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TAXATION

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I. INTRODUCTION

This article reviews significant recent developments in the law affecting Virginia taxation. Each section covers recent judicial decisions, legislative changes, and selected opinions or pronouncements from the Virginia Department of Taxation and the Virginia Attorney General 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 their practices. This article will not, however, discuss many of the numerous technical legislative changes to the State Taxation Code of Title 58.1.

PART ONE: TAXES ADMINISTERED BY THE VIRGINIA DEPARTMENT OF TAXATION

II. INCOME TAX

A. *Recent Significant Legislative Activity*

1. Fixed Date Conformity

The Conformity of terms to the Internal Revenue Code ("I.R.C.") Virginia Code section 58.1-301, was amended by the

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General Assembly to advance Virginia's fixed date conformity to the federal income tax laws from December 30, 2002 to December 30, 2003.[1] This legislation continues the disallowance of the thirty percent bonus depreciation allowed for certain assets under federal income taxation to flow through to the Virginia income tax base by virtue of I.R.C. § 168(k)(1)(A)[2] and of any five-year carryback of net operating losses ("NOL") allowed for NOLs granted in either taxable year 2001 or 2002.[3] By advancing the conformity date to December 31, 2003, Virginia conforms to the other provisions adopted by Congress in the Job Creation and Worker Assistance Act of 2002,[4] including the increase and expansion of the I.R.C. § 179 asset expense deduction from $25,000 to $100,000,[5] the changes made by the Military Family and Tax Relief Act of 2003,[6] and the Medicare Prescription Drug, Improvement, and Modernization Act of 2003.[7]

This fixed date conformity legislation was passed and enacted as emergency legislation that became effective on April 12, 2004, the date Governor Warner signed the bill into law.[8] As the legislation was adopted less than three weeks before the filing date of Virginia income tax returns, the Virginia Department of Taxation issued a tax bulletin nine days after this legislation became law to address the impact of the advanced fixed date conformity on Virginia taxpayers who had already filed their income tax returns for 2003 before the legislation had passed, and to provide guidance to those taxpayers who would be filing shortly after the change was enacted.[9]

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1. Act of Apr. 12, 2004, ch. 512, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-301(B) (Repl. Vol. 2004)).

2. *See* VA. CODE ANN. § 58.1-301(B)(1) (Repl. Vol. 2004).

3. I.R.C. § 172(b)(1)(H) (West Supp. 2004); *see* VA. CODE ANN. § 58.1-301(B)(2) (Repl. Vol. 2004).

4. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21.

5. *Id.*

6. Military Family Tax Relief Act of 2003, Pub. L. No. 108-121, 117 Stat. 1335.

7. Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, 117 Stat. 2066.

8. Act of Apr. 12, 2004, ch. 512, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-301 (Repl. Vol. 2004)).

9. VA. DEP'T OF TAX'N, TAX BULLETIN 04-2 (Apr. 23, 2004), *available at* http://tax.state.va.us/ (last visited Sept. 25, 2004).

2. Qualified Equity and Subordinated Debt Investment Tax Credit

The 2004 General Assembly made a number of changes to the Qualified Equity and Subordinated Debt Investment Tax Credit ("QESDITC") when it amended Virginia Code section 58.1-339.4.[10] The QESDITC grants an income tax credit to individuals, trusts, and estates in an amount equal to fifty percent of qualified investments made in a qualified Virginia small business venture.[11] The credit provides an incentive for capital investment in small businesses located in Virginia. The aggregate amount of the credit available to a taxpayer in a taxable year is limited to the lesser of the tax imposed for such taxable year or $50,000.[12] Unused credits can be carried forward to offset future income tax liability for up to fifteen taxable years.[13]

The General Assembly amended Virginia Code section 58.1-339.4(A) to reduce the minimum period in which an issuer may require redemption of an equity investment from five to three years from the date of issuance.[14] However, the definition of equity for purposes of the QESDITC did not change.[15] "'Equity' means common stock or preferred stock, regardless of class or series, of a corporation; a partnership interest in a limited partnership; or a membership interest in a limited liability company, which is not required or subject to an option on the part of the taxpayer . . . ."[16]

The location of the qualified business in which the investment is made was also expanded by the Virginia legislature. Prior to this legislation, a qualified business had to be domiciled in Virginia.[17] The new legislation replaced the domicile requirement for the qualified business with a requirement that the business's

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10. Act of Apr. 12, 2004, ch. 614, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-339.4 (Repl. Vol. 2004)).

11. VA. CODE ANN. § 58.1-339.4(B) (Repl. Vol. 2004).

12. *Id.* § 58.1-339.4(D) (Repl. Vol. 2004).

13. *Id.*

14. Act of Apr. 12, 2004, ch. 614, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-339.4(A) (Repl. Vol. 2004)).

15. *Id.*

16. VA. CODE ANN. § 58.1-339.4(A) (Repl. Vol. 2004).

17. *Id.* (Repl. Vol. 2000).

principal office or facility be located in Virginia.[18] The annual maximum revenue level required for a qualified business was reduced from $5,000,000 to $3,000,000 in its most recent fiscal year.[19] Furthermore, the definition of a qualified business now excludes those businesses that have already successfully raised more than $3,000,000 in total investment capital.[20]

The legislation also limits the tax credits to prohibit taxpayers that manage capital in excess of $10,000,000 and engage in the business of making debt or equity investments in private businesses from claiming the QESDITC.[21] This restriction also applies to any taxpayer that has allocated the credit as a partner, shareholder, member or owner of an entity that engages in making debt or equity investments in private businesses.[22]

The General Assembly also reduced the holding period from five to three calendar years for which a taxpayer must retain ownership in the equity investment.[23] The existing tax penalty for failure to meet this holding period was also removed.[24] On a procedural note, the legislature expressly permits the Virginia Department of Taxation to accept an application for certification as a qualified business to be filed at any time during the calendar year regardless of when the investment is made during the calendar year.[25] All of these legislative changes to the QESDITC will become effective on January 1, 2005.[26]

3. Major Business Facility Job Tax Credit

The 2004 General Assembly made two changes to the major business facility job tax credit. First, the legislature created Virginia Code section 58.1-439(L), which will reduce the threshold

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18. *Id.* (Repl. Vol. 2004).

19. Act of Apr. 12, 2004, ch. 614, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-339.4(A) (Repl. Vol. 2004)).

20. VA. CODE ANN. § 58.1-339.4(A) (Repl. Vol. 2004).

21. *Id.* § 58.1-339.4(B) (Repl. Vol. 2004).

22. *Id.*

23. Act of Apr. 12, 2004, ch. 614, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-339.4(F) (Repl. Vol. 2004)).

24. *Id.*

25. VA. CODE ANN. § 58.1-339.4(G) (Repl. Vol. 2004).

26. Act of Apr. 12, 2004, ch. 614, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-339.4 (Repl. Vol. 2004)).

required to qualify for the major business facility job tax credit from one hundred to twenty-five new qualified full-time jobs provided the facility is located in a severely economically depressed area.[27] A severely economically distressed area is one in which the unemployment rate for the preceding year is at least twice the statewide average unemployment rate.[28] The legislation directs the Virginia Economic Development Partnership to identify and publish a list of all severely economically distressed areas at least annually.[29] The total amount of credit allowed for a business qualifying for the major business facility job tax credit in a severely economically distressed area shall not exceed $100,000 in aggregate.[30] This reduced threshold is only available for tax years 2004 and 2005.[31]

The General Assembly also amended Virginia Code section 58.1-439(A) to extend the sunset date for the major business facility job tax credit from January 1, 2005 to January 1, 2010.[32]

4. Land Preservation Tax Credit

The Virginia Land Conservation Incentives Act of 1999[33] created an income tax credit for individuals, estates, trusts, partnerships, limited liability companies, limited partnerships, and corporations donating land for conservation and preservation purposes.[34] The credit is not refundable, but it can be carried forward up to five years.[35] This credit equals fifty percent of the fair market value of the land transferred to a private or public conservation agency up to a maximum credit of $100,000 per taxable year.[36] Furthermore, unused land conservation tax credits may be transferred to other taxpayers for use by such other taxpayers on

27. Act of Apr. 12, 2004, ch. 619, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-439(L) (Repl. Vol. 2004)).

28. VA. CODE ANN. § 58.1-439(L) (Repl. Vol. 2004).

29. *Id.*

30. *Id.*

31. *Id.*

32. Act of Mar. 19, 2004, ch. 170, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-439(A) (Repl. Vol. 2004)).

33. Act of Apr. 7, 1999, ch. 983, 1999 Va. Acts 2595 (codified at VA. CODE ANN. §§ 58.1-510 to -513 (Repl. Vol. 2004)).

34. *See* VA. CODE ANN. §§ 58.1-512, - 513 (Repl. Vol. 2004).

