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## Taxation

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# TAXATION

*Craig D. Bell* \*

## I. INTRODUCTION

This article reviews significant developments in the law affecting Virginia taxation. Each section covers recent legislative changes, judicial decisions, and selected opinions or pronouncements from the Virginia Department of Taxation and the Attorney General of Virginia 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, mandated by Virginia Code section 58.1-301, was amended by the

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2006 General Assembly to advance Virginia's fixed date conformity to the Internal Revenue Code from January 7, 2005 to December 31, 2005.<sup>1</sup> Virginia continues, however, to disallow the federal bonus depreciation deduction and the five-year net operating loss carry-back period for state income tax purposes.<sup>2</sup>

The new conforming date enables the state to adopt the provisions of three federal tax acts. The first set of provisions is from the Energy Policy Act of 2005,<sup>3</sup> which modifies the depreciation rules for certain properties and provides a temporary fifty percent expensing for certain equipment.<sup>4</sup> The second set of provisions is from the Katrina Emergency Tax Relief Act of 2005,<sup>5</sup> which provides a temporary suspension of limitations for qualified contributions and allows enhanced deductions for contributions of food and books.<sup>6</sup> Finally, the new conforming date also enables the state to adopt the provisions of the Gulf Opportunity Zone Act of 2005,<sup>7</sup> which temporarily waives the limit on charitable contribution deductions for corporations to include contributions made for Hurricane Rita and Hurricane Wilma, as well as extending the provision to allow combat pay to count as income for purposes of calculating the earned income tax credit.<sup>8</sup>

## 2. Coal Tax Credits

The 2006 General Assembly amended Virginia Code section 58.1-433.1 by creating a subsection B that will allow the Virginia Coal Employment and Production Incentive Tax Credit to be allocated between the electricity generator and certain sellers of coal.<sup>9</sup> Under this new subsection, the Virginia Coal Employment

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1. Act of Mar. 23, 2006, ch. 162, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-301(B) (Cum. Supp. 2006)); Act of Mar. 7, 2006, ch. 63, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-301(B) (Cum. Supp. 2006)). For additional guidance, see VA. DEPT OF TAX'N, TAX BULLETIN 06-1 (Mar. 16, 2006), available at <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow "Searching by Number" hyperlink).

2. VA. CODE ANN. § 58.1-301(B) (Cum. Supp. 2006).

3. Pub. L. No. 109-58, 119 Stat. 594 (2005).

4. *Id.*

5. Pub. L. No. 109-73, 119 Stat. 2016 (2005).

6. *Id.* §§ 301, 305, 306.

7. Pub. L. No. 109-135, 119 Stat. 2577 (2005).

8. *Id.* §§ 201, 302.

9. Act of Apr. 6, 2006, ch. 788, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-433.1(B) (Cum. Supp. 2006)); Act of Apr. 6, 2006, ch. 803, 2006 Va. Acts \_\_\_

and Production Incentive Tax Credit may be shifted from an electricity generator that is subject to the minimum tax on certain electric suppliers to the person with an economic interest in the coal.<sup>10</sup> An economic interest in coal for this three-dollar-per-ton tax credit is defined under Virginia Code section 58.1-439.2.<sup>11</sup> Under section 58.1-439.2, “A party who only receives an arm’s length royalty shall not be considered as having an economic interest in coal mined in the Commonwealth.”<sup>12</sup> In no case, however, may the credit allocated between the electricity generator and a person having an economic interest in the coal exceed three dollars per ton.<sup>13</sup> The amended tax credit is available for coal purchased on or after January 1, 2006 and prior to July 1, 2011.<sup>14</sup> “If the credits earned on or after January 1, 2006, and prior to July 1, 2011, exceed the state tax liability . . . [of the] person with an economic interest in coal, the excess [tax credit] shall be redeemable by the Virginia Tax Commissioner as set forth in subsection D of [Virginia Code] § 58.1-439.2.”<sup>15</sup> The legislation also extended the carryover period for this credit from five years to ten years.<sup>16</sup>

The legislature also extended the sunset date of when the Coalfield Employment Enhancement Tax Credit can be earned and claimed to 2014 (taxable year earned) and 2017 (taxable year redeemed), respectively.<sup>17</sup> Both the Virginia Coal Employment and Production Incentive Tax Credit and the Coalfield Employment Enhancement Tax Credit may be used against the corporate income tax imposed by Virginia Code section 58.1-400.<sup>18</sup>

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(codified as amended at VA. CODE ANN. § 58.1-433.1(B) (Cum. Supp. 2006)).

10. VA. CODE ANN. § 58.1-433.1(B) (Cum. Supp. 2006).

11. *Id.*

12. *Id.* § 58.1-439.2(C) (Cum. Supp. 2006).

13. *Id.* § 58.1-433.1(B) (Cum. Supp. 2006).

14. *Id.*

15. *Id.*

16. Act of Apr. 6, 2006, ch. 788, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-433.1(A) (Cum. Supp. 2006)); Act of Apr. 6, 2006, ch. 803, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-433.1(A) (Cum. Supp. 2006)).

17. Act of Apr. 6, 2006, ch. 788, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-439.2(A), (G) (Cum. Supp. 2006)); Act of Apr. 6, 2006, ch. 803, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-439.2(A), (G) (Cum. Supp. 2006)).

18. VA. CODE ANN. §§ 58.1-433.1(A), -439.2(A) (Cum. Supp. 2006). Note that the Virginia Coal Employment and Production Incentive Tax Credit may also be utilized by any electricity supplier that operates as a cooperative and is subject to tax at the six percent tax rate set by Virginia Code section 58.1-400 on “all modified net income derived from nonmember sales.” *Id.* § 58.1-400.2(B) (Repl. Vol. 2004); see also Craig D. Bell, *Annual Survey of Virginia Law: Taxation*, 39 U. RICH. L. REV. 413, 420–21 (2004).

### 3. Clean Fuel Vehicle Job Creation Tax Credit Expanded

Virginia Code section 58.1-439.1 provides a credit against the corporate income tax:

[E]qual to \$700 for each job which is created in either (i) the manufacture of components for vehicles designed to operate on a clean special fuel, (ii) the manufacture of components used to convert vehicles designed to operate on gasoline or diesel fuel to operate on clean special fuel, (iii) the conversion of vehicles designed to operate on gasoline or diesel fuel to operate on clean special fuel, [or] (iv) the manufacture of vehicles designed to operate on clean special fuel  
 . . . .<sup>19</sup>

The credit is “allowed in the taxable year in which the job is created and in each of the two succeeding years in which the job is continued.”<sup>20</sup> The definition of “clean special fuel” set forth in Virginia Code section 46.2-749.3<sup>21</sup> applies to this tax credit.<sup>22</sup>

The 2006 General Assembly broadened the scope of this tax credit by adding “the manufacture of components designed to produce, store, and dispense hydrogen as a vehicle fuel” to the credit coverage and by extending the sunset provisions applicable to this credit from December 31, 2006 to December 31, 2011.<sup>23</sup>

### 4. Long-Term Care Insurance Tax Credit Created

The 2006 General Assembly enacted Virginia Code section 58.1-339.11 to create an individual income tax credit for “certain long-term care insurance premiums.”<sup>24</sup> The credit is granted to any individual taxpayer who enters into a long-term care insurance contract on or after January 1, 2006.<sup>25</sup> The amount of the credit is equal to “15% of the amount paid by the individual during the taxable year in long-term care insurance premiums for

19. VA. CODE ANN. § 58.1-439.1(A) (Cum. Supp. 2006).

20. *Id.*

21. *Id.* § 46.2-749.3(A) (Supp. 2006).

