN. § 47-1808.5 (1997).
34. *See* § 41-114(2).

In filing their Virginia income tax returns for tax years 1991 through 1993, the Mathys reported Mr. Mathy's share of the net income from the D.C. partnership. When the Mathys filed those returns, they did not claim an out-of-state tax credit against their Virginia taxes for the taxes paid pursuant to the District of Columbia unincorporated business tax.[35]

In 1994, the Mathys filed amended Virginia income tax returns for the previous three tax years, claiming an out-of-state tax credit pursuant to Virginia Code section 58.1-332(A) and requesting refunds from Virginia for each of the three tax years at issue.[36] This provision of the Virginia Tax Code provides a tax credit to Virginia residents who become liable in another state for income tax on any earned or business income derived from sources outside of Virginia and subjected to taxation.[37] The tax credit is equal to the amount of the tax actually paid to the other state.[38] The statute excludes franchise taxes, license taxes, excise taxes, unincorporated business taxes, occupation taxes or other similar forms of taxes.[39]

After the Virginia Department of Taxation determined that the Mathys were not entitled to the tax credit under section 58.1-332(A), the Mathys initiated a lawsuit which resulted in the grant of a motion for summary judgment to the Department of Taxation.[40] The trial court held that the Mathys were not entitled to a credit against their Virginia taxes for payment of the District of Columbia's unincorporated business tax.[41]

The trial court found that the District of Columbia unincorporated business tax was not an income tax subject to the credit available under section 58.1-332(A), but instead was an unincorporated business tax on income imposed for the privilege of conducting business in the District.[42] On appeal, the taxpayers argued that the trial court's ruling conflicted with prior case law from both the Supreme Court of Virginia and the District

35. *See Mathy*, 253 Va. at 358-59, 483 S.E.2d at 803.
36. *See id.* at 359, 483 S.E.2d at 803.
37. *See* VA. CODE ANN. § 58.1-332(A) (Repl. Vol. 1997).
38. *See id.*
39. *See id.*
40. *See Mathy*, 253 Va. at 360, 483 S.E.2d at 804.
41. *See id.* at 359, 483 S.E.2d at 803.
42. *See id.*

of Columbia Court of Appeals, citing *King v. Forst*,[43] and *Bishop v. District of Columbia*.[44] The Mathys argued these two cases held that the unincorporated business tax was an income tax and not an unincorporated business tax, franchise tax or privilege tax.[45]

The Department of Taxation argued to the Supreme Court of Virginia that the District of Columbia tax was, in fact, an unincorporated business tax within the meaning of Virginia Code section 58.1-332(A), and was characterized as such by the District of Columbia tax statute.[46] The supreme court held that its prior decision in *King v. Forst* was dispositive of the issue on whether the unincorporated business tax of the District of Columbia was an income tax.[47] In *King*, the supreme court held that the District of Columbia's unincorporated business tax was an income tax for purposes of the section 58.1-332(A) tax credit.[48] The supreme court in *King* concluded that a Virginia taxpayer, a sole proprietor of an unincorporated business located in the District, was entitled to the Virginia tax credit for payment of the District of Columbia unincorporated business tax.[49] As a result of the *King* decision, the Mathys would be entitled to a credit under Virginia Code section 58.1-332(A) unless the tax "would be illegal and unauthorized under such other state's controlling or enabling legislation."[50]

The supreme court next had to determine whether the District of Columbia's unincorporated business tax would be illegal and unauthorized under the District of Columbia's Home Rule Act.[51] In the Home Rule Act, the United States Congress gave the District of Columbia Council legislative authority over most matters involving the District.[52] However, the supreme court noted that the Home Rule Act "expressly prohibits the Council

43. 239 Va. 557, 391 S.E.2d 60 (1990).
44. 401 A.2d 955 (D.C. 1979), *aff'd en banc*, 411 A.2d 997 (1980).
45. *See Mathy*, 253 Va. at 360, 483 S.E.2d at 803.
46. *See id.*
47. *See id.* at 361, 483 S.E.2d at 804.
48. *See King*, 239 Va. at 561, 391 S.E.2d at 62.
49. *See Mathy*, 253 Va. at 360-61, 483 S.E.2d at 804.
50. *Id.* at 361, 483 S.E.2d at 804.
51. *See id.*
52. *See* D.C. CODE ANN. §§ 1-201(a), 1-204 to 1-229 (Repl. Vol. 1992 & Cum. Supp. 1996).

from imposing a 'commuter tax,' defined as 'any tax on the whole or any portion of the personal income . . . of any individual not a resident of the District.'"[53]

The Department of Taxation argued that if the District of Columbia unincorporated business tax was an income tax, it violated the Home Rule Act by taxing the personal income of a non-resident of the District of Columbia.[54] The Mathys argued that the tax did not violate the Home Rule Act since (1) the tax was imposed on their rental business income, not on their personal income, and (2) the Home Rule Act only protected personal income.[55] The supreme court disagreed with both arguments made by the taxpayers. It noted that the *Bishop* decision of the District of Columbia Court of Appeals specifically concluded that the unincorporated business tax was levied on personal income, thus constituting, "'in reality, a tax on associates or partners who run the business.'"[56]