35. *Id.* § 58.1-512(B)(1) (Repl. Vol. 2004).

36. *Id.*

their Virginia income tax returns.[37] The types of property that qualify for this credit include conservation easements, any partial interest, mineral right, remainder or future interest, or other interest or right in real property.[38] The conveyance of real property under this statute must be permanent and irrevocable.[39]

The 2004 General Assembly amended Virginia Code section 58.1-513 to authorize a pass-through entity that allocates or transfers Land Preservation Tax Credits among taxpayers to designate a general partner, member, or shareholder as the person that the Virginia Tax Commissioner would first contact for the collection of taxes in the event any portion of the credit is disallowed in the future.[40] If the designated person fails to satisfy the liability, the Virginia Department of Taxation would proceed with collection actions against the persons claiming the tax credit.[41]

5. Recyclable Materials Tax Credit

Corporations are allowed an income tax credit equal to ten percent of the purchase price paid during the tax year for machinery and equipment used to process recycled materials.[42] The total credit allowed in any taxable year is limited to forty percent of the corporation's Virginia income tax liability prior to applying the recycling tax credit.[43] The Virginia Department of Environmental Quality must certify the purchases made by the corporation were integral to the recycling process before the corporation is entitled to claim the credit.[44]

The 2004 General Assembly amended Virginia Code section 58.1-439.7 to extend the sunset date from December 31, 2003 to

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37. *Id.* § 58.1-513(C) (Repl. Vol. 2004). For additional guidance see VA. DEP'T OF TAX'N, PUB. DOC. 03-77 (Oct. 31, 2003), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004); VA. DEP'T OF TAX'N, PUB. DOC. 03-55 (Aug. 7, 2003), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004); VA. DEP'T OF TAX'N, PUB. DOC. 03-12 (Feb. 27, 2003), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004).

38. VA. CODE ANN. § 58.1-511 (Repl. Vol. 2004).

39. *Id.* § 58.1-512 (Repl. Vol. 2004).

40. Act of Apr. 12, 2004, ch. 635, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-513(F) (Repl. Vol. 2004)).

41. *Id.*

42. VA. CODE ANN. § 58.1-439.7(A) (Repl. Vol. 2004).

43. *Id.* § 58.1-439.7(B) (Repl. Vol. 2004).

44. *Id.* § 58.1-439.7(A) (Repl. Vol. 2004).

December 31, 2006 for this corporate income tax credit for machinery and equipment used to produce personal property from recyclable materials.[45]

6. Neighborhood Assistance Tax Credit

The Neighborhood Assistance Act[46] allows income tax credits for business entities and individuals who contribute to approved neighborhood assistance organizations designed to benefit impoverished individuals.[47] The credit can be applied against the income tax imposed on individuals, trusts, estates, and corporations.[48] The credit may also be applied against the bank franchise tax; the gross receipts tax imposed on insurance; and public service corporations.[49] Business firms are permitted a tax credit equal to forty-five percent of contributions made, and a business must make a minimum donation to receive a credit.[50] A business donor may take a maximum of $175,000 in tax credits in any tax year.[51] Any tax credit that is not used in the year of receipt may be carried forward for the next five years.[52] Individual donors may not claim more than $750 of the credit for any tax year.[53] Calculation of the credit is also computed as an amount equal to forty-five percent of the donation.[54]

The General Assembly made several changes to the Neighborhood Assistance Act in 2004. First, the legislature amended Virginia Code section 63.2-2004 to make Neighborhood Assistance Tax Credits available to eligible health professionals who provide health care services within the scope of their licensure, without charge, regardless of where the services are delivered.[55] Prior to this amendment the health care services had to be provided at a

45. Act of Apr. 12, 2004, ch. 611, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-439.7(A) (Repl. Vol. 2004)).

46. VA. CODE ANN. §§ 63.2-2000 to -2006 (Repl. Vol. 2002 & Cum. Supp. 2004).

47. *Id.* §§ 63.2-2002, -2004 (Cum. Supp. 2004).

48. *See id.* § 63.2-2003(B)(Repl. Vol. 2002).

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* § 63.2-2006(B) (Repl. Vol. 2002).

54. *Id.*

55. Act of Apr. 12, 2004, ch. 725, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 63.2-2004(C) (Cum. Supp. 2004)).

free or not-for-profit clinic in order for these health care professionals to be eligible for the tax credit.[56] The legislature also added chiropractors to the list of health care professionals eligible to participate in the Neighborhood Assistance Act and receive the tax credits.[57] Lastly, the General Assembly extended the sunset dates for the tax credits allowed under the Neighborhood Assistance Act from the close of the fiscal year 2004 to the close of fiscal year 2009 on June 30, 2009.[58]

7. Minimum Tax on Certain Electric Suppliers

The 2004 General Assembly enacted legislation that will require electric suppliers to pay a minimum tax rather than a corporate income tax for any taxable year in which their minimum tax liability is greater than their corporate income tax liability.[59] The minimum tax will be equal to 1.45% of the electric supplier's gross receipts minus Virginia's portion of the electric utility consumption tax billed to consumers.[60]

For electric suppliers that are organized as a cooperative and exempt from federal taxation under I.R.C. § 501(c)(3), the minimum tax is equal to 1.45% of the cooperative's gross receipts from sales to nonmembers minus the Virginia electric utility consumption tax billed to nonmembers of the electric cooperative.[61] Electric cooperatives will pay the minimum tax only if it exceeds their modified net income tax.[62]

The new legislation defines an electric supplier as "an incumbent electric utility in the Commonwealth that, prior to July 1, 1999, supplied electric energy to retail customers located in an exclusive service territory established by the State Corporation

56. VA. CODE ANN. § 63.2-2004(C) (Repl. Vol. 2002).

57. Act of Apr. 12, 2004, ch. 657, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 63.2-2004(C) (Cum. Supp. 2004)).

58. Act of Apr. 12, 2004, ch. 699, 2004 Va. Acts. ___ (codified as amended at VA. CODE ANN. § 63.2-2002(D) (Cum. Supp. 2004)).

59. Act of Apr. 12, 2004, ch. 716, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-400.3(A)(1) (Repl. Vol. 2004)). The electric utility consumption tax is governed by VA. CODE ANN. §§ 58.1-2900 to -2903 (Repl. Vol. 2004).

60. VA. CODE ANN. § 58.1-400.3(A)(2) (Repl. Vol. 2004).

61. *Id.* § 58.1-400.3(B) (Repl. Vol. 2004); *see also* I.R.C. § 501(c)(3) (West Supp. 2004).