22. *Id.* § 58.1-439.1(B) (Cum. Supp. 2006).

23. Act of Mar. 24, 2006, ch. 238, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-439.1(A) (Cum. Supp. 2006)).

24. Act of Apr. 5, 2006, ch. 570, 2006 Va. Acts \_\_\_ (codified at VA. CODE ANN. § 58.1-339.11 (Cum. Supp. 2006)); Act of Apr. 5, 2006, ch. 599, 2006 Va. Acts \_\_\_ (codified at VA. CODE ANN. § 58.1-339.11 (Cum. Supp. 2006)).

25. VA. CODE ANN. § 58.1-339.11(A) (Cum. Supp. 2006).

long-term care” for himself or herself.<sup>26</sup> In no event, however, may the total credits over the life of the long-term care policy exceed fifteen percent of the amount of the premiums paid for the first twelve months of coverage.<sup>27</sup> Unused amounts of the credit “may be carried over for credit” against income taxes for the “next five taxable years or until the full credit is used, whichever occurs first.”<sup>28</sup> The new credit may not be claimed if the taxpayer has claimed either “a deduction for federal income tax purposes for long-term care insurance premiums” or a deduction under Virginia Code section 58.1-322(D)(10).<sup>29</sup>

For purposes of this new credit, “*long-term care insurance premium*” means the amount paid during a taxable year for any qualified long-term care insurance contract as defined in § 7702B(b) of the Internal Revenue Code . . . covering an individual.”<sup>30</sup>

## 5. Death Benefit Subtraction Created

The 2006 General Assembly created a subtraction from adjusted gross income, for purposes of calculating a Virginia resident’s Virginia taxable income, for “the death benefit payments from an annuity contract that are received by a beneficiary of such contract and [to the extent such death benefits] are subject to federal income taxation.”<sup>31</sup> The import of this legislation is to effectively exempt all annuity payments received by beneficiaries from Virginia income tax. The legislation is effective for taxable years beginning on or after January 1, 2007.<sup>32</sup>

## 6. Amended Tax Return After Change in Another State

Virginia allows residents to claim a credit against their income tax liability when they pay income tax to any other state.<sup>33</sup> This

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26. *Id.*

27. *Id.*

28. *Id.* § 58.1-339.11(B) (Cum. Supp. 2006).

29. *Id.* § 58.1-339.11(C) (Cum. Supp. 2006).

30. *Id.* § 58.1-339.11(A) (Cum. Supp. 2006) (citing 26 U.S.C. § 7702B(b) (2000)).

31. Act of Apr. 5, 2006, ch. 617, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-322(C)(32) (Cum. Supp. 2006)).

32. VA. CODE ANN. § 58.1-322(C)(32) (Cum. Supp. 2006).

33. *Id.* § 58.1-332(A) (Repl. Vol. 2004).

statutory credit provides Virginia residents relief in situations when a taxpayer is taxed by both Virginia and any other state. Administrative burdens occur when the other state adjusts the tax paid by a Virginia resident. When this act occurs, the amount of the Virginia credit for taxes paid to other states changes. As the frequency of other state audits rises, a Virginia resident will often file a protective claim with the Virginia Department of Taxation to toll the statute of limitations applicable to the Virginia resident taxpayer.<sup>34</sup>

Under Virginia law, a taxpayer generally has “three years from the last day prescribed by law” to timely file an amended tax return.<sup>35</sup> Should a taxpayer’s non-resident tax return be audited by another state and the three-year limitations period approach its end, the taxpayer can either file a protective claim pursuant to Virginia Code section 58.1-1824 or seek to extend the statute of limitations by executing a written waiver before the expiration of the statute of limitations.<sup>36</sup>

The 2006 General Assembly enacted Virginia Code section 58.1-311.1 to allow taxpayers one year from the final determination of a change made by any other state to file an amended return to request a refund resulting from credits for taxes paid to other states.<sup>37</sup> The new statute requires the taxpayer to file an amended return with the Virginia Department of Taxation “reporting the effects of such change or correction.”<sup>38</sup> The rationale for this requirement is to coordinate a taxpayer’s right to claim a refund with the Virginia Department of Taxation’s right to assess additional tax.<sup>39</sup> A taxpayer’s failure to comply with new Virginia Code section 58.1-311.1, “by not reporting a change or correction decreasing the tax paid to another state” for which the taxpayer claimed credit on his or her Virginia income tax return to the Virginia Department of Taxation, will permit the Virginia De-

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34. Based on the author’s experience representing businesses in a multistate context.

35. VA. CODE ANN. § 58.1-1823(A) (Cum. Supp. 2006).

36. *See id.* § 58.1-1824 (Repl. Vol. 2004).

37. Act of Mar. 24, 2006, ch. 234, 2006 Va. Acts \_\_\_\_ (codified at VA. CODE ANN. § 58.1-311.1 (Cum. Supp. 2006)).

38. VA. CODE ANN. § 58.1-311.1 (Cum. Supp. 2006).

39. *See id.*

partment of Taxation to assess additional tax without regard to the statute of limitations.<sup>40</sup>

## 7. Penalty for False Claims of Employment Status Authorized

Employers must withhold income tax from employees' wages or they may be personally liable for the tax that the employer should have withheld.<sup>41</sup> If an employer willfully fails to withhold taxes, or withholds tax but willfully fails to pay those taxes to the Virginia Department of Taxation, he or she will be guilty of a Class 1 misdemeanor.<sup>42</sup> It is also a Class 1 misdemeanor for an individual to supply false or fraudulent information to the employer about his identity or job classification.<sup>43</sup>

The 2006 General Assembly enacted Virginia Code section 58.1-485.1 to make it "unlawful for any person to knowingly coerce or threaten an individual to falsely declare his employment status for the purpose of evading the withholding or payment of taxes."<sup>44</sup> The new statute also makes it unlawful "to knowingly and falsely claim an individual's employment status for the purpose of evading the withholding or payment of taxes."<sup>45</sup> Such violation is a Class 1 misdemeanor.<sup>46</sup>

## 8. Land Preservation Tax Credit Revamped

In a Special Session of the 2006 General Assembly, the legislature adopted a substitute version of two identical bills submitted by Governor Timothy M. Kaine, which made substantial changes to the Land Preservation Tax Credit program.<sup>47</sup>

Effective on January 1, 2007, numerous changes will go into effect for the Land Preservation Tax Credit. The credit is currently

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40. *Id.* § 58.1-312(A)(4) (Cum. Supp. 2006).

41. *See id.* § 58.1-1813(A) (Repl. Vol. 2004).

42. *Id.* § 58.1-1815 (Repl. Vol. 2004).

43. *See id.* § 58.1-1814 (Repl. Vol. 2004).

44. Act of Mar. 31, 2006, ch. 393, 2006 Va. Acts \_\_\_ (codified at VA. CODE ANN. § 58.1-485.1(A) (Cum. Supp. 2006)).

45. VA. CODE ANN. § 58.1-485.1(B) (Cum. Supp. 2006).

46. *Id.* § 58.1-485.1(C) (Cum. Supp. 2006).

47. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. §§ 58.1-512, -512.1, -513, -901); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. §§ 58.1-512, -512.1, -513, -901).



a corporate or individual income tax credit equal to fifty percent of the fair market value of an unconditional donation in perpetuity of real property and interests in real property located in Virginia to governmental and nonprofit organizations whose purpose is to conserve natural resources, save land, and preserve historical sites.<sup>48</sup> Donations of a less than fee interest in the property are required to also qualify for a federal charitable contribution deduction under section 170(h) of the Internal Revenue Code.<sup>49</sup> Anyone earning a credit is allowed to transfer the credit to any other taxpayer.<sup>50</sup> The only limitations on this credit are an annual \$100,000 limitation per taxpayer and a five-year carryover period.<sup>51</sup>

Chief among the many changes is a new annual aggregate limitation of \$100 million in credits that may be granted each year along with a lowering of the credit percentage from fifty percent to forty percent of the fair market value of the qualified donation.<sup>52</sup> The \$100 million cap will be applied on a first come-first served basis instead of pro-rating the available credit among those that apply.<sup>53</sup>

An interesting feature of the \$100 million cap is that for the taxable years 2008 and thereafter, the cap is indexed to the consumer price index.<sup>54</sup> This makes the Land Preservation Tax Credit the only tax preference item available in Virginia to have a limitation indexed. Virginia does not index the standard deduction, personal and dependent exemptions, or the age deduction for the individual income tax.

In conjunction with the \$100 million cap, a new application process will take effect on January 1, 2007 for taxpayers wishing to earn the credit. Any taxpayer that has made a qualified dona-

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48. VA. CODE ANN. § 58.1-512(A) (Cum. Supp. 2006).

49. *Id.* § 58.1-512(C) (Cum. Supp. 2006).

50. *Id.* § 58.1-513(C) (Cum. Supp. 2006).

51. *Id.* § 58.1-512(C)(1) (Cum. Supp. 2006).

52. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(A)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(A)).

53. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(4)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(4)).

54. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(4)(b)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified at as amended VA. CODE ANN. § 58.1-512(D)(4)(b)).

tion must apply to the Virginia Department of Taxation to receive the credit.<sup>55</sup> For credits in the amount of one million dollars or more, the taxpayer's application must also be filed with the Virginia Department of Conservation and Recreation.<sup>56</sup> The Department of Conservation and Recreation is then required to verify the value of the donation before the credit may be granted.<sup>57</sup>

In another change to the credit, charitable organizations that may hold conservation easements, and that actually hold at least one such easement, are not allowed to earn a Land Preservation Tax Credit.<sup>58</sup> Prior to this bill, there were no statutory limitations in place that limited a nonprofit organization's ability to earn credits. However, in a Ruling of the Virginia Tax Commissioner,<sup>59</sup> the Tax Commissioner through dicta opined that a nonprofit organization that could hold a conservation easement could not earn a credit because:

[T]he purpose of the Act would be accomplished once ownership of the land is held by a conservation agency that is able ensure that the land is preserved. Any subsequent transfer of the land, or any interest in the land, to a similarly qualified organization would be redundant and would merely be done to gain tax credits. Because transferring land or an interest in land to obtain credits does not qualify as an approved purpose under the Act, Land Preservation Tax Credits would not be granted in that situation.<sup>60</sup>

Finally, among the other changes made to the Land Preservation Tax Credit, a fee of two percent of the value of the credit or \$10,000, whichever is less, will be applied to each transfer of the credit.<sup>61</sup> No fee is currently imposed on the transfer of Land Pres-

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55. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(1)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(1)).

56. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(1)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(1)).

57. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(3)(a)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(D)(3)(a)).

58. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(C)(5)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-512(C)(5)).

59. VA. DEP'T OF TAX'N, PUB. DOC. 05-125 (July 26, 2005), available at <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink).

60. *Id.*

61. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA.

ervation Tax Credits. The carry-over period for any unused credits is extended from five years to ten years by this legislation.<sup>62</sup> Also, a new five-year limitation is placed on property that may be eligible for a Land Preservation Tax Credit as well as a Historic Rehabilitation Tax Credit. Taxpayers earning a Land Preservation Tax Credit will have to wait five years before earning a Historic Rehabilitation Tax Credit for a building which is on land that is the basis for a Land Preservation Tax Credit.<sup>63</sup> The converse is also true in that the taxpayer may choose to earn the Historic Rehabilitation Tax Credit and wait five years to earn a Land Preservation Tax Credit.<sup>64</sup>

### III. ESTATE TAX

In a Special Session of the 2006 General Assembly, the legislature repealed the Virginia Estate Tax for the estates of all Virginians who die on or after July 1, 2007.<sup>65</sup> Virginia bases its estate tax on the amount of the federal credit that was available for state death taxes paid.<sup>66</sup> The legislation amended Virginia Code section 58.1-901, which defined the term "federal credit" to mean the maximum amount of state death taxes allowed under section 2011 of the Internal Revenue Code.<sup>67</sup> The legislation removed a provision of the Virginia statute that specified that the maximum federal credit could not be allowed in an amount less than the

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CODE ANN. § 58.1-513(C)(2)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-513(C)(2)).

62. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-513(D)(5)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-513(D)(5)).

63. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-513(A)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-513(A)).

64. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-513(A)); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-513(A)).

65. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_; Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_.

66. VA. CODE ANN. § 58.1-901 (Repl. Vol. 2004).

67. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-901); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-901).

federal credit under section 2011 of the Internal Revenue Code as it existed on January 1, 1978.<sup>68</sup>

#### IV. RETAIL SALES AND USE TAX

##### A. *Recent Significant Legislative Activity*

##### 1. Communications Tax Reform

The 2006 General Assembly enacted the Virginia Communications Sales and Use Tax Act ("Communications Sales and Use Tax"), which applies a statewide communications sales and use tax of five percent to retail communications and video services.<sup>69</sup> The legislation largely replaces a patchwork of state and local taxes on electronic communications services. The Communications Sales and Use Tax will be a state tax administered and enforced by the Virginia Department of Taxation.<sup>70</sup> The new Communications Sales and Use Tax will become effective on January 1, 2007.<sup>71</sup>

On January 1, 2007, the new law will repeal the following state and local taxes and fees: (1) local consumer utility tax on landline and wireless telephone service;<sup>72</sup> (2) local E-911 tax on landline telephone service;<sup>73</sup> (3) Virginia Relay Center Assessment on landline telephone service for the costs of a telephone relay service for the hearing impaired;<sup>74</sup> (4) the portion of the local business, professional, and occupational license tax on public service companies exceeding one-half of one percent (0.5%) billed to customers in some Virginia localities;<sup>75</sup> (5) Local Video Programming

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68. Act of Aug. 28, 2006, ch. 4, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-901); Act of Aug. 28, 2006, ch. 5, 2006 Va. Acts \_\_\_ (to be codified as amended at VA. CODE ANN. § 58.1-901).

69. Act of Apr. 6, 2006, ch. 780, 2006 Va. Acts \_\_\_ (codified at VA. CODE ANN. §§ 58.1-645 to -662 (Cum. Supp. 2006)).

70. VA. CODE ANN. § 58.1-646 (Cum. Supp. 2006).

71. *Id.* § 58.1-648(A) (Cum. Supp. 2006).

72. Act of Apr. 6, 2006, ch. 780, 2006 Va. Acts \_\_\_ (repealing VA. CODE ANN. § 51.1-3812 (Cum. Supp. 2006)).

73. *Id.* (repealing VA. CODE ANN. § 58.1-3813.1 (Cum. Supp. 2006)).

74. *Id.* (repealing VA. CODE ANN. §§ 56-484.4 to -484.6 (Cum. Supp. 2006)).