The supreme court concluded that the trial court reached the correct result but for the wrong reason. The correct reasoning, according to the supreme court, was that the plain language of the second paragraph of Virginia Code section 58.1-332(A) excluded the unincorporated business tax as a tax which is eligible for the tax credit.[57]

3. Virginia Additions and Subtractions—Individuals

In a unanimous decision, the Supreme Court of Virginia reversed a ruling by the Richmond Circuit Court and held that a state income tax return must mirror that of a federal income tax return in reporting unearned income of children under age fourteen.[58] The circuit court decision held that a parent's election to include his or her children's unearned income with the

53. *Mathy*, 253 Va. at 361, 483 S.E.2d at 804 (quoting D.C. CODE ANN. § 1-233(a)(5)).
54. *See id.* at 362, 483 S.E.2d at 804-05.
55. *See id.*
56. *Id.* (quoting Bishop v. District of Columbia, 401 A.2d 955, 961 n.181 (D.C. 1979)).
57. *See id.*
58. *See* Virginia Dep't of Taxation v. Davenport, 253 Va. 228, 482 S.E.2d 808 (1997).

parent's gross income from federal income tax returns did not make such income a part of the parent's Virginia taxable income.[59]

For tax years 1992, 1993 and 1994, the Davenports' five minor children had unearned income which the Davenports elected to include in their gross income when they filed a joint federal tax return, pursuant to section 1(g) of the Internal Revenue Code of 1986.[60] This provision,

> "commonly known as the 'Kiddie Tax,' generally provides that the unearned income of a child under the age of 14 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."[61]

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.[62] Virginia issued a notice of assessment to the Davenports for their 1992 Virginia income tax return. The Davenports paid the additional tax assessment under protest and filed an application for correction of erroneous or improper assessments of state income taxes in Richmond Circuit Court, arguing they were entitled to subtract their children's unearned income from their federal adjusted gross income.[63]

At trial, the Virginia Department of Taxation argued that Virginia Code section 58.1-322[64] defined "Virginia taxable income" and set 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

59. *See* Davenport v. Virginia Dep't of Taxation, 38 Va. Cir. 421 (Richmond City 1996). For a more thorough discussion of the Richmond Circuit Court decision, see Craig D. Bell, *Virginia Taxation*, 30 U. RICH. L. REV. 1543, 1547-48 (1996).

60. I.R.C. § 1(g)(7) (1994).

61. *Davenport*, 38 Va. Cir. at 421.

62. *See Davenport*, 253 Va. at 230, 482 S.E.2d at 809.

63. *See id.*

64. VA. CODE ANN. § 58.1-322 (Repl. Vol. 1997).

Virginia taxable income."[65] A deduction of the children's unearned income is not one of the items listed as a possible subtraction from a taxpayer's federal adjusted gross income in order to arrive at the taxpayer's Virginia taxable income. The Department also argued that on two occasions the Virginia 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.[66]

The circuit court noted that the Department's arguments were compelling and logical; however, they were rejected.[67] The circuit court stated that section 58.1-322(A) provides that: "'[t]he Virginia taxable income of a resident individual means *his* federal adjusted gross income for the taxpayer year . . . with the modifications specified in this section.'"[68] The trial court found 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."[69]

The Department made the same arguments on appeal, and the supreme court reversed the circuit court decision and held for the Department of Taxation.[70] In reaching this result, the supreme court stated that the plain language of Virginia Code sections 58.1-301 and 58.1-322 clearly and unambiguously required the taxpayers to report their federal adjusted gross income as taxable income on the Virginia tax returns.[71] The supreme court stated that the Davenports elected to include their children's unearned income in the taxpayer's federal adjusted gross income for federal taxation purposes and, having made such election, the taxpayers may not change that election in computing their state income tax.[72] The supreme court also

65. *Davenport*, 38 Va. Cir. at 422.

66. *See id.* at 423 (citing H.B. 1556, Va. Gen. Assembly, (Reg. Sess. 1991); S.B. 216, Va. Gen. Assembly, (Reg. Sess. 1992)).

67. *See id.*

68. *Id.* (emphasis added) (quoting VA. CODE ANN. § 58.1-322(A)(Repl. Vol. 1997)).

69. *Id.* at 424.

70. *See* Virginia Dep't of Taxation v. Davenport, 253 Va. 228, 231, 482 S.E.2d 808, 810 (1997).

71. *See id.* at 230, 482 S.E.2d at 809.