62. VA. CODE ANN. § 58.1-400.3(B)(1) (Repl. Vol. 2004).

Commission."[63] The new statute also provides an apportionment formula for when an electric supplier subject to the minimum tax is one of several affiliated corporations that file a consolidated or combined income tax return to determine whether the minimum tax is applicable to such electric supplier.[64]

8. Pass-Through Entities to File Information Returns

Pass-through entities are business entities such as partnerships, limited liability companies and Subchapter S corporations that are not subject to federal and state income taxes at the entity level.[65] The partners, members, or shareholders of the pass-through entity report their share of the income and expenses from the entity on their own income tax returns.[66] Pass-through entities are required to file informational returns (i.e., IRS Form 1065 for partnerships or limited liability companies who elect to be taxed as a partnership and IRS Form 1120S for Subchapter S corporations) with the Internal Revenue Service.[67] Virginia eliminated the requirement, however, that partnerships file a state information return in 1988.[68] Virginia Code section 58.1-392, prior to January 1, 2004, provided that no information report must be filed with the Virginia Department of Taxation by a Virginia partnership having income from Virginia sources.[69]

As a result of the lack of any requirement for pass-through entities to file information returns reporting Virginia source income, the Virginia Department of Taxation has no real effective way of identifying the owners of pass-through entities who have liability for Virginia income taxes on Virginia source income.[70] This inefficiency is assumed by the Virginia Department of Taxation to lead to the belief that non-resident owners of pass-through entities

63. *Id.* § 58.1-400.3(K) (Repl. Vol. 2004).

64. *Id.* § 58.1-400.3(E) (Repl. Vol. 2004).

65. 26 U.S.C. §§ 701, 1366 (2000).

66. *Id.*

67. Treas. Reg. §§ 1.701-1, 1.1366-1(a) (2004).

68. Act of Mar. 23, 1988, ch. 249, 1988 Va. Acts 297 (codified as amended at VA. CODE ANN. § 58.1-392 (Repl. Vol. 2000)).

69. VA. CODE ANN. § 58.1-392 (Repl. Vol. 2000).

70. *See id.* This section only provides that the Tax Commissioner has the authority to issue regulations requiring partnerships to furnish copies of federal partnership returns and attached schedules when he deems necessary. *Id.* Failure to comply may lead to the imposition of a $100 penalty. *Id.*

having Virginia source income may not be filing non-resident Virginia income tax returns and making the payment of Virginia taxes due on their Virginia income from Virginia sources.[71]

As part of the budget legislation approved by the 2004 General Assembly, the legislature amended Virginia Code section 58.1-392 to require pass-through entities to file information returns with the Virginia Department of Taxation effective for tax years beginning on and after January 1, 2004.[72] This new requirement authorizes the Virginia Department of Taxation to establish an income threshold for the filing requirement.[73] Pass-through entities and owners with income below this threshold will not be required to file an information return.[74] The legislation also authorizes the Tax Commissioner to require pass-through entities to file such informational returns electronically.[75] A pass-through entity may apply for a waiver of the electronic filing requirement from the Tax Commissioner.[76] The Tax Commissioner is also authorized to exclude from the electronic filing requirement pass-through entities that have fewer owners (partners, members, shareholders) than an established minimum number of owners set by the Tax Commissioner.[77]

The General Assembly also enacted Virginia Code section 58.1-394.1, which will impose a $200 penalty for failure by the pass-through entity to timely file the information return within the first month when such return is due, plus an additional penalty of $200 for each month or fraction thereof during which such failure to file continues.[78] The penalty, in the aggregate, shall not exceed six months ($1,200).[79] Failure to file the return in excess of six months past the due date will result in a penalty assessment of

71. Meeting with Virginia Tax Commissioner Kenneth W. Tharson and Senior Tax Policy Analyst William White on December 10, 2003 at the Department of Taxation's offices. Notes of meeting maintained by author.

72. Act of June 3, 2004, ch. 15, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-392(A) (Repl. Vol. 2004)).

73. VA. CODE ANN. § 58.1-392(C) (Repl. Vol. 2004).

74. *Id.*

75. *Id.* § 58.1-392(E) (Repl. Vol. 2004).

76. *Id.*

77. *Id.*

78. Act of June 3, 2004, ch. 15, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-394.1(A) (Repl. Vol. 2004)).

79. VA. CODE ANN. § 58.1-394.1(A) (Repl. Vol. 2004).

six percent of the total amount of Virginia taxable income derived by the pass-through entities' owners for the tax year.[80]

The legislature also adopted a new statute making officers or owners of pass-through entities, who make fraudulent returns or statements with the intent of assisting or facilitating the evasion of the payment of the taxes, face a civil penalty of not more than $1,000.[81] Officers or owners, who fully fail or refuse to make a return, will be guilty of a Class 1 misdemeanor.[82] There is a five-year statute of limitations established for any prosecution of this new criminal penalty.[83]

Pass-through entities are authorized as a result of this legislation to apply to the Tax Commissioner to file a single composite return for all non-resident owners and thereby relieve non-resident owners from filing individual non-resident returns.[84]

9. Individual and Fiduciary Income Tax Return Filing Option

The General Assembly amended Virginia Code sections 58.1-305 (individuals) and 58.1-306 (fiduciaries) to permit taxpayers to file their individual and fiduciary income tax returns with the Virginia Department of Taxation as well as with their local commissioners of the revenue.[85] Prior to these amendments individual taxpayers were required to file their income tax returns with their local commissioner of the revenue, unless the locality had opted to have its residents file directly with the Virginia Department of Taxation.[86]

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80. *Id.* § 58.1-394.1(B) (Repl. Vol. 2004).

81. Act of June 3, 2004, ch. 15, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-394.2(A) (Repl. Vol. 2004)).

82. VA. CODE ANN. § 58.1-394.2(B) (Repl. Vol. 2004).

83. *Id.*

84. Act of June 3, 2004, ch. 15, 2004 Va. Acts ___ (codified at VA. CODE ANN. § 58.1-395 (Repl. Vol. 2004)).

85. Act of Apr. 12, 2004, ch. 544, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. §§ 58.1-305, -306 (Repl. Vol. 2004)).

86. VA. CODE ANN. §§ 58.1-305, -306 (Repl. Vol. 2000).

10. Anti-Delaware Holding Company Legislation

Virginia has joined a number of other states that have recently adopted legislation severely limiting the ability of Virginia-domiciled corporations to enjoy the benefits provided by the use of intellectual property or passive investment holding companies.[87] An intangible holding company is a corporation that is formed to hold intangible property assets such as trademarks, trade names, patents, and similar assets.[88] The corporation generally receives these assets from a parent corporation or affiliated company in exchange for stock or other equity ownership in the intangible property holding company.[89] The intangible holding company will enter into a contractual relationship with its affiliates, and additionally sometimes unrelated entities, that allow another entity to use the trademark, trade name, or patent in exchange for a reasonable license fee or royalty payment paid to the intangible holding company for use of the intangible asset.[90] The intangible holding company is traditionally domiciled in a no-tax or lower-tax state.[91] For example, Delaware exempts from the Delaware corporate income tax income received by a Delaware corporation whose activities within Delaware "are confined to the maintenance and management of their intangible investments . . . and the collection and distribution of the income from such investments. . . ."[92] For purposes of this exemption, the Delaware definition of intangible investments includes investments in "stocks, bonds, notes . . . patents, patent applications, trademarks, trade names and similar types of intangible assets."[93]

87. The following states have recently adopted legislation aimed at reducing the tax effects on state taxable income to corporations who use intangible property holding companies: Alabama, Arkansas, Connecticut, Massachusetts, Michigan, Mississippi, New Jersey, North Carolina and Ohio. Virginia Department of Taxation, 2004 Fiscal Impact Statement for Senate Bill 683 at 2, *available at* http://leg1.state.va.us/ (last visited Sept. 25, 2004).

88. Based on the author's experience in evaluating and analyzing the suitability of intangible asset holding companies for clients, and structuring transactions involving the use of intangible asset holding companies as a component to the overall restructuring of a company and its affiliates.