75. *Id.*

Excise Tax on cable television services;<sup>76</sup> and (6) Local Consumer Utility Tax on cable television.<sup>77</sup>

The Communications Sales and Use Tax will include a five percent tax on the cost of communications services as that term is defined in Virginia Code section 58.1-647.<sup>78</sup> A communications service is defined to include: (1) landline and wireless telephone services (including Voice Over Internet Protocol); (2) paging; (3) cable television; and (4) satellite television and radio service.<sup>79</sup>

The Communications Sales and Use Tax will be collected by all communications services providers ("Providers") with sufficient contact, or nexus, with the commonwealth to be subject to the tax using the same rules that apply to the retail sales and use tax.<sup>80</sup> Providers will register with the Virginia Department of Taxation in the same manner as sales tax dealers.<sup>81</sup> Each Provider will "separately state the amount of the tax and add that tax to the sales price of the service."<sup>82</sup> "Thereafter, the tax shall be a debt from the customer to the [Provider] until paid."<sup>83</sup> All sums collected by a Provider will be held in trust for the commonwealth.<sup>84</sup> As with the retail sales and use tax, every Provider required to collect or pay the Communications Sales and Use Tax will be required to file with the Virginia Department of Taxation a monthly return and remit the tax due "on or before the twentieth day of the month following the month in which the tax is billed."<sup>85</sup> Providers will be allowed a dealer discount on the first three percent of the Communications Sales and Use Tax in the following percentages:

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76. *Id.* (repealing VA. CODE ANN. §§ 58.1-3818.1 to -3818.7 (Cum. Supp. 2006)).

77. *Id.*

78. VA. CODE ANN. § 58.1-648 (Cum. Supp. 2006).

79. *See id.* § 58.1-647 (Cum. Supp. 2006). Note, prior to adoption of the Communications Sales and Use Tax Act, satellite television was not subject to any state and local communications taxes.

80. *Id.* § 58.1-651(A) (Cum. Supp. 2006).

81. *Id.* § 58.1-651(A), (B) (Cum. Supp. 2006).

82. *Id.* § 58.1-651(A) (Cum. Supp. 2006).

83. *Id.*

84. *Id.* § 58.1-659(D) (Cum. Supp. 2006).

85. *Id.* § 58.1-654(A) (Cum. Supp. 2006).

| <u>Monthly Taxable Sales</u> | <u>Percentage</u> <sup>86</sup> |
|------------------------------|---------------------------------|
| \$0 to \$62,500              | 4%                              |
| \$62,501 to \$208,000        | 3%                              |
| \$208,001 and above          | 2%                              |

The legislation provides a mandatory procedure for customers to resolve erroneous billings of the Communications Sales and Use Tax and E-911 tax by writing their service provider.<sup>87</sup>

The new law provides accounting rules for transactions where services that are subject to different tax treatments are sold for a nonitemized charge.<sup>88</sup> The law states that:

[I]f the charge is attributable to services that are taxable and services that are nontaxable, the portion of the charge attributable to the nontaxable services shall be subject to tax unless the [Provider] can reasonably identify the nontaxable portion from its books and records kept in the regular course of business.<sup>89</sup>

For purposes of the Communications Sales and Use Tax, the sales price will not include the following:

- (i) [A]n excise . . . tax . . . [on] any communications service that is permitted or required to be added to the sales price of such service, if the tax is stated separately;
- (ii) a fee or assessment . . . that is required to be added to the price of service if the fee or assessment is separately stated;
- (iii) coin-operated communications [sic] services;
- (iv) sale or recharge of a prepaid calling service;
- (v) . . . air-to-ground radiotelephone services . . . ;
- (vi) a [Provider's] internal use of communications services in connection with its business of providing communications services;
- (vii) charges for property or other services that are not part of the sale of communications services, if the charges are stated separately from the charges for communications services;
- (viii) sales for resale; and

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86. *Id.* § 58.1-656 (Cum. Supp. 2006).

87. *Id.* § 58.1-652 (Cum. Supp. 2006).

88. *Id.* § 58.1-650(A) (Cum. Supp. 2006).

89. *Id.* § 58.1-650(B) (Cum. Supp. 2006).

(ix) charges for communications services to the Commonwealth, any political subdivision of the Commonwealth, and the federal government and any agency or instrumentality of the federal government.<sup>90</sup>

The following would not be considered taxable communications services:

- (i) [I]nformation services;
- (ii) installation or maintenance of wiring or equipment on a customer's premises;
- (iii) the sale or rental of tangible personal property;
- (iv) the sale of advertising, including but not limited to, directory advertising;
- (v) bad check charges;
- (vi) billing and collection services;
- (vii) Internet access service, electronic mail service, electronic bulletin board service, or similar services that are incidental to Internet access, such as voice-capable e-mail or instant messaging;
- (viii) digital products delivered electronically, such as software, downloaded music, ring tones, and reading materials; and
- (ix) over-the-air radio and television service broadcast without charge by an entity licensed for such purposes by the Federal Communications Commission.<sup>91</sup>

All sales by a Provider will be subject to the Communications Sales and Use Tax until the contrary is established.<sup>92</sup> "The burden of proving that sale of communications services is not taxable is upon the [Provider]" unless it obtains an exemption certificate from the customer.<sup>93</sup> Internet access service providers that purchase telecommunications services to provide Internet access will be authorized to use self-issued exemption certificates.<sup>94</sup> Upon receipt of the certificate, the Provider will be relieved of any liability for the tax related to that sale.<sup>95</sup> "In the event the provider of Internet access uses the telecommunications service for any taxable purpose," the Internet access service provider will be re-

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90. *Id.* § 58.1-648(B) (Cum. Supp. 2006).

91. *Id.* § 58.1-648(C) (Cum. Supp. 2006).

92. *Id.* § 58.1-657(A) (Cum. Supp. 2006).

93. *Id.*

94. *See id.* § 58.1-657(C) (Cum. Supp. 2006).

95. *Id.*

quired to pay the Communications Sales and Use Tax directly to the Virginia Department of Taxation.<sup>96</sup>

The Virginia Department of Taxation is required to allow a person who uses taxable communications services to pay the Communications Sales and Use Tax directly to the Virginia Department of Taxation and waive the collection of tax by the Provider.<sup>97</sup>

The legislation also imposes a new E-911 tax on landline telephone service.<sup>98</sup> The E-911 tax will also be state administered and enforced by the Virginia Department of Taxation.<sup>99</sup> The E-911 tax will be imposed on the end user of each access line at the rate of \$0.75 per access line.<sup>100</sup> Providers will be allowed a dealer discount of three percent of the amount of the E-911 tax revenues.<sup>101</sup>

## 2. Semiconductor Production Exemption Enacted

The 2006 General Assembly amended Virginia Code section 58.1-609.3(14) to exempt equipment, fuel, power, energy, and supplies used primarily in the integrated process or sub-process of designing, developing, manufacturing, or testing of semiconductors, without regard to whether the item is used in a cleanroom environment, touches the product, is used prior to or after production, or is affixed to real property.<sup>102</sup> This new semiconductor production exemption from sales and use tax is much broader than the industrial manufacturing and processing exemption provided to other manufacturers under Virginia Code section 58.1-609.3(2).<sup>103</sup>

To interpret the new semiconductor production exemption, the 2006 General Assembly adopted several new definitions. First, the term

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96. *Id.*

97. *Id.* § 58.1-658(A) (Cum. Supp. 2006).

98. *See id.* § 58.1-1730(A)-(B) (Cum. Supp. 2006).

99. *See id.* § 58.1-1730(B) (Cum. Supp. 2006).