72. *See id.* at 230-31, 482 S.E.2d at 809-10.

noted that the phrase "his federal adjusted gross income" contained in Virginia Code section 58.1-322 did not refer to only one taxpayer's income, but referred to the amount of federal adjusted gross income that the taxpayers specified on their federal income tax return, subject to any modification authorized by Virginia tax statutes.[73]

B. *Recent Significant Legislative Activity*

1. Income Tax Credits

a. Major Business Facility Job Tax Credit Amended

In 1997, the General Assembly amended Virginia Code section 58.1-439 to clarify current law as to which companies are eligible to claim the Major Business Facility Job Tax Credit.[74] Generally, the Major Business Facility Job Credit, $1,000 per qualified employee in excess of 100 employed during the year, is granted to the person who pays taxes for the qualified full-time employees.[75] While a number of technical amendments were made to section 58.1-439, one of the more significant revisions involves the calculation of the number of qualified full-time employees at a major business facility, which "includes employees of a contractor or a subcontractor if such employees are permanently assigned to the taxpayer's major business facility."[76]

The 1997 legislation provides that the credit for any taxpayer who includes employees of a contractor or subcontractor as qualified full-time employees during the twenty-four-month period ending between January 1, 1995 and December 31, 1996 will be limited to $750,000, and can only be claimed for the establishment of major business facilities in a city with a population of more than 170,000, but less than 172,000.[77] The re-

73. *See id.* at 231, 482 S.E.2d at 810.
74. *See* VA. CODE ANN. § 58.1-439 (Repl. Vol. 1997).
75. *See id.*
76. *Id.* § 58.1-439(Q) (Repl. Vol. 1997).
77. *See* Act of April 2, 1997, ch. 786, 1997 Va. Acts 1915.

maining revisions to the Major Business Facility Job Tax Credit were declaratory of existing law.[78]

b. Worker Retraining Tax Credit

The 1997 General Assembly created a new income tax credit to begin with taxable years on or after January 1, 1999, which encourages employers to retrain their workers. This legislation creates a new Virginia Code section 58.1-439.6 providing a tax credit in an amount equal to thirty percent of all expenditures made by employers for eligible worker retraining for qualified employees, or up to $100 per qualified employee if the worker retraining occurs at private schools.[79] Qualified worker retraining consists of noncredit courses at any of the Commonwealth of Virginia's community colleges, private schools or retraining programs through apprenticeship agreements approved by the Virginia Apprenticeship Council.[80] The new credit permits a pass-through of the credit attributable to a partnership, electing small business corporation, or limited liability company to the individual partners, shareholders or members, respectively, of such entities in proportion to their ownership or interest in such business entities.[81] The legislation also permits a carry forward of any credit not used during the taxable year for the next three taxable years.[82] "No credit shall be carried back to a preceding taxable year" and "[t]he amount of credit allowed shall not exceed the tax imposed for such taxable year."[83] The legislation also contains a prioritization of tax credits when an employer is subject to the tax limitation imposed by the legislation, but is allowed other tax credits pursuant to other sections of the Virginia State Tax Code.[84]

78. *See id.*
79. *See* VA. CODE ANN. § 58.1-439.6(B) (Repl. Vol. 1997).
80. *See id.* § 58.1-439.6(A) (Repl. Vol. 1997).
81. *See id.* § 58.1-439.6(C) (Repl. Vol. 1997).
82. *See id.* § 58.1-439.6(E) (Repl. Vol. 1997).
83. *Id.*
84. *See id.*

2. Gains on the Sale of Certain Government Obligations Excluded from Virginia Taxable Income

Virginia Code sections 58.1-322 and 58.1-402 were amended by the 1997 General Assembly to exclude from the Virginia corporate and individual income tax the gains on the sale of federal obligations and obligations issued by Virginia and its localities.[85] Prior to this legislation, only interest or dividends on certain federal obligations and obligations issued by Virginia and its localities were excluded from Virginia taxable income. This legislation broadens the exemption to include gains realized from the sale or exchange of such obligations.

3. Enterprise Zone Program Expanded

In a continuation of what amounts to an annual revamping or restructuring of the Virginia Enterprise Zone Program, the 1997 General Assembly passed a number of changes which have the cumulative effect of expanding the program. The amount of the general business credit and the real property investment tax credit components of the Enterprise Zone Program that a taxpayer may take will now depend on whether the taxpayer is considered small or large. A "large qualified business firm" is a "qualified business firm making qualified zone investments in excess of $25 million . . . result[ing] in the creation of at least 100 permanent full-time positions."[86] A "small qualified business firm" is any qualified business firm that is not a large qualified business firm.[87]

The credit for small qualified business firms remains at eighty percent of the tax due for the first year, and sixty percent of the tax due for the second through tenth tax years.[88] The credit allowable to a large qualified business firm will be determined by agreement with the Department of Taxation, but the credit may not exceed the percentage allowed for small firms.[89]

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85. *See id.* §§ 58.1-322(C)(1), (2), -02(C)(1), (2) (Repl. Vol. 1997).
86. VA. CODE ANN. § 59.1-280(A) (Cum. Supp. 1997).
87. *See id.*
88. *See id.* § 59.1-280(C) (Cum. Supp. 1997).
89. *See id.* § 59.1-280(D) (Cum. Supp. 1997).