89. *Id.*

90. *Id.*

91. *Id.*

92. DEL. CODE ANN. tit. 30, § 1902(b)(8) (1997 & Supp. 2002).

93. *Id.* For additional background information on the use of Delaware holding companies for owning intangible personal property see William G. Fendley IV, *Fact or* Fiction: *Legitimate Tax Savings Through Delaware IP Holding Companies?*, VA. LAW., Feb. 2004,

When computing Virginia corporate taxable income, corporations start with their federal taxable income as reflected on its federal corporate income tax return, which reflects deductions taken for royalties, interest and other expenses paid to an affiliated intangible holding company.[94] The result is that Virginia taxable income is reduced by the apportionable amount of the deductions relating to the intangible holding company.[95] The royalties, license fees, and related expense payments are reported as revenue by the intangible holding company. As set forth above, Delaware exempts such income. No tax is paid by the affiliate in Delaware on the royalty or license fees it receives,[96] and Virginia taxable income has been reduced to the extent these business expenses are apportioned to Virginia.[97]

In a conscious effort to curtail the benefits of using Delaware holding companies in Virginia, the 2004 General Assembly significantly curtailed the benefits by requiring additions to be made to federal taxable income for certain deductions claimed for intangible property and interest expenses related to Delaware holding companies.[98] Under the new legislation, corporations will be required to add back to federal taxable income any interest and intangible expense directly or indirectly paid to one or more related members.[99] However, this add-back provision would not be required if the corresponding item of income is subject to a tax based on or measured by net income or capital in another state or foreign country that has a comprehensive tax treaty with the United States;[100] or "[t]he related member derives at least one-third of its gross revenues from the licensing of intangible property to parties who are not related members, and the transaction giving rise to the expenses and costs between the corporation and the related member was made at rates and terms comparable to the rates and terms of agreements that the related member has entered into with parties who are not related members for the li-

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at 36.

94. *See* VA. DEP'T OF TAX'N 2003 Form 500, 2003 Virginia Corporate Income Tax Return, line 1, *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004).

95. *See* VA. CODE ANN. § 58.1-406 (Repl. Vol. 2004).

96. DEL. CODE ANN. tit. 30, § 1902(b)(8) (1997 & Supp. 2002).

97. *See* VA. CODE ANN. §§ 58.1-406, -408 (Repl. Vol. 2004).

98. Act of June 3, 2004, ch. 3, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. §§ 58.1-302, -402(B)(8), -402(B)(9), -1206(A)(4) (Repl. Vol. 2004)).

99. VA. CODE ANN. § 58.1-402(B)(8)(a), -402(B)(9)(a) (Repl. Vol. 2004).

100. *Id.* § 58.1-402(B)(8)(a)(1), -402(B)(9)(a)(4)(i) (Repl. Vol. 2004).

censing of intangible property;"[101] or the corporation can establish to the satisfaction of the Tax Commissioner that the intangible expenses and costs were accrued, incurred or paid to a person who is not a related member, and the transaction giving rise to the intangible expenses and costs between the corporation and the related member were not entered into for tax avoidance purposes.[102]

The General Assembly also set forth a procedure whereby a corporation is required to add back to its federal taxable income intangible expenses and costs, pursuant to Virginia Code section 58.1-402(B)(8). Corporations may petition the Tax Commissioner for review, though the procedure is draconian.[103] First, no petition may be filed until after filing the tax return and making the add-back of expenses and costs directly or indirectly relating to the intangible holding company.[104] Second, all taxes, penalties, and interest due for the tax year involved in the petition must be paid, including tax due as a result of the additions to federal taxable income from expenses and costs directly or indirectly related to the intangible holding company.[105] Third, the corporation must demonstrate to the Tax Commissioner's "sole satisfaction, by clear and convincing evidence, that the transaction or transactions between the corporation and a related member or members resulting in [the disputed] increase in taxable income [as a result of the add-back of the intangible holding company costs and expenses] had a valid business purpose other than the avoidance or reduction of the tax due. . . ."[106] The Tax Commissioner is authorized to charge a fee for all costs, either direct or indirect, relating to the review of the corporation's petition, to include the costs necessary for the Virginia Department of Taxation to hire outside experts to assist in evaluating the petition.[107] The Tax Commissioner may require the corporation to pay this fee before reviewing the petition.[108] If the corporation's petition is successful, the corporation will be permitted to file an amended return within

101. *Id.* § 58.1-402(B)(8)(a)(2) (Repl. Vol. 2004).
102. *Id.* § 58.1-402(B)(8)(a)(3) (Repl. Vol. 2004).
103. *Id.* § 58.1-402(B)(8)(b) (Repl. Vol. 2004).
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*
108. *Id.*

one year from the Tax Commissioner's decision.[109] However, if the Tax Commissioner denies the corporation's petition, the new legislation provides that no lawsuit may be initiated in any Virginia court challenging the Tax Commissioner's denial of the corporation's petition.[110]

The anti-Delaware holding company legislation does create several "safe harbor" rules for intangible holding companies where interest expenses are paid to the related member.[111] The corporation will not be required to add-back interest expenses to its federal taxable income if the following conditions are met. First, the related member (intangible holding company) must pay the expenses for at least five full-time employees "who maintain, manage, defend or are otherwise responsible for operations or administration relating to the interest-generating activities"[112] and the related member must have substantial business operations relating to the interest-generating activities.[113] Second, the interest expenses and costs must not be "directly or indirectly for, related to or in connection with the direct or indirect acquisition, maintenance, management, sale, exchange, or disposition of intangible property."[114] Third, the related member must have a valid business purpose other than the avoidance or reduction of taxes, and payments between the parties must be made at arm's length rates and terms.[115] Lastly, one of the following four conditions must be met: (1) the income received by the related member must be subject to a net income or capital tax by Virginia, another state, or a foreign government that has entered into a comprehensive tax treaty with the United States; (2) the payments relate to a pre-existing contract entered into when the parties were not related members, provided the payments continue to be made at arm's length rates and terms; (3) the related member engages in at least $2,000,000 in business annually with unrelated members; or (4) the interest expense is at an arm's length rate and satisfies one of the following: (i) the related member obtains funds from an unrelated entity; (ii) the related member centrally

109. *Id.*
110. *Id.*
111. *Id.* § 58.1-402(B)(9)(a) (Repl. Vol. 2004).
112. *Id.* § 58.1-402(B)(9)(a)(l) (Repl. Vol. 2004).
113. *Id.*
114. *Id.* § 58.1-402(B)(9)(a)(2) (Repl. Vol. 2004).
115. *Id.* § 58.1-402(B)(9)(a)(3) (Repl. Vol. 2004).

manages the funds of the corporation; (iii) the interest expense is used to finance the expansion of business operations; or (iv) the interest expense restructures the debt of the related members.[116]

The legislature created a petition process similar to the procedures outlined above for challenging non-interest expenses and costs of intangible holding companies.[117] The petition must be filed after all of the following events have occurred: the tax return that claims the interest expense as an add-back item on the return is filed; payment of all taxes, penalties, and interest due; and payment of a fee for the Tax Commissioner's review of the corporation's petition, including any fee for the Tax Department's hired experts.[118] No court review of a petition denial by the Tax Commissioner is permitted.[119]

B. *Recent Judicial Decisions*

1. State Taxation of Interest Income Derived from Investment Funds

In *General Motors Corp. v. Virginia Department of Taxation*,[120] the Fairfax County Circuit Court held that General Motors properly demonstrated to the satisfaction of the court that a portion of its interest income was derived from investment funds, as opposed to capital funds, and was not subject to apportionment to and taxation by Virginia.[121] The court also concluded that Virginia was not entitled to apply the I.R.C. § 6621(c) federal interest rate applicable to large corporate underpayments.[122] The court did uphold the Virginia Department of Taxation regulation excluding from the computation of "cost of performance" for a financial corporation the costs of activities performed by unrelated third parties.[123]

116. *Id.* § 58.1-402(B)(9)(a)(4) (Repl. Vol. 2004).
117. *Id.* § 58.1-402(B)(9)(b) (Repl. Vol. 2004).
118. *Id.*
119. *Id.*
120. 62 Va. Cir. 4 (Cir. Ct. 2003) (Fairfax County).
121. *Id.* at 9.
122. *Id.* at 6.
123. *Id.* at 10 (citing 9 VA. ADMIN. CODE § 10-20-250 (2004)).