100. *Id.*

101. *Id.* § 58.1-1730(D) (Cum. Supp. 2006).

102. Act of Apr. 4, 2006, ch. 519, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-609.3(14) (Cum. Supp. 2006)); Act of Apr. 4, 2006, ch. 541, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-609.3(14) (Cum. Supp. 2006)).

103. *See* VA. CODE ANN. § 58.1-609.3(2) (Cum. Supp. 2006).



*“Integrated process,”* when used in relation to semiconductor manufacturing, means a process that begins with the research or development of semiconductor products, equipment, or processes, includes the handling and storage of raw materials at a plant site, and continues to the point that the product is packaged for final sale and either shipped or conveyed to a warehouse . . . . [S]emiconductor equipment, fuel, power, energy, supplies, or other tangible personal property shall be deemed used as part of the integrated process if its use contributes before, during, or after production to higher product quality, production yields, or process efficiencies.<sup>104</sup>

“[S]emiconductor cleanrooms” includes, among other things, fixtures, piping, flooring, lighting, and all other property used to provide a controlled environment.<sup>105</sup> “Semiconductor equipment” includes supports, bases, foundations, and other equipment, wafers, and equipment used in quality control and testing, regardless of where or when the equipment is used or whether it comes in contact with the item being manufactured.<sup>106</sup>

Items used in pre-production and in post-production testing and quality control, as well as supports and foundations taxable to other manufacturers, are exempt to semiconductor manufacturers under this legislation.<sup>107</sup> In a separate bill, the 2006 General Assembly added an exemption for all semiconductor wafers used or consumed by a semiconductor manufacturer, regardless of their use.<sup>108</sup>

### 3. Exemption for Medicines and Drugs for Farm Animals

The 2006 General Assembly amended Virginia Code sections 58.1-609.2(1) and 58.1-609.10(9) to exempt from the sales and use tax medicines and drugs that are: (1) used directly by veterinarians in treating agricultural production animals; (2) sold by veterinarians to farmers for direct use in producing an agricultural product for market; or (3) used by a veterinarian for agricultural production animals and dispensed and sold on prescription by the

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104. *Id.* § 58.1-602 (Cum. Supp. 2006).

105. *Id.*

106. *Id.*

107. *Id.* § 58.1-609.3(14) (Cum. Supp. 2006).

108. S.B. 601, Va. Gen. Assembly (Reg. Sess. 2006) (enacted as Act of Apr. 4, 2006, ch. 524, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-609.3(15) (Cum. Supp. 2006))).

veterinarian.<sup>109</sup> The legislation does not apply to those items used to treat domesticated animals, such as dogs and cats, or recreational animals, such as horses. The exemption applies only to medicines and drugs used for the treatment of “agricultural production animals.”<sup>110</sup>

#### 4. Exemption for Medicines and Drugs Purchased by Nursing Homes

The 2006 General Assembly amended Virginia Code section 58.1-609.10(9) to expand the sales and use tax exemption for medicines and drugs to include medicines and drugs purchased by for-profit nursing homes, clinics, and similar corporations.<sup>111</sup> Prior to enacting this legislation, only licensed hospitals and non-profit nursing homes, clinics, and similar corporations could purchase medicines and drugs exempt of the sales and use tax.<sup>112</sup>

#### 5. Exclusion of Gratuities on Meals

The 2006 General Assembly amended the sales and use tax definition of “sales price” to exclude any gratuity or service charge added to the price of a meal at the discretion of the purchaser, and any mandatory gratuity or service charge added by a restaurant to the sales price of a meal, to the extent that such mandatory gratuity does not exceed twenty percent of the sales price.<sup>113</sup> Prior to adopting this legislation, a gratuity or service charge was considered part of the sale price and taxed when such service charge was included on the sales ticket provided to the purchaser as part of the bill.<sup>114</sup>

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109. Act of Mar. 30, 2006, ch. 331, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. §§ 58.1-609.2(1), -609.10(9) (Cum. Supp. 2006)); Act of Mar. 30, 2006, ch. 361, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. §§ 58.1-609.2(1), -609.10(9) (Cum. Supp. 2006)).

110. VA. CODE ANN. §§ 58.1-609.2(1), -609.10(9) (Cum. Supp. 2006).

111. Act of Mar. 24, 2006, ch. 217, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-609.10(9) (Cum. Supp. 2006)).

112. VA. CODE ANN. § 58.1-609.10(9) (Repl. Vol. 2004).

113. Act of Apr. 5, 2006, ch. 568, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-602 (Cum. Supp. 2006)); Act of Apr. 5, 2006, ch. 602, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-602 (Cum. Supp. 2006)).

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

The legislation also amended Virginia Code sections 58.1-3833(E) and 58.1-3840(A) to exempt from the local meals tax any discretionary gratuity added by the purchaser or any mandatory gratuity or service charge added to the price of a meal by the restaurant, provided such charge does not exceed twenty percent of the cost of the meal.<sup>115</sup> The effect of the legislation is to eliminate the sales tax and local meals tax on gratuity or service charges that are mandatory or automatically added to the price of a meal by a restaurant. The legislation overturns the Virginia Department of Taxation's regulations that have subjected gratuities to the sales tax since 1966.<sup>116</sup>

## 6. Natural Gas and Oil Exploration Exemption Sunset Date Extended

The 2006 General Assembly amended Virginia Code section 58.1-609.3(12) to extend the sunset date for the natural gas and oil exploration exemption from July 1, 2006 to July 1, 2011.<sup>117</sup> The legislation also removed natural gas and oil refining and processing from the exemption for gas and oil drilling and extraction and included it within the general industrial manufacturing and processing exemption.<sup>118</sup>

## 7. True Object Test to Government Contracts Revised

The Virginia legislature, in its 2006 Special Session, adopted the 2006 Appropriations Act that contains language altering the Virginia Department of Taxation's interpretation of the true object test used in government contracts for sales and use tax purposes.<sup>119</sup> Effective July 1, 2006, the true object test will be applied

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115. Act of Apr. 5, 2006, ch. 568, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. §§ 58.1-3833(E), -3840(A) (Cum. Supp. 2006)); Act of Apr. 5, 2006, ch. 602, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. §§ 58.1-3833(E), -3840(A) (Cum. Supp. 2006)).

116. 23 VA. ADMIN. CODE § 10-210-930(D) (1996).

117. Act of Apr. 5, 2006, ch. 618, 2006 Va. Acts \_\_\_ (codified as amended VA. CODE ANN. § 58.1-609.3(12) (Cum. Supp. 2006)); Act of Mar. 30, 2006, ch. 385, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-609.3(12) (Cum. Supp. 2006)).

118. Act of Apr. 5, 2006, ch. 618, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-609.3(2), (12) (Cum. Supp. 2006)); Act of Mar. 30, 2006, ch. 385, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-609.3(2), (12) (Cum. Supp. 2006)).

119. Act of June 30, 2006, ch. 3, 2006 Va. Acts \_\_\_.

to each separate work order, task order, or statement of work entered into after July 1, 2006.<sup>120</sup> The language will not be codified in the Code of Virginia, however.

This change in policy brings some clarity to this issue that had not existed in Virginia. The only guidance previously issued on the subject came from rulings of the tax commissioner. Contractors cannot rely on those, because the Supreme Court of Virginia ruled five years ago that the rulings are accorded only judicial notice by the courts and are not accorded great weight.<sup>121</sup> Further, a Virginia court has never addressed the true object test for purposes of the sales tax treatment of a government contract.