The General Assembly also made a number of revisions to the component of the Enterprise Zone Program which involves the real property investment tax credit. First, availability of the real property investment tax credit will now depend upon whether the qualified zone resident is a small qualified zone resident or a large qualified zone resident. A "large qualified zone resident" is a "qualified zone resident making qualified zone investments in excess of $100 million . . . [which] result in the creation of at least 200 permanent full-time positions."[90] A "small qualified zone resident" is any qualified zone resident that is not a large qualified zone resident.[91] Small qualified zone residents remain entitled to a real property investment tax credit equal to thirty percent of their qualified zone improvements.[92] Large qualified zone residents are allowed a real property investment tax credit in an amount of up to five percent of their qualified zone investments in lieu of the real property improvement credit.[93] The percentage amount of this credit, up to the five percent maximum, is to be determined by agreement between the Tax Department and the large qualified zone resident.[94]

The 1997 General Assembly also created an apportionment formula which has the effect of permitting the general business credit to be taken only against taxable income attributable to the conduct of business within the enterprise zone. The legislation provides for apportionment of the credit for any firm that has taxable income from business activity conducted "within and without the enterprise zone."[95]

To determine the amount of Virginia income apportioned within the zone, a qualified business firm must multiply its Virginia taxable income by the fraction resulting from adding the enterprise zone property factor and enterprise zone payroll factor and dividing the sum by two.[96] The property factor "is a fraction [in which t]he numerator is the average value of real

90. *Id.* § 59.1-280.1(A) (Cum. Supp. 1997).
91. *See id.*
92. *See id.* § 59.1-280.1(C) (Cum. Supp. 1997).
93. *See id.* § 59.1-280.1(D) (Cum. Supp. 1997).
94. *See id.*
95. *Id.* § 59.1-280(G) (Cum. Supp. 1997).
96. *See id.* § 59.1-280(G)(1) (Cum. Supp. 1997).

and tangible personal property of the . . . firm . . . used in the enterprise zone [and t]he denominator is the average value of real and tangible personal property . . . used everywhere in [Virginia]."[97] The payroll factor is a fraction in which the numerator is the total compensation paid or accrued by the firm during the taxable period in the enterprise zone, and the denominator is the total compensation paid or accrued everywhere in Virginia for the same period.[98] The legislation also permits qualified business firms that believe the apportionment formula operates to apportion to an enterprise zone a smaller portion of Virginia taxable income than is reasonably attributable to the business conducted in the zone, to apply to the Department of Taxation to use an alternative method.[99]

The 1997 General Assembly also made a number of other important changes to the Enterprise Zone Program. The definition of a "qualified business firm" was amended to reduce from forty percent to twenty-five percent the threshold percentage of low-income or zone resident employees that must be employed by a business in an enterprise zone for that business to be eligible for the general business credit.[100]

For purposes of the real property investment tax credit and enterprise zone grants creating permanent full-time positions, the definition of permanent full-time position has been amended to include employees working a minimum of 1680 hours a year who receive standard fringe benefits paid by the business for the employee.[101]

The legislation also brought within the confidentiality and secrecy provisions of the State Tax Code all tax information provided to the Department of Housing and Community Development from the Department of Taxation to facilitate the administration of the Enterprise Zone Act.[102] Any disclosures or other improper dissemination of information, except in accor-

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97. *Id.* § 59.1-280(G)(1)(a) (Cum. Supp. 1997).
98. *See id.* § 59.1-280(G)(1)(b) (Cum. Supp. 1997).
99. *See id.* § 59.1-280(G)(3) (Cum. Supp. 1997).
100. *See id.* § 59.1-279(A)(1) (Cum. Supp. 1997).
101. *See id.* §§ 59.1-280.1(A) and 59.1-282.1(A) (Cum. Supp. 1997).
102. *See* VA. CODE ANN. § 58.1-3(C) (Repl. Vol. 1997).

dance with a proper judicial order or otherwise provided by law, are now subject to criminal sanctions.[103]

In separate legislation, the 1997 General Assembly expanded the ability of any locality to define a single enterprise zone to consist of two non-contiguous zone areas. These two non-contiguous zone areas will not be considered separate zones for purposes of calculating the maximum number of zone designations established under the Enterprise Zone Act.[104] In essence, the legislation increases the statutory authority to create sub-zones for all localities. Previously, only rural enterprise zones could have non-contiguous zone areas.

The legislation also permits a locality or localities who apply for designation as an enterprise zone to propose adoption of a local enterprise zone development taxation program "to use tax increments to encourage private investment in local enterprise zones."[105] The governing body of any county, city or town can adopt this program by passing an ordinance designating an enterprise zone in its boundaries as a local enterprise zone, or can designate an area as a local enterprise zone contingent on the locality's designation as an enterprise zone.[106] The governing body must "hold a public hearing on the need for a local enterprise zone development taxation program" before adopting the ordinance.[107] The ordinance must provide that all or a specified percentage of the real estate taxes, machinery and tool taxes, or both, in the local enterprise zone are treated as follows: (1) "[r]eal estate taxes or machinery and tool taxes attributable to the lower of the current assessed value or base assessed value of real estate or machinery and tools located in a local enterprise zone"[108] will be allocated in the normal manner, as they would absent the ordinance; and (2) "all or the specified percentage of the increase in real estate taxes or machinery and tools taxes, or both, attributable to the difference between (i) the current assessed value of [the] property and (ii) the base assessed value of [the] property" are allocated