The Virginia Department of Taxation taxed interest earned from investment income of General Motors, a foreign (non-Virginia) corporation.[124] General Motors used a centralized account, known as the New York Treasury Office (the "NYTO account"), which held substantial liquid assets.[125] The Virginia Department of Taxation argued that the NYTO account contained working capital assets of the business and therefore the income generated from this account was apportionable and subject to taxation by Virginia.[126] General Motors, on the other hand, argued that interest generated by investments made from a taxpayer's excess cash is not subject to state tax where the investment activities occur outside of the state seeking to tax the interest.[127]

The court, relying primarily on the Supreme Court of the United States's decision *Allied-Signal, Inc. v. Director, Division of Taxation,*[128] narrowed the issue of whether Virginia can tax the "excess" investment interest to a determination of whether General Motors's income is derived from a capital transaction that serves an operational function or an investment function.[129] The court noted that under the *Allied-Signal* decision "a state is only constitutionally permitted to tax a non-domiciliary corporation on income that the corporation realizes out of state if that income is related to business conducted by the corporation within the non-domiciliary state."[130] In other words, "income from investment of working capital is apportionable between the states in which the business is conducted for which the working capital is held."[131]

The court determined that the NYTO account was operational; it received money generated from Virginia sources and such funds could be transferred back to Virginia when needed for operational expenses.[132] The court concluded that the amount of funds in the NYTO account were far in excess of any working capital needed

124. *Id.* at 6.
125. *Id.*
126. *Id.*
127. *Id.*
128. 504 U.S. 768 (1992).
129. *Gen. Motors*, 62 Va. Cir. at 7.
130. *Id.* (citing *Allied-Signal,* 504 U.S. at 788).
131. *Id.* (quoting *Allied-Signal*, 504 U.S. at 787–88).
132. *Id.*

by General Motors for its Virginia business.[133] "[T]he investments were not used as security to borrow working capital, to acquire stock or securities in other companies, or to support any bond issues."[134] Rather, the court noted that the NYTO account was a hybrid account serving both investment and operational purposes.[135] Relying upon uncontroverted witness testimony that apportioned the income between investment and operational purposes, the court held Virginia could not tax the non-operational portion of the investment income.[136]

The court also addressed the Virginia Department of Taxation's attempt to impose the higher underpayment interest rate attributable to large underpayments by corporations for federal income tax underpayments.[137] I.R.C. § 6621(a)(2) imposes an underpayment rate based on the federal short-term rate determined under I.R.C. § 6621(b) plus three percentage points.[138] The Virginia Department of Taxation asserted that Virginia Code section 58.1-15 incorporated this higher federal underpayment interest rate.[139] The Virginia Department of Taxation reasoned that since I.R.C. § 6621(a)(2) "refers to the 'underpayment rate *established by this section*,' it necessarily requires reference to the entirety of the section, including the large corporate underpayment rate set forth in [I.R.C. § 6621(c)(2)]."[140] The court rejected the Virginia Department of Taxation's analysis. The circuit court concluded that Virginia Code section 58.1-15 is "clear and unambiguous, and it [does] not incorporate the federal interest rate applicable to large corporate underpayments set forth in [I.R.C. § 6621(c)]."[141]

133. *Id.* at 8.
134. *Id.*
135. *Id.* at 9.
136. *Id.*
137. *Id.* at 5–6.
138. I.R.C. § 6621(a)(2) (West Supp. 2004).
139. *Gen. Motors*, 62 Va. Cir. at 5.
140. *Id.* (quoting I.R.C. § 6621(a)(2) (West Supp. 2004)).
141. *Id.* at 6.

III. RETAIL SALES AND USE TAX

A. *Recent Significant Legislative Activity*

1. Declaratory Relief to Adjudicate Nexus for Remote Sellers

The Virginia General Assembly enacted new Virginia Code section 8.01-184.1 to provide circuit courts with jurisdiction, under specified circumstances, to enable Virginia-domiciled businesses to secure declaratory relief against an official of another state to prevent such other state from requiring the Virginia-based business to collect that state's sales and use tax.[142] Virginia circuit courts will now have jurisdiction over civil actions where another state's official asserts that the business seeking declaratory relief is obligated to collect that state's tax based upon conduct that occurs wholly or partially within Virginia, and the business (a) is organized under the laws of Virginia or is a sole proprietorship owned by a Virginia domiciliary; or (b) has qualified to do business in Virginia.[143] The Virginia business will be entitled to declaratory relief if being obligated to collect the other state's tax constitutes an undue burden on interstate commerce under the United States Constitution.[144]

2. Exemption for Software/Data Delivered Via the Internet

Virginia Code section 58.1-609.5(1) provides a sales and use tax exemption for professional and personal service transactions which involve sales as *de minimis* elements for which no separate charges are made, and services not involving an exchange of tangible personal property which provide access to or use of the Internet and any other related electronic communication service.[145] The Virginia legislature amended this exemption to codify

142. Act of Apr. 12, 2004, chs. 609, 647, 2004 Va. Acts ___ (codified at VA. CODE ANN. §8.01-184.1 (Cum. Supp. 2004)).

143. VA. CODE ANN. § 8.01-184.1(A) (Cum. Supp. 2004).

144. *Id.* § 8.01-184.1(B) (Cum. Supp. 2004); *see* U.S. CONST. art. I, § 8, cl. 3; *see also* Quill Corp. v. North Dakota, 504 U.S. 298, 309–319 (1992) (holding the state's enforcement of a use tax against an out-of-state business places an unconstitutional burden on interstate commerce).

145. VA. CODE ANN. § 58.1-609.5(1) (Repl. Vol. 2004).

the Virginia Department of Taxation's policy that exempts software, data, content and other information services delivered electronically via the Internet as professional and personal service transactions.[146]

3. Telephone Calling Cards Subject to Sales Tax

The General Assembly amended Virginia Code section 58.1-602 to define telephone calling cards as tangible personal property and make the initial purchase of telephone calling cards subject to sales and use tax.[147] The initial purchase of the calling cards is to be exempt of all other state and local utility taxes.[148]

4. Film and Audio Visual Works Exemption Extended

Virginia Code section 58.1-609.6(6)(a)(i) provides an exemption for "[t]he lease, rental, license, sale, other transfer, or use of any audio or video tape, film or other audiovisual work . . . [when acquired] for the purpose of licensing, distributing, broadcasting, commercially exhibiting or reproducing the work or using or incorporating the work into another such work. . . ."[149] The exemption also applies to the provision of production services or fabrication related to the production of any portion of a qualifying audio visual work.[150] The exemption was to expire on July 1, 2004.[151]

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146. Act of Apr. 12, 2004, ch. 607, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-609.5(1) (Repl. Vol. 2004)). For examples of the Virginia Department of Taxation's existing policy, see VA. DEP'T OF TAX'N, PUB. DOC. 98-15 (Feb. 4, 1998), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004); VA. DEP'T OF TAX'N, PUB. DOC. 97-405 (Oct. 2, 1997), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004); VA. DEP'T OF TAX'N, PUB. DOC. 97-213 (Apr. 30, 1997), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004); VA. DEP'T OF TAX'N, PUB. DOC. 97-117 (Mar. 6, 1997), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004); VA. DEP'T OF TAX'N, PUB. DOC. 95-68 (Mar. 30, 1995), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004); and VA. DEP'T OF TAX'N, PUB. DOC. 95-30 (Feb. 27, 1995), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004).