Before the change in policy, the Virginia Department of Taxation applied the true object test to the overall government contract in situations in which the contract called for the provision of both tangible personal property and services.<sup>122</sup> Under the former application, if the true object of the contract was for the provision of tangible personal property, the contractor purchased all tangible personal property ultimately transferred to the government using a resale exemption. The ultimate sale of the property to the

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120. *Id.*

121. *Chesapeake Hosp. Auth. v. Commonwealth*, 262 Va. 551, 560, 554 S.E.2d 55, 59 (2001).

122. *See* VA. DEPT OF TAX'N, PUB. DOC. 05-141 (Aug. 25, 2005), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 02-130 (Oct. 6, 2002), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 98-182 (Oct. 30, 1998), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 96-155 (June 27, 1996), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 95-329 (Dec. 22, 1995), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 95-293 (Nov. 20, 1995), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 95-139 (May 31, 1995), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 95-124 (May 18, 1995), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 94-267 (Aug. 26, 1994), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 94-155 (May 23, 1994), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 88-159 (June 23, 1988), *available at* <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink).

government was exempt under the governmental entity exemption.<sup>123</sup>

Under the old rule, if the true object of the contract was for the provision of services, the contractor paid sales and use tax on all tangible personal property purchased to perform the contract; the contractor was deemed to be the taxable user of all tangible personal property purchased under the contract.<sup>124</sup> That was also the case for individual task orders performed under the service contract in which, under the task order, the contract was simply purchasing tangible personal property for resale to the government.<sup>125</sup>

Under the new rule, the overall contract will not be used to determine the taxability of each transaction under the contract.<sup>126</sup> Rather, the true object test will be applied to each separate task order, work order, and statement of work.<sup>127</sup> The test will then be used to determine the taxability of the property purchased under each order.<sup>128</sup>

The new rule will provide sales tax relief for task orders for the purchase of tangible personal property under what the department would previously have considered a service contract. However, the opposite will also be true. A contractor will now pay sales tax on tangible personal property purchased under a task order for the provision of a service even though the overall contract could be considered a contract for tangible personal property. For purposes of such an order, the contractor will be considered the taxable user of all tangible personal property purchased to perform the task.

The application of the true object test to individual task or work orders is not new to Virginia. The Virginia Department of Taxation applies the true object test to individual task or work orders issued under indefinite delivery/indefinite quantity

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123. See, e.g., VA. DEP'T OF TAX'N, PUB. DOC. 05-141 (Aug. 25, 2005), available at <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow "Searching by Number" hyperlink).

124. See, e.g., *id.*

125. See, e.g., *id.*

126. See Act of June 30, 2006, ch. 3, 2006 Va. Acts \_\_\_\_.

127. See *id.*

128. *Id.*

“ID/IQ”) contracts. In Public Document 01-6,<sup>129</sup> the contractor entered into a fixed-price ID/IQ contract with the federal government. Under the terms of the contract, the contractor was not required to perform any services or provide any tangible personal property until a delivery order was issued. The Virginia Tax Commissioner recognized that when the contract was signed, neither the federal government nor the contractor knew what specific property or services would be required over the life of the contract.<sup>130</sup>

## B. Recent Judicial Decisions

### 1. Fabrication Services Not Subject to Use Tax

In a letter opinion, the Richmond City Circuit Court granted summary judgment to the taxpayer holding that the use tax imposed by Virginia Code section 58.1-604 (the “Use Tax”), as opposed to the sales tax imposed by Virginia Code section 58.1-603 (the “Sales Tax”), does not apply to services.<sup>131</sup> The circuit court further held that regardless of whether the Sales Tax applies to a service, the tax may not be levied directly by the Virginia Department of Taxation against the purchaser of the service.<sup>132</sup>

The taxpayer, Hardaway Construction Corporation of Tennessee (“Hardaway”), entered into a contract with the Federal Bureau of Prisons to perform site preparation work at a parcel of property located in Virginia.<sup>133</sup> In connection with the project, Hardaway engaged an out-of-state subcontractor (“Mellott”) to come onto the site in Virginia and crush shot rock which had previously been severed from the land into gravel.<sup>134</sup> On audit of Hardaway, the Virginia Department of Taxation determined that crushing rock into gravel constituted “fabrication,” that “fabrication” as such was subject to the Sales Tax, that Mellott had not

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129. VA. DEP'T OF TAX'N, PUB. DOC. 01-6 (Jan. 4, 2001), available at <http://www.policylibrary.tax.virginia.gov/otp/policy.nsf> (follow “Searching by Number” hyperlink).

130. *Id.*

131. *Hardaway Constr. Corp. of Tenn. v. Commonwealth*, 69 Va. Cir. 59, 61 (Cir. Ct. 2005) (Richmond City).

132. *See id.*

133. *Id.* at 59; see also Stipulation of Facts at 2, *Hardaway*, 69 Va. Cir. 59 (No. LR-1165-1).

134. *Hardaway*, 69 Va. Cir. at 59.

collected the Sales Tax from Hardaway and remitted it to the state and, as a result, that Hardaway was liable for Use Tax on its purchase of rock crushing services.<sup>135</sup>

After an unsuccessful administrative appeal, Hardaway paid the tax and brought suit for refund in the Richmond City Circuit Court.<sup>136</sup> Hardaway's suit was based on three alternative arguments. First, Hardaway argued that the Use Tax did not apply to services of any kind, even services otherwise subject to the Sales Tax.<sup>137</sup> Second, Hardaway argued that even if crushing rock into gravel constituted fabrication subject to the Sales Tax, the Sales Tax may only be levied by the Virginia Department of Taxation against Mellott (i.e., the retailer) and not the purchaser.<sup>138</sup> And finally, Hardaway argued that crushing rock into gravel did not constitute fabrication subject to either the Sales Tax or the Use Tax in any event.<sup>139</sup>

In response, the Virginia Department of Taxation argued that Mellott sold fabrication services and therefore should have collected and remitted the Sales Tax.<sup>140</sup> Because Mellott failed to collect the Sales Tax, the Virginia Department of Taxation reasoned that Hardaway was required to remit Use Tax on its purchase of the fabrication service.<sup>141</sup> *Commonwealth v. Miller-Morton Co.*<sup>142</sup> was the case upon which the Virginia Department of Taxation based this argument.<sup>143</sup> In *Miller-Morton*, the Supreme Court of Virginia described the Sales and Use Taxes as complementary components of one charge upon commerce.<sup>144</sup> This complementary nature of the two taxes, reasoned the Virginia Department of Taxation, supported the imposition of the Use Tax to all events otherwise subject to the Sales Tax.<sup>145</sup> The Virginia Department of Taxation argued that this position was further bolstered by the fact that the legal incidence of the Sales Tax fell on the pur-

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135. See Stipulation of Facts, *supra* note 133, at 2-3.

136. *Id.* at 3.

137. *Hardaway*, 69 Va. Cir. at 60; see also Applicant's Memorandum of Law at 3-4, *Hardaway*, 69 Va. Cir. 59 (No. LR-1165-1).

138. Applicant's Memorandum of Law, *supra* note 137, at 10-12.

139. *Id.* at 13-16.

140. Defendant's Memorandum of Law at 5, *Hardaway*, 69 Va. Cir. 59 (No. LR-1165-1).

141. *Id.*

142. 220 Va. 852, 263 S.E.2d 413 (1980).

143. Defendant's Memorandum of Law, *supra* note 140, at 5.

144. *Miller-Morton*, 220 Va. at 855, 263 S.E.2d at 416.