103. *See* VA. CODE ANN. § 59.1-282.4 (Cum. Supp. 1997).
104. *See id.* § 59.1-274(B) (Cum. Supp. 1997).
105. VA. CODE ANN. § 58.1-3245.7 (Repl. Vol. 1997).
106. *See id.* § 58.1-3245.8(A) (Repl. Vol. 1997).
107. *Id.* § 58.1-3245.8(B) (Repl. Vol. 1997).
108. *Id.* § 58.1-3245.8(A)(2) (Repl. Vol. 1997).

into a local development fund that can be spent for specified purposes.[109]

The legislation defines "base assessed value" as the assessed value on January 1 of the year before the effective date of the ordinance establishing the local enterprise zone development taxation program.[110]

II. RETAIL SALES AND USE TAXES

A. *Recent Judicial Decision*

In *Boehringer Ingelheim Pharmaceuticals, Inc. v. Department of Taxation*[111] the Richmond Circuit Court held that Boehringer Ingelheim's distribution of free drug samples to Virginia licensed physicians was a taxable use not covered by the prescription drug and medicine exemption from the Virginia Retail Sales and Use Tax Act.[112]

Boehringer Ingelheim manufactures pharmaceutical products, including prescription and over-the-counter medications. Boehringer Ingelheim regularly packaged some of its prescription medicines in smaller containers, labeled Professional Samples, while the rest of the production batch was packaged in larger quantities for distribution to pharmacies, hospitals and other approved recipients.[113] Boehringer Ingelheim provided prescription drug and medicine samples to selected employees, referred to as Detail Persons.[114] The Detail Persons visited with Virginia doctors informing them about products being manufactured by Boehringer Ingelheim, and upon the written request and signature of the doctor, the Detail Persons provided samples of the medications to the doctors.[115] The doctors could then "distribute the samples to their patients when prescribing that medication."[116] Following a sales and use tax audit by

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109. *Id.* § 58.1-3245.8(A)(3) (Repl. Vol. 1997).
110. *See id.* § 58.1-3245.6 (Repl. Vol. 1997).
111. 40 Va. Cir. 541 (Richmond City 1996).
112. *See id.* at 541.
113. *See id.*
114. *See id.* at 542.
115. *See id.*
116. *Id.*

the Department of Taxation, Boehringer Ingelheim received and paid two use tax assessments.[117]

At trial, Boehringer Ingelheim argued that its free distribution of prescription drug samples by its Detail Persons and the distribution by the doctors was exempt from Virginia use taxes pursuant to the prescription drug and medicine exemption.[118] The Department of Taxation contended, however, that "the manufacturer's distribution of samples to physicians [was] a taxable use not covered by the exemption."[119] The circuit court held that the plain meaning of the statutory exemption language did not apply to the free distribution of drug samples by Detail Persons to authorized recipients. The court noted that

> no taxable event occurs when a licensed individual (in this case, the physician) distributes prescription medication to patients. The Department has honored this statute in not imposing a tax on a physician or the patient for that distribution. However, this statute does not deal with the distribution from the manufacturer to the physician. Rather, it deals with medicines distributed by the physicians and medicines sold by a pharmacy on the order of a physician. Neither event occurred here. As such, the use involved was not exempt from taxation.[120]

Boehringer Ingelheim was successful with the second aspect of its lawsuit which concerned the "cost price" upon which the use tax rate would be applied to determine the appropriate amount of use tax owed to the Commonwealth. Boehringer Ingelheim provided "full absorption" method of accounting figures to the Department of Taxation.[121] These figures were internal management accounting data and did not coincide with "cost price" definition required under Virginia Code section 58.1-602.[122] This provision defines "cost price" as "the actual

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117. *See id.*

118. VA. CODE ANN. § 58.1-609.7(1) (Cum. Supp. 1995) and its predecessor VA. CODE ANN. § 58.1-608(A)(7)(a) (Cum. Supp. 1989), were applicable during the audit time period. The 1996 session of the General Assembly amended section 58.1-609.7(1) to specifically exempt prescription drugs from the sales and use tax. *See* Act of April 1, 1996, ch. 479, 1996 Va. Acts 809.

119. *Boehringer Ingelheim*, 40 Va. Cir. at 543.

120. *Id.* at 544.

121. *See id.* at 544-45.