147. Act of Mar. 8, 2004, ch. 60, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-602 (Repl. Vol. 2004)).

148. *Id.*

149. VA. CODE. ANN. § 58.1-609.6(6)(a)(i) (Repl. Vol. 2004).

150. *Id.*

151. *Id.* (Repl. Vol. 2000).

The General Assembly amended the exemption to extend the availability of the exemption until July 1, 2009.[152]

5. Printed Advertisement Exemption Extended

Virginia Code section 58.1-609.6(4) provides a sales tax exemption for sales of printing to a Virginia advertising business for distribution out-of-state.[153] The exemption also includes newspaper supplements that are not otherwise exempted, when purchased by advertising agencies for placement in in-state or out-of-state publications.[154] The General Assembly amended this exemption to prevent its lapse on July 1, 2004.[155] The exemption will now remain in effect until July 1, 2008.[156]

6. Sales and Use Tax Return Dealer Filing Option

The General Assembly amended Virginia Code section 58.1-615 to adopt a new subsection C that will permit dealers to deliver sales and use tax returns and remit collected sales taxes to his or her local commissioner of the revenue or local treasurer.[157] The local officials will certify the date the return is delivered to them by the dealer and date stamp the return.[158] The locality will then forward the return and tax payment to the Virginia Tax Commissioner for processing in the normal manner.[159]

B. *Recent Judicial Decision*

In a letter opinion released on August 21, 2003, the Montgomery County Circuit Court granted summary judgment to the Virginia Department of Taxation upholding its assessment of sales

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152. Act of Mar. 12, 2004, ch. 101, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-609.6(6) (Repl. Vol. 2004)).

153. VA. CODE ANN. § 58.1-609.6(4) (Repl. Vol. 2004).

154. *Id.*

155. Act of Apr. 14, 2004, ch. 821, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-609.6(4) (Repl. Vol. 2004)).

156. *Id.*

157. Act of Apr. 12, 2004, ch. 567, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-615(C) (Repl. Vol. 2004)).

158. VA. CODE ANN. § 58.1-615(C) (Repl. Vol. 2004).

159. *See id.*

and use taxes imposed on the total charges attributable to the lease and pumping services on portable toilets.[160] The taxpayer, LZM, Inc., was in the business of leasing portable toilets and offering a pumping service to a company with a portable toilet lease.[161] LZM leased 445 portable toilets.[162] All of these toilets included a pumping service except for 115 toilets.[163] The latter toilets were leased without the pumping service.[164] Evidence was presented at trial that these 115 toilets were subject to short term leases on one day or for one event.[165] When these 115 toilets were returned, the taxpayer would pump them out as part of the cleaning and sanitation process.[166]

The issue was whether the pumping services provided to customers by means of a separate contract and billing statement by LZM were subject to sales tax.[167] Virginia Code section 58.1-602 defines sales to include leases of tangible personal property.[168] The question arises when the transaction includes both services and the use of property.[169] The court looked at the "true object" test set forth in the applicable Virginia tax regulation.[170] The "true object" test provides:

> If the object of the transaction is to secure a service and the tangible personal property which is transferred to the customer is not critical to the transaction, then the transaction may constitute an exempt service. However, if the object of the transaction is to secure the property which it produces, then the entire charge, including the charge for any services provided, is taxable.[171]

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160. LZM, Inc. v. Va. Dep't of Taxation, No. CL01-0552 (Cir. Ct. Aug. 21, 2003) (Montgomery County) (unpublished decision), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004).

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. VA. CODE ANN. § 58.1-602 (Repl. Vol. 2004).

169. *LZM,* No. CL01-0552 (Cir. Ct. Aug. 21, 2003), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004).

170. *Id.*; 23 VA. ADMIN. CODE 10-210-404(D) (1996 & Cum. Supp. 2004).

171. 23 VA. ADMIN. CODE § 10-210-404(D) (1996 & Cum. Supp. 2004); *see also* WTAR Radio-TV Corp. v. Commonwealth, 217 Va. 877, 883 (1977) (adopting the "true object" test in Virginia).

LZM argued that the pumping service was separate from the portable toilet lease because the taxpayer also provided pumping services for portable toilets owned by other companies.[172] Evidence provided to the trial court showed that such pumping services were not available as a separate service to individuals, but more as a convenience to other rental company's toilets.[173]

The court noted the fact the companies were not competing to provide pumping services to the general public showed that pumping was a part of the portable toilet lease, and not a separate service sought by the customers.[174] The court also noted that the pumping service agreement was negotiated at the same time the lease agreement was negotiated.[175] In essence, the court found they were not separate transactions, but all part of one transaction.[176]

The trial court also considered evidence that the taxpayer's charges for pumping services did not vary with the amount of waste pumped.[177] The pricing of the toilets was based on the number of portable toilets leased and not on the amount of waste pumped from the toilets.[178] The court held that the "true object" of the transaction was the rental of portable toilets, and the pumping services provided were only sought in connection with the proper operation of the portable toilet rental.[179]

172. *LZM*, No. CL01-0552 (Cir. Ct. Aug. 21, 2003), *available at* http://www.tax.state.va.us/ (last visited Sept. 25, 2004).

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

PART TWO: TAXES ADMINISTERED BY LOCALITIES

IV. REAL PROPERTY TAX

A. *Recent Significant Legislative Activity*

1. Property Exemption for Elderly and Disabled

The 2004 General Assembly made a number of changes to the rules governing the exemption from real property taxes for the elderly and disabled. First, the legislature amended Virginia Code section 58.1-3211 to modify the income and net worth limitations for persons sixty-five years and older, or those who are permanently and totally disabled, to qualify for the exemption or deferral of real property taxes.[180] The net worth limitation was raised from $100,000 to $200,000[181] and the amount of income that may be excluded in determining the combined income limitation was increased from $7,500 to $10,000.[182]

The legislature also increased the amount of income of a non-spouse relative living on the property for which the exemption is sought from $8,500 to $10,000.[183] The amended statute also increases from $5,000 to $10,000 the total amount of assets that a taxpayer may transfer to a relative who resides with and provides care to the taxpayer seeking the property tax exemption.[184] Failure to abide with the latter limitation causes the caretaker-relative's income to be taken into account as part of the taxpayer's income for purposes of qualifying for the exemption from real property taxes.[185]

Lastly, the General Assembly amended the exemption statute to provide that the general net worth calculation does not include

180. Act of Mar. 12, 2004, ch. 77, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3211(1)(a) (Repl. Vol. 2004)).

181. VA. CODE ANN. § 58.1-3211(2) (Repl. Vol. 2004).

182. *Id.* § 58.1-3211(1)(a) (Repl. Vol. 2004).

183. *Id.*

184. *Id.* § 58.1-3211(1)(b) (Repl. Vol. 2004).

185. *Id.*

the value of the residence and land not exceeding ten acres.[186] Prior to this change, the value of the residence and land not exceeding one acre was excluded from the general net worth calculation of the taxpayer seeking to qualify for the exemption from real property taxes.[187]

2. Nonjudicial Sale of Tax Delinquent Property Authorized

The General Assembly adopted legislation authorizing the nonjudicial sale of parcels of real property assessed at $10,000 or less (and a size of less than 4,000 square feet or a parcel that is not a buildable lot).[188] New Virginia Code section 58.1-3975 establishes a procedure to sell small parcels of real property on which delinquent taxes have accrued for five years or more.[189] The legislation permits treasurers or other officials responsible for collecting Virginia property taxes to sell, at public auction, any unimproved parcel of real property assessed below $10,000 on which delinquent taxes have accrued for at least five years.[190]

3. New Classification and Designation Property Tax Exemption Procedures Adopted

The General Assembly adopted emergency legislation that was declarative of existing law to implement the procedures to be used in exempting property by designation or classification, to be effective January 1, 2003, and also provided that ordinances to be adopted pursuant to this legislation may be made effective on or after January 1, 2003.[191] The legislation created a notice and public hearing requirement for any ordinance a locality seeks to adopt that establishes procedures governing tangible and real property exemption by classification.[192]

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186. Act of Mar. 12, 2004, ch. 78, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3211(b)(2) (Repl. Vol. 2004)).