145. Defendant's Memorandum of Law, *supra* note 140, at 5.

chaser, thereby confirming that the application of the Use Tax when the Sales Tax was not collected was appropriate.<sup>146</sup> The Virginia Department of Taxation also cited *United States v. Forst*<sup>147</sup> in support of this argument.<sup>148</sup>

By way of digression, Virginia Code section 58.1-604 imposes the Use Tax “upon the use or consumption of *tangible personal property* in this Commonwealth . . . [on] the cost price of each item or article of *tangible personal property* used or consumed in this Commonwealth.”<sup>149</sup> This section explicitly applies the Use Tax solely to tangible personal property.<sup>150</sup> Nowhere in this section is the word “service” even found.<sup>151</sup> And, Virginia Code section 58.1-603 imposes the Sales Tax:

[U]pon every person who engages in the business of selling at retail or distributing tangible personal property in this Commonwealth, or who rents or furnishes any of the things or services taxable under this chapter, . . . [on] the gross sales price of each item or article of tangible personal property when sold at retail or distributed in this Commonwealth.<sup>152</sup>

A “sale,” for purposes of the Sales Tax, is defined by Virginia Code section 58.1-602 to include “the *fabrication* of tangible personal property for consumers who furnish . . . the materials.”<sup>153</sup> Therefore, the service of fabrication is arguably subject to the Sales Tax.

The circuit court ultimately sided with Hardaway. Citing the plain language of the statute, the circuit court concluded that the Use Tax, on its face, does not apply to services of any kind.<sup>154</sup> Instead, it applies only to tangible personal property.<sup>155</sup> Further, while the circuit court agreed that the Sales Tax and the Use Tax are complementary in that only one of the two can apply to a single transaction, it declined to infer that the two are “coexten-

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146. *Id.*

147. 442 F. Supp. 920 (W.D. Va. 1977), *aff'd*, 569 F.2d 811 (4th Cir. 1978).

148. Defendant's Memorandum of Law, *supra* note 140, at 5–6.

149. VA. CODE ANN. § 58.1-604 (Repl. Vol. 2004) (emphases added).

150. *See id.*

151. *See id.*

152. *Id.* § 58.1-603 (Repl. Vol. 2004).

153. *Id.* § 58.1-602 (Cum. Supp. 2006) (emphasis added).

154. *See Hardaway Constr. Corp. of Tenn. v. Commonwealth*, 69 Va. Cir. 59, 61 (Cir. Ct. 2005) (Richmond City).

155. *Id.*



sive.”<sup>156</sup> In the case of services, the circuit court concluded that *only* the Sales Tax applies.<sup>157</sup>

Finally, the circuit court concluded that the Sales Tax, by its clear unequivocal terms, is imposed on the seller, or “dealer,” for the privilege of making taxable “retail sales,” and that Mellott—not Hardaway—was the dealer.<sup>158</sup> The circuit court found unpersuasive the Virginia Department of Taxation’s argument that it may levy the Sales Tax against Hardaway simply because the “legal incidence” of the tax may be passed on by Mellott ultimately to Hardaway.<sup>159</sup> In reaching this conclusion, the circuit court relied on the carefully detailed mechanics governing the levy and collection of Sales Tax under Virginia Code section 58.1-625.<sup>160</sup> Under that section, the dealer/seller is levied the tax and dealer/seller pays the Sales Tax to the Virginia Department of Taxation.<sup>161</sup> The dealer (and only the dealer) then has rights against the purchaser to collect the tax.<sup>162</sup> Indeed, Hardaway had pointed out the rather curious nature of the Department’s reliance on *Forst* as authority for its ability to assess Sales Tax directly on purchasers.<sup>163</sup> In *Forst*, which dealt with federal immunity from state taxation, the Virginia Department of Taxation had argued that it had no right to levy the tax directly on the federal government as purchaser, and as such, federal immunity did not attach.<sup>164</sup> In *Forst*, the United States District Court for the Western District of Virginia agreed with the Virginia Department of Taxation on this contention but ultimately concluded that a strict right of direct assessment was not required in order for federal immunity to attach if the statute contemplated that the seller (as opposed to the Virginia Department of Taxation) was expected to, and in fact had the authority to, collect the tax from the purchaser.<sup>165</sup>

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156. *Id.*

157. *See id.* at 60–61.

158. *See id.* at 61.

159. *See id.*; Defendant’s Memorandum of Law, *supra* note 140, at 5 (citing *United States v. Forst*, 442 F. Supp. 920, 923 (W.D. Va. 1977), *aff’d*, 569 F.2d 811 (4th Cir. 1978)).

160. *Hardaway*, 69 Va. Cir. at 60–61.

161. VA. CODE ANN. § 58.1-625 (Cum. Supp. 2006).

162. *Id.*

163. Applicant’s Memorandum of Law, *supra* note 137, at 10.

164. *See Forst*, 442 F. Supp. at 922.

165. *See id.* at 923–24.

Hardaway's final argument—that crushing rock was not fabrication<sup>166</sup>—was ultimately rendered moot, and the circuit court offered no opinion on the matter.<sup>167</sup>

## 2. Sales Tax Refund for Internet Equipment

The Fairfax County Circuit Court has held that a sales and use tax exemption for certain types of Internet equipment applies solely to the type of equipment used and not to the type of Internet service provider (“ISP”) using the equipment.<sup>168</sup>

Cisco Systems, Inc. and Cisco Systems Sales and Services, Inc., (“Cisco”) initiated this case by petitioning for a refund of excess sales taxes paid under Virginia Code section 58.1-1825.<sup>169</sup> Cisco is a company that provides Internet access via equipment, software, and services to other companies that provide Internet access to end-user customers.<sup>170</sup> In short, Cisco is a wholesale ISP.<sup>171</sup> Cisco argued that the Internet equipment exemption applied to all equipment regardless of the type of Internet services a company supplied to its customers.<sup>172</sup> Accordingly, Cisco asserted that it had paid sales tax on purchases of certain types of Internet equipment that were exempted from the sales and use tax under

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166. See Applicant's Memorandum of Law, *supra* note 137, at 13–16.

167. See *Hardaway Constr. Corp. of Tenn. v. Commonwealth*, 69 Va. Cir. 59, 61 (Cir. Ct. 2005) (Richmond City). However, given the long-standing precedent in Virginia that statutes imposing taxes are construed against the Virginia Department of Taxation and in favor of the taxpayer, it seems likely that crushing rock was not within the plain meaning of the word “fabrication.” This is especially so in light of the Virginia Department of Taxation's own regulations which define crushing rock into gravel as “processing” as opposed to “fabrication.” In the end, this decision highlights how a long-standing, colloquial Departmental view that the Sales Tax and the Use Tax are “interchangeable” failed to pass statutory muster when examined carefully. Undoubtedly, as a matter of practice, Departmental “Sales and Use Tax audits” consist of an examination of transactions which are subject to the Sales Tax, and undoubtedly, the assumption was that when the audit involved a purchaser in an otherwise taxable transaction, the proper means of levying the tax was the “Use Tax.” Taxpayers should review carefully their most recent Virginia audits and determine whether tax (whether it be the Sales or Use Tax) has been levied on the purchase of services. If so, the *Hardaway* decision supports a finding that the assessment is incorrect.

168. See *Cisco Sys., Inc. v. Thorsen*, 68 Va. Cir. 385, 396 (Cir. Ct. 2005) (Fairfax County).

169. *Id.* at 386.