122. *See id.*

cost of an item or article of tangible personal property computed in the same manner as the sales price as defined in this section without any deductions therefrom on account of the cost of materials used, labor, or service costs, transportation charges, or any expenses whatsoever."[123] The circuit court held that the Department of Taxation could not use Boehringer Ingelheim's "full absorption" cost figures, which included a number of items beyond those identified in the definition in Virginia Code section 58.1-602 of cost price.[124] The circuit court ordered the Department of Taxation to recalculate the taxes based on the definition of cost price in Virginia Code section 58.1-602.[125]

B. *Recent Significant Legislative Activity*

1. Exemptions

a. Broadcasting Exemption Expanded

The 1997 General Assembly expanded the current exemption for broadcasting equipment to include (1) land based wireless cable television systems, and (2) open video systems provided by telephone common carriers.[126] The legislation also repealed the exemption which was available to video dial tone systems.[127]

Prior to the 1997 legislation, the broadcasting exemption applied to broadcasting equipment used by commercial radio and television companies in amplification, transmission and distribution equipment in towers used or to be used by cable television systems or video dial tone systems. The 1997 legislation expanded the exemption to any land based wired or wireless cable television systems and includes, for example, television programming provided through microwave transmissions.[128] This type of system is available through common car-

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123. *Id.* at 545 (quoting VA. CODE ANN. § 58.1-602 (Repl. Vol. 1997)).
124. *See id.*
125. *See id.*
126. *See id.* § 58.1-609.6(2) (Repl. Vol. 1997).
127. *See id.*
128. *See id.*

rier telephone companies and utilizes fiber optic technology to deliver video programming.[129]

b. Non-Prescription Drug Exemption Amended

The 1997 General Assembly amended Virginia Code section 58.1-609.7(15) to specifically include within the sales and use tax exemption for non-prescription drugs and proprietory medicines, "samples of non-prescription drugs and proprietary medicines distributed free of charge by the manufacturer, including packaging materials and constituent elements and ingredients."[130] This legislation did not change the effective date of the exemption, which remains July 1, 1998.[131] The non-prescription drug exemption was originally enacted by the 1990 General Assembly to be effective on July 1, 1992.[132] The effective date has been deferred every two years since 1992 by subsequent sessions of the General Assembly.

c. Non-Profit School Exemption Expanded

The 1997 General Assembly expanded the current sales and use tax exemption for non-profit public and private colleges and other institutions of learning (including primary and secondary schools) to include "food purchased for free distribution at the facilities of the [non-profit] college or other institution of higher learning."[133] Prior to this legislation, it was the policy of the Department of Taxation that food purchased by the school was exempt if used or consumed by the school in providing its educational services. However, food purchased by schools and subsequently served free of charge to faculty, staff or guests of the school was taxable because the food was used or consumed by the individuals to whom the food was served and not by the school. This interpretation had previously been approved by a 1970 opinion of the Attorney General.[134]

129. *See id.*
130. *Id.* § 58.1-609.7(15)(a) (Repl. Vol. 1997).
131. *See id.*
132. *See* Act of March 10, 1990, ch. 117, 1990 Va. Acts 194, 199.
133. VA. CODE ANN. § 58.1-609.4(2) (Repl. Vol. 1997).
134. 1970 Op. Va. Att'y Gen. 291.

d. Definition of Tax-Exempt Organization Adopted

The 1997 General Assembly created a statutory definition of the term "tax-exempt organization" for all taxes imposed under the State Tax Code. The legislation defines a tax-exempt organization as any organization designated as such in writing by the Internal Revenue Service.[135] The legislation is significant because it provides a uniform definition of tax-exempt organizations, a concept missing from the non-profitable and charitable exemptions contained in the Virginia Retail Sales and Use Tax Act. Whenever the General Assembly amends the non-profit and charitable exemptions, it must specifically define the type or classification of tax exempt status an organization received from the Internal Revenue Service to fit within the statutory exemptions. The new general definition eliminates this technical requirement and also allows exempt organizations to amend or change their tax exempt classification with the Internal Revenue Service without the necessity of going back to the Virginia legislature to amend their particular sales and use tax exemption.

PART TWO: TAXES ADMINISTERED BY LOCALITIES

I. REAL PROPERTY TAX

A. *Recent Judicial Decision*

In *Augustine Golf Development Corp. v. Stafford County Board of Supervisors*[136] the Stafford County Circuit Court held that a county is not required to accept an offer to maintain an open-space agreement which substantially comports with Virginia Code section 58.1-3233(3).[137] The issue presented to the Stafford County Circuit Court was "whether an owner had a statutory right to have his real property assessed at 'open space' value, pursuant to a county ordinance permitting [this

135. *See* VA. CODE ANN. § 58.1-1 (Repl. Vol. 1997).
136. 40 Va. Cir. 308 (Stafford County 1996).
137. *See id.* at 311.

designation]."[138] Virginia Code section 58.1-3233(3)(iii) provides that land appropriately qualified as "open space" land may be assessed at lesser value by the taxing authority when the land is "subject to a recorded commitment entered into by the landowners with the local governing body . . . not to change the use to a non-qualifying use for the time period stated in a commitment of not less than four years and not more than ten years."[139]