187. VA. CODE ANN. § 58.1-3211(b)(2) (Repl. Vol. 2004).

188. Act of Mar. 12, 2004, ch. 100, 2004 Va. Acts ___ (codified at VA. CODE ANN. § 58.1-3975 (Repl. Vol. 2004)).

189. VA. CODE ANN. § 58.1-3975 (Repl. Vol. 2004).

190. *Id.*

191. Act of Apr. 12, 2004, ch. 557, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3651(E) (Repl. Vol. 2004)).

192. VA. CODE ANN. § 58.1-3651(C) (Repl. Vol. 2004).

The legislation also removed confusing and ambiguous language concerning the implementation of the 2002 constitutional amendment that served as the basis for former Virginia Code section 58.1-3651(D).[193] The legislature removed the ambiguous language that it determined was not intended by the constitutional amendment to implement any restrictions on entities that seek the recognition of their exempt status for personal and real property classification exemptions at the local government level.[194]

4. Annual Property Report Filing by Utilities

The General Assembly amended Virginia Code section 58.1-2628 to ensure that leased real and tangible personal property directly associated with the production of furnishing heat, light and power by means of electricity is reported to the State Corporation Commission annually along with the tangible personal and real property owned by those corporations in the business of furnishing heat, light, and power by electricity.[195]

5. Tax Rates for Electric Suppliers' Generating Equipment Clarified

The legislature amended Virginia Code section 58.1-2606(C) to clarify for localities that local taxing jurisdictions may tax certain electric suppliers' generating equipment at a rate less than the local real estate rate.[196]

B. *Recent Judicial Decisions*

1. *Alderson v. County of Alleghany*

The Supreme Court of Virginia rejected an attempt by residents of the Town (formerly City) of Clifton Forge to avoid per-

193. Act of Apr. 12, 2004, ch. 557, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3651(E) (Repl. Vol. 2004)).

194. *Id.*

195. Act of Apr. 12, 2004, ch. 661, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-2628(C) (Repl. Vol. 2004)).

196. Act of Apr. 12, 2004, ch. 504, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-2606(C) (Repl. Vol. 2004)).

sonal property tax for 2001 on the basis that a special law adopted by the General Assembly violated the uniformity and *ex post facto* provisions of the Virginia Constitution.[197] In July 2001, the City of Clifton Forge reverted to "town" status.[198] In its 2002 session, the General Assembly unanimously passed Chapter 78 of the 2002 Acts of Assembly ("Chapter 78"), which was subsequently signed by the governor.[199] Chapter 78 splits 2001 into two years for tax purposes; the first year is taxed by Clifton Forge and the second year is taxed by Alleghany County.[200]

J. Chris Alderson, the county commissioner of revenue, and other Clifton Forge citizens paid their personal property taxes for 2001 and then sued in circuit court, because the county lacked authority to tax any personal property located in Clifton Forge.[201] In court, the taxpayers' counsel agreed that if Chapter 78 was constitutional, then the taxpayers' petition should be dismissed.[202] The circuit court determined that it was constitutional, and the taxpayers appealed to the Supreme Court of Virginia.[203]

Before the court, the taxpayers raised several constitutional arguments. First, they claimed that Chapter 78 violated the constitutional provision of Article IV, section 14, which prohibits special laws on the collection of taxes.[204] The high court rejected this argument and ruled that the more specific provisions of Article VII, section 2, controlled the matter.[205] Section 2 grants the General Assembly authority to reorganize local governments, including their powers of taxation and assessment.[206] Next, the taxpayers argued Chapter 78 violated the uniformity requirements in Article X, section 1, because they "moved" into the county effective July 1, 2001.[207] The court rejected this argument and noted that the taxpayers did not move, but had a change in govern-

197. Alderson v. County of Alleghany, 266 Va. 333, 585 S.E.2d 795 (2003).
198. *Id.* at 336, 585 S.E.2d at 796.
199. *Id.*
200. *Id.* at 336–38, 585 S.E.2d at 796–97.
201. *Id.* at 338–39, 585 S.E.2d at 797.
202. *Id.* at 339, 585 S.E.2d at 798.
203. *Id.*
204. *Id.* at 341–42, 585 S.E.2d at 799.
205. *Id.*
206. *Id.* at 341, 585 S.E.2d at 799.
207. *Id.* at 342, 585 S.E.2d at 799–80.

ment.[208] Chapter 78, the court concluded, increased uniformity by making Clifton Forge taxation consistent with other county residents.[209] Finally, the court rejected claims that Chapter 78 was an *ex post facto* law and that it violated the appropriations clause in Article VII, section 7.[210] Thus, the circuit court's decision was affirmed.[211]

2. *Shenandoah Associates v. Shenandoah County*

In *Shenandoah Associates v. Shenandoah County,*[212] the circuit court held that Shenandoah County's failure to consider the fact that restrictions on certain property rendered the property not freely marketable constituted the disregard of controlling evidence.[213] The court further held that the taxpayer overcame the presumption that the county's assessment was correct.[214] Specifically, the taxpayer's property, a housing facility for the elderly and handicapped, was subject to a deed of trust under which the debtor had no right to prepayment unless the Department of Housing and Urban Development ("HUD") approved such prepayment.[215] The deed of trust prevented conveyance or encumbrance of the property, and the loan on the property was not assumable.[216] Based on expert testimony provided by the parties, the court determined a revised assessment of the property value for the 1996 tax year at issue in the case.[217]

C. *Recent Significant Opinions of the Attorney General*

The Virginia Attorney General issued a formal opinion addressing the effect of the November 2002 amendment to Article X, section 6(a)(6) of the Constitution of Virginia, relating to local property tax exemptions granted by the General Assembly, either

208. *Id.*
209. *Id.* at 342–43, 585 S.E.2d at 800.
210. *Id.* at 343–44, 585 S.E.2d at 800.
211. *Id.* at 344, 585 S.E.2d at 800.
212. 62 Va. Cir. 231 (Cir. Ct. 2003) (Shenandoah County).
213. *Id.* at 235.
214. *Id.*
215. *Id.* at 231, 234–35.
216. *Id.* at 235.
217. *Id.* at 235–36.

by classification or by designation, prior to January 1, 2003.[218] Specifically, the Virginia Attorney General opined that local property tax exemptions granted by the General Assembly prior to January 1, 2003, either by designation or classification, remain valid and are not repealed by the ratified amendment to Virginia Constitution Article X, section 6(a)(6).[219]

On November 5, 2002, the voters of the Commonwealth of Virginia ratified an amendment to the Virginia Constitution relating to property made exempt from taxation.[220] "[O]n and after January 1, 2003, any county, city, or town may by designation or classification exempt from real or personal property taxes, or both, by ordinance adopted by the local governing body, the real or personal property, or both . . . ."[221] The constitutional amendment was implemented by the Virginia legislature through the adoption of Virginia Code section 58.1-3651.[222] The Attorney General opined that nothing in the constitutional amendment or in Virginia Code section 58.1-3651 repealed the classification and designation exemptions for personal and real property that existed before January 1, 2003.[223] The Attorney General further opined that the localities lack any authority to repeal an exemption enacted by the General Assembly.[224] Rather, the General Assembly has the authority to repeal classification or designation exemptions granted before January 1, 2003.[225]

V. MISCELLANEOUS PROCEDURAL CHANGES AND REFORMS

A. *Sharing of Taxpayer Information Among Government Agencies Expanded*

The Virginia legislature amended Virginia Code section 58.1-3(C) with three separate pieces of legislation. First, the Virginia

218. Op. to Hon. William J. Howell, Speaker, House of Delegates (Aug. 5, 2003), *available at* http://www.oag.state.va.us (last visited on Sept. 25, 2004).