170. *Id.*

171. *Id.*

172. *Id.*

Virginia Code section 58.1-609.6(2).<sup>173</sup> The Virginia Department of Taxation contended that the equipment was not exempt from the sales and use tax based on the services that Cisco provides to its customers.<sup>174</sup>

The exemptions provided for under Virginia Code section 58.1-609.6 are media-related exemptions. Among other things, Virginia Code section 58.1-609.6(2) provides an exemption from the sales and use tax for broadcasting, amplification, transmission, and distribution equipment.<sup>175</sup> The Internet exemption is embedded in this exemption by defining certain words to include Internet Service.<sup>176</sup> "Internet Service" is defined by Virginia Code section 58.1-602 as "a service that enables users to access proprietary and other content, information electronic mail, and the Internet as part of a package of services sold to end-user subscribers."<sup>177</sup>

The Attorney General of Virginia and the Virginia Tax Commissioner issued conflicting opinions on the scope of this exemption. On March 15, 2000, the Attorney General of Virginia responded to a written inquiry from Virginia Senator William Mims concerning whether the equipment that qualifies for this exemption can be used in either providing Internet service to end users or providing Internet access to other companies who provide Internet access to end users.<sup>178</sup> The Attorney General of Virginia opined that the equipment can be used for both.<sup>179</sup> In three separate subsequent rulings, the Virginia Tax Commissioner answered that only equipment providing Internet access to end users qualifies for the exemption.<sup>180</sup>

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173. *Id.*

174. *Id.* at 387.

175. VA. CODE ANN. § 58.1-609.6(2) (Repl. Vol. 2004 & Cum. Supp. 2006).

176. *See Cisco Sys.*, 68 Va. Cir. at 387-88.

177. VA. CODE ANN. § 58.1-602 (Cum. Supp. 2006).

178. 2000 Op. Va. Att'y Gen. 215.

179. *Id.* at 217.

180. VA. DEPT OF TAX'N, PUB. DOC. 04-89 (Aug. 31, 2004), *available at* <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 01-29 (Mar. 29, 2001), *available at* <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow "Searching by Number" hyperlink); VA. DEPT OF TAX'N, PUB. DOC. 00-18 (Mar. 17, 2000), *available at* <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow "Searching by Number" hyperlink).

The Fairfax County Circuit Court addressed the weight that should be accorded opinions of the Attorney General and, in smaller part, rulings of the Tax Commissioner.<sup>181</sup> In regards to the weight that should be accorded the opinion of the Attorney General, the circuit court cited *Board of Supervisors v. Marshall*<sup>182</sup> and adopted the principle that when the Attorney General issues an opinion concerning the interpretation of a statute, and the General Assembly fails to contradict the Attorney General's opinion, the interpretation is given the presumption of correctness.<sup>183</sup>

The circuit court stated that this result is even more emphatic when the issue posed to the Attorney General comes from a member of the General Assembly.<sup>184</sup> The General Assembly had actual notice of the advice rendered to Virginia Senator Mims and took no steps to overrule or change the advice during the five subsequent annual sessions of the General Assembly.<sup>185</sup> The court stated that at most, the General Assembly had presumed notice of the Virginia Tax Commissioner's rulings.<sup>186</sup> In any event, the circuit court expressly stated that the Virginia Tax Commissioner was wrong in each of his three rulings on the Internet service exemption because the Virginia Tax Commissioner added a requirement to the exemption that was not contained in the statutory exemption.<sup>187</sup>

The circuit court reached the correct conclusion in this case—that the exemption applies solely to the type of equipment used and not to the type of ISP using the equipment.<sup>188</sup> In so holding, the circuit court reasoned that the Virginia Tax Commissioner was attempting to “read language into the statute that . . . does not appear.”<sup>189</sup> This reasoning comes from the fact that the words of Virginia Code section 58.1-609.6(2) refer only to equipment that is exempt and not to who may take the exemption.<sup>190</sup>

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181. *Cisco Sys.*, 68 Va. Cir. at 389.

182. 215 Va. 756, 214 S.E.2d 146 (1975).

183. *Cisco Sys.*, 68 Va. Cir. at 395–96.

184. *See id.* at 396.

185. *Id.* at 391.

186. *Id.* at 396.

187. *Id.* at 395.

188. *See id.* at 396.

189. *Id.* at 395.

190. *Id.*

The Virginia Tax Commissioner asserted at trial that “the legislature intended to differentiate between ‘wholesale’ and ‘retail’ ISPs by parsing the language of the statute and examining [the second subparagraph of Virginia Code section 58.1-609.6(2)] in isolation” from the remainder of the tax statute.<sup>191</sup> The Virginia Tax Commissioner asserted that the exemption is to be applied to those to whom the exemption should apply and not to what equipment is exempt from taxation.<sup>192</sup>

The Fairfax County Circuit Court disagreed. Relying on the 1995 decision of the Supreme Court of Virginia in *Carr v. Forst*,<sup>193</sup> the circuit court held that the Virginia Tax Commissioner was again attempting to read language into the statute that simply does not appear.<sup>194</sup> In *Carr*, the Supreme Court of Virginia abated a tax assessment when the Virginia Tax Commissioner imposed a “purpose” component into a publication to entitle such publication to qualify for an exemption for publications.<sup>195</sup> The publication at issue in *Carr* was a commercial real estate sales publication that was regularly published and distributed at no cost to end-users of the magazine.<sup>196</sup> The supreme court in *Carr* stated that had the General Assembly intended such an exclusion, it could have created it by adding such language into the statute.<sup>197</sup>

The Fairfax County Circuit Court found the *Carr* decision to apply squarely to this case.<sup>198</sup> The circuit court stated that nowhere in the Internet service exemption was there any language restricting the exemption to retail ISPs who provide content to their customers.<sup>199</sup> Rather, the statute is designed to apply to certain types of Internet service equipment, regardless of whether the equipment’s owner provides this equipment to ISPs on either a wholesale or retail basis.<sup>200</sup>

The language the Virginia Tax Commissioner read into the statute was from the definitions of the words in the statute defined in Virginia Code section 58.1-602. Specifically, the Virginia

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191. *Id.* at 393.

192. *Id.*

193. 249 Va. 66, 453 S.E.2d 274 (1995).

194. *Cisco Sys.*, 68 Va. Cir. at 395.

195. *Carr*, 249 Va. at 71, 453 S.E.2d at 276.

196. *Id.* at 67, 453 S.E.2d at 274–75.

197. *Id.* at 71, 453 S.E.2d at 276.

198. *Cisco Sys.*, 68 Va. Cir. at 394.

199. *See id.* at 396.

200. *See id.*

Tax Commissioner relied upon the limiting language in the definition of "Internet service" in Virginia Code section 58.1-602.<sup>201</sup>

Even though the term "Internet service" is not used in the language of the exemption at issue in this case, the term is used in the definitions section of the Virginia Retail Sales and Use Tax Act.<sup>202</sup> The exemption statute at issue in *Cisco* includes the following:

Broadcasting equipment and parts and accessories thereto and towers used or to be used by commercial radio and television companies, wired or land based wireless cable television systems, common carriers or *video programmers* using an *open video system* or other video platform provided by telephone common carriers, or concerns which are under the regulation and supervision of the Federal Communications Commission and *amplification, transmission and distribution equipment* used or to be used by wired or land based wireless cable television systems, or *open video systems* or other video systems provided by telephone common carriers.<sup>203</sup>

The definitions of the italicized words in the exemption quoted above all include Internet service as defined by Virginia Code section 58.1-602. "'Internet service' means a service that enables users to access proprietary and other content, information electronic mail, and the Internet