The landowner, Augustine Golf Development Corporation, operated a public golf course, clubhouse, and other amenities consisting of approximately 190 acres in Stafford County, Virginia.[140] In the fall of 1994, Augustine Golf prepared and tendered to Stafford County an "Open-Space Use Agreement," which covered the entire 190 acres owned by Augustine and was to have a term of ten consecutive years.[141] Stafford County declined to execute the agreement tendered by Augustine Golf. The County conceded that had Augustine Golf elected to record a perpetual easement held by Stafford County and devoted to open-space use as authorized by Virginia Code section 58.1-3233(3)(ii), Stafford County would have no discretion and would be required to accept the easement and grant open space tax assessment to the parcel.[142] However, Stafford County argued that when a property owner elects to proceed under Virginia Code section 58.1-3233(3)(iii), the County "retains the discretion to accept or decline the proffered agreement."[143]

The circuit court reviewed the agreement offered by Augustine Golf and noted that it contained many terms of contractual-type language which suggested mutual agreement and willingness between the parties.[144] The court concluded that the "'open-space use agreement' tendered by Augustine Golf was an offer to maintain its property as open space for a period of ten years, if the County was willing to accept that offer and in consideration thereof grant Augustine Golf open-space tax as-

138. *Id.* at 308.
139. VA. CODE ANN. § 58.1-3233(3)(iii) (Repl. Vol. 1997).
140. *See Augustine Golf*, 40 Va. Cir. at 309.
141. *See id.*
142. *See id.*
143. *Id.*
144. *See id.* at 310.

sessment for that period of time."[145] The court found that Stafford County had a choice of accepting or rejecting the offer made by Augustine Golf and that Stafford County was within its rights in rejecting the open-space tax assessment offer.[146]

B. *Recent Significant Legislative Activity*

The 1997 General Assembly created a separate classification for real property tax for environmental restoration sites.[147] This legislation authorizes localities, by ordinance, "to exempt or partially exempt such [real] property from local taxation annually for a period not in excess of five years."[148]

An "environmental restoration site" is defined to include "real estate which contains or did contain environmental contamination from the release of hazardous substances, hazardous wastes, solid waste or petroleum, the restoration of which would abate or prevent pollution to the atmosphere or waters of the Commonwealth," provided the land is restored as part of a voluntary remediation effort pursuant to Virginia Code section 10.1-1429.1 and "receives a certificate of continued eligibility from the Virginia Waste Management Board during each year which the [restoration site] qualifies for tax treatment" under this legislation.[149]

II. BUSINESS, PROFESSIONAL AND OCCUPATIONAL LICENSE TAX

A. *Recent Significant Legislative Activity*

The 1997 General Assembly amended Virginia Code section 58.1-3984(A) to expand the statute of limitations for taxpayers appealing license tax assessments to a circuit court to allow appeals to be made within one year from a final determination made by the Department of Taxation.[150] The legislation also permits local assessing officials to appeal final determinations

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145. *Id.* at 311.
146. *See id.*
147. *See* VA. CODE ANN. § 58.1-3664 (Repl. Vol. 1997).
148. *Id.*
149. *Id.*
150. *See id.* § 58.1-3984(A)(iii) (Repl. Vol. 1997).

to the appropriate circuit court within one year from the date of the determination.[151] Both taxpayers and local assessing officials wishing to appeal Department of Taxation determinations now have the later of (i) three years from the last day of the year for which an assessment is made, (ii) one year from the date of the assessment, or (iii) one year from the date of a final determination made by the Tax Commissioner, in which to file an appeal.[152]

B. *BPOL Guidelines Released*

In 1996, the Virginia General Assembly enacted a major bill reforming the local business, professional and occupational license, BPOL, tax.[153] Included within the 1996 legislation was the creation of "Uniform Ordinance" provisions.[154] The 1996 legislation also réquired the Department of Taxation to promulgate guidelines.[155] On January 1, 1997, the Department of Taxation released the BPOL Guidelines.[156] Virginia Code section 58.1-3701 provides that these guidelines will be subject to the Administrative Process Act and accorded the weight of a regulation under Virginia Code section 58.1-205.[157]

The guidelines are comprehensive in nature. They include detailed definitions for a number of terms which have traditionally caused ambiguity in the interpretation and administration of the BPOL tax by localities. The guidelines also provide a detailed description of the structure of the BPOL tax and discuss the procedures for appeals by taxpayers of BPOL tax assessments.

Any taxpayer who is assessed with a local BPOL tax as a result of an audit may appeal that assessment to the State Tax

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151. *See id.* § 58.1-3984(B) (Repl. Vol. 1997).
152. *See id.* § 58.1-3984(A) (Repl. Vol. 1997).
153. *See id.* §§ 58.1-3700 to -3735. For a discussion of the 1996 BPOL legislation, see Craig D. Bell, *Virginia Taxation*, 30 U. RICH. L. REV. 1543, 1603-08 (1996).
154. *See* VA. CODE ANN. § 58.1-3703.1 (Repl. Vol. 1997).
155. *See id.* § 58.1-3701 (Repl. Vol. 1997).
156. DEPARTMENT OF TAXATION, COMMONWEALTH OF VIRGINIA GUIDELINES FOR BUSINESS, PROFESSIONAL AND OCCUPATIONAL LICENSE TAX IMPOSED BY CITY, COUNTY AND TOWN ORDINANCES (1997) [hereinafter GUIDELINES].
157. *See* VA. CODE ANN. § 58.1-3701 (Repl. Vol. 1997).