219. *Id.*

220. Act of Apr. 6, 2002, ch. 630, 2002 Va. Acts 895.

221. VA. CODE ANN. § 58.1-3651(A) (Repl. Vol. 2004).

222. *Id.*

223. Op. to Hon. William J. Howell, Speaker, House of Delegates (Aug. 5, 2003), *available at* http://www.oag.state.va.us (last visited Sept. 25, 2004).

224. *See id.*

225. *Id.*

Department of Taxation was authorized to provide tax information about employers and employees to the Virginia Commissioner of Labor and Industry to facilitate the collection of unpaid wages.[226] Second, the Virginia Department of Taxation was authorized to provide confidential tax information to the Virginia Department of Human Resource Management to facilitate the identification of persons receiving worker's compensation indemnity benefits who have failed to report earnings as required by law, and to collect overpayments resulting from the failure of injured workers to report income.[227] The third bill amended section 58.1-3(C) of the Virginia Code to authorize the Tax Commissioner to provide to the Virginia Department of the Treasury, for its confidential use, the tax information needed to locate the holders of unclaimed property.[228]

B. *Advisory Opinions, Offers in Compromise, and Appeals*

1. Offers in Compromise Authorized for Localities

The General Assembly enacted new Virginia Code section 58.1-3994 to authorize the commissioner of the revenue or other tax assessment official to compromise and settle certain tax assessments prior to the exhaustion of all administrative or judicial review if the commissioner or other official responsible for assessment determines that there is substantial doubt under applicable law, regulations or guidelines as to the taxpayer's liability for such taxes.[229] The offer in compromise legislation is applicable with regard to any assessment of gross receipts taxes and business personal property, merchants' capital, and machinery and tools taxes.[230]

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226. Act of Mar. 19, 2004, ch. 166, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3(C)(xv) (Repl. Vol. 2004)).

227. Act of Apr. 12, 2004, ch. 594, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3(C)(xvi) (Repl. Vol. 2004)).

228. Act of Apr. 12, 2004, ch. 582, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3(C)(viii) (Repl. Vol. 2004)).

229. Act of Apr. 12, 2004, ch. 526, 2004 Va. Acts ___ (codified at VA. CODE ANN. §58.1-3994(A) (Repl. Vol. 2004)).

230. *See* VA. CODE ANN. § 58.1-3994(A) (Repl. Vol. 2004); *see also id.* § 58.1-3983.1(A) (Repl. Vol. 2004) (defining local taxes).

The new statute also permits the treasurer or other official responsible for the collection of any local tax to compromise and settle the amount due and payable when the treasurer or other official determines that the collection of the entire amount due and owing is in substantial doubt and the best interests of the locality will be served by such compromise.[231]

Any offer in compromise must be submitted in writing to the locality.[232] The offer will not be deemed accepted until the taxpayer is notified in writing by the responsible official.[233] When a locality accepts an offer in compromise, it must create a complete record of the case.[234] The record must include the following information:

> (i) the tax assessed;
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> (ii) audit findings, if any;
>
> (iii) the taxpayer's grounds for dispute or contest together with all evidences thereof;
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> (iv) factors calling collectibility into substantial doubt;
>
> (v) any nonprivileged reports or recommendations made with respect to the liability of the taxpayer, the requirements of effective tax administration considered, and/or the collectibility of taxes due; and
>
> (vi) the amount assessed or accepted and the terms and conditions attendant to settlement or compromise, with respect to the liability in question.[235]

After a local official accepts an offer in compromise, this statute prohibits the matter from being reopened unless there is a showing of fraud, malfeasance or misrepresentation of material fact.[236]

2. State Tax Commissioner Authorized to Issue Advisory Opinions on Local Taxes

The Virginia legislature amended Virginia Code section 58.1-3983.1 to authorize the Virginia Tax Commissioner to issue advisory opinions in specific cases regarding business tangible per-

231. VA. CODE ANN. § 58.1-3994(B) (Repl. Vol. 2004).
232. *Id.* § 58.1-3994(C) (Repl. Vol. 2004).
233. *Id.*
234. *Id.* § 58.1-3994(D) (Repl. Vol. 2004).
235. *Id.*
236. *Id.* § 58.1-3994(F) (Repl. Vol. 2004).

sonal property tax, the machinery and tools tax, and the merchants' capital tax.[237] The expanded authority of the Virginia Tax Commissioner is available to both taxpayers and local tax officials.[238] Advisory opinions may be sought prior to the filing of a local business tax appeal by an aggrieved taxpayer.[239]

3. Mobile Property Tax Appeals Authorized

The General Assembly expanded the Virginia Department of Taxation's authority to hear local tax appeals to include assessments of the tangible personal property tax on airplanes, boats, campers, recreational vehicles and trailers (the "local mobile property tax").[240] Appeals of local mobile property tax assessments would be governed by the same rules and procedures that are already in place for the appeals of assessments of the machinery and tools tax, business tangible personal property tax, and similar local business property taxes.[241] The legislation specifically excludes from the Virginia Tax Commissioner the authority to make any determinations regarding the valuation of the mobile property at issue in the local mobile property tax appeal.[242]

4. Issuance of Licenses and Permits During Pendency of a Local Tax Appeal

The Virginia legislature adopted a new requirement prohibiting localities from denying licenses and permits to taxpayers who have not paid taxes, penalties and interest that are the subject of an administrative appeal of such assessment.[243] Prior to this legislation, localities could refuse to issue a license or permit to a taxpayer that owes taxes, penalties and interest, even if the tax-

237. Act of Apr. 12, 2004, ch. 527, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. § 58.1-3983.1(G) (Repl. Vol. 2004)).

238. *Id.*

239. *See id.*

240. Act of Apr. 12, 2004, ch. 534, 2004 Va. Acts ___ (codified as amended at VA. CODE ANN. §§ 58.1-3103, -3983.1 (Repl. Vol. 2004)).

241. VA. CODE ANN. § 58.1-3983.1 (Repl. Vol. 2004).

242. *Id.* § 58.1-3983.1(D)(1) (Repl. Vol. 2004).

243. Act of Apr. 15, 2004, ch. 902, 2004 Va. Acts ___ (codified at VA. CODE ANN. § 58.1-3995(A) (Repl. Vol. 2004)).

payer has filed an administrative appeal of these assessments.[244] The legislation does not apply to the issuance of local vehicle licenses when an applicant owes any local vehicle license fees or delinquent personal property tax.[245] In these situations, localities may continue to withhold the issuances of these licenses.[246]

5. Tax Department Announces Policy Change for Administrative Appeals

In an important announcement the Virginia Department of Taxation issued Tax Bulletin 03-8 declaring that a complete administrative appeal must be filed within ninety days of the date of an assessment.[247] Previously, the Virginia Department of Taxation would accept administrative appeals filed more than ninety days after a tax assessment is made, although it would not always agree to cease collection activities on untimely filed tax appeals.[248] The announcement provides that the Virginia Department of Taxation will no longer accept appeals filed after the ninetieth day from the date of the assessment.[249] A new form was also produced as part of the new administrative appeal procedures.[250] The Virginia Department of Taxation recommends the use of this form when filing an administrative appeal.[251]

244. Only collection activity by the locality was suspended pending administrative appeal of the tax assessment. *See* VA. CODE ANN. §§ 58.1-3703.1(A)(5)(b), -3983.1(E) (Repl. Vol. 2004).

245. VA. CODE ANN. § 58.1-3995(B) (Repl. Vol. 2004).

246. *Id.* § 58.1-3995(C) (Repl. Vol. 2004).

247. VA. DEP'T OF TAX'N TAX BULLETIN 03-8 (July 15, 2003) *available at* http://www.tax.state.va.us/ (last visited Sept.2 5, 2004).

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

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