Commissioner, who has the authority to reverse the local assessing officer's determination.[158]

Taxpayers retain their right to file an administrative refund request under Virginia Code section 58.1-3980.[159] As a result of the 1996 legislation, taxpayers are also afforded a special appeal procedure with respect to BPOL taxes and audits only. Any taxpayer aggrieved by an audit assessment of BPOL taxes may proceed administratively under Virginia Code section 58.1-3703.1(A)(5).[160] This special procedure permits appeal of the local assessing officer's determination to the Virginia Tax Commissioner.[161] The new BPOL tax appeal procedure is limited to assessments of tax resulting from an audit.[162] "Audit" is defined generally as any examination of the taxpayer's books and records by the local assessing official.[163] As a result, a refusal of a local assessing officer to make a refund based on an amended return is probably not appealable because there is no assessment based on the audit. On the other hand, if the amended return results in an examination of the taxpayer's books and records and the assessing officer makes some adjustment resulting in an increase of tax, all issues arising in the audit may be appealed.[164] It is not clear how local assessing officers will interpret the term "audit" for purposes of triggering a taxpayer's new appeal rights.

Under the BPOL appeal procedures, any arguments raised for the first time on appeal to the State Tax Commissioner may be returned to the local assessing officer for his determination.[165] The form of the administrative BPOL appeal, both to the local assessing officer and to the State Tax Commissioner, is informal. The appeal may be made in a letter that sets forth all the relevant facts, circumstances, and arguments favoring the taxpayer's position.[166] The taxpayer must attach a copy of

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158. *See id.* § 58.1-3703.1(A)(5)(c) (Repl. Vol. 1997).
159. *See id.* § 58.1-3980 (Repl. Vol. 1997).
160. *Id.* § 58.1-3703.1(A)(5) (Repl. Vol. 1997).
161. *See* GUIDELINES § 4.1.
162. *See id.*
163. *See* GUIDELINES § 4.4.
164. *See id.*
165. *See* GUIDELINES § 4.8.5.
166. *See* GUIDELINES § 4.4 (defining "Appeal to the Tax Commission" and "Application for Review").

the assessment appealed from, and, on appeal to the State Tax Commissioner, copies of all materials reviewed by the local assessing officer and the local assessing officer's determination.[167] A taxpayer generally has ninety days from the date of the assessment in which to make an application for review to the local assessing officer,[168] and ninety days after that officer's final determination in which to appeal to the State Tax Commissioner.[169] Any locality which "loses" an administrative appeal to the State Tax Commissioner is afforded the right to apply to the appropriate circuit court for judicial relief in the same manner as an aggrieved taxpayer.[170]

The Guidelines also provide procedures and details which elaborate on the State Tax Commissioner's new authority to issue rulings interpreting the application of Virginia's BPOL statutes.[171] The State Tax Commissioner, however, will not issue rulings that turn solely on the interpretations of a local ordinance.[172] Examples of issues on which the Tax Commissioner may render advisory opinions include:

- Interpretation of changes made to the BPOL legislation;
- Questions, the answers of which depend upon both state law and the laws of a locality;
- Situations where two jurisdictions are attempting to tax the same gross receipts;
- Classifications of businesses under the BPOL enabling legislation;
- Whether a business qualifies as a manufacturer under existing court decisions;
- Whether a business qualifies for deductions, exclusions, or reduced rates of tax contained within the BPOL legislation;

167. *See id.*
168. *See* GUIDELINES § 4.7.1.
169. *See* VA. CODE ANN. § 58.1-3703.1(A)(5)(a), (c) (Repl. Vol. 1997); GUIDELINES § 4.8.1.
170. *See* GUIDELINES § 4.10.
171. *See* GUIDELINES § 2.1.7.
172. *See* GUIDELINES § 4.12.

- Situs rules contained within the BPOL enabling legislation; and

- Whether changes made to a local statute conform with required changes under recent Virginia law.[173]

The Guidelines state that the Tax Commissioner will likely decline to render advisory opinions on interpretations of wording contained within individual local BPOL ordinances and on interpretations questioning the validity of a particular locality's appeal process.[174]

Collection activity by a locality must be suspended upon the filing by a taxpayer of a timely and complete Application for Review, a Notice of Intent to Appeal or upon receipt of notice of the filing of an Appeal to the Virginia Tax Commissioner.[175] Collection activity may commence or resume if the local assessing officer determines that collection will be jeopardized by delay, a Final Local Determination is issued, a taxpayer's appeal is not timely filed after a prior timely Notice of Appeal was filed with the Tax Commissioner, a final written determination is issued by the Tax Commissioner which does not totally abate the local license tax assessment, or the taxpayer withdraws its appeal with the Tax Commissioner.[176]

Local assessing officers also have the power to issue binding rulings.[177]

173. *Id.*
174. *See id.*
175. *See* GUIDELINES § 4.6
176. *See id.*
177. *See* GUIDELINES § 4.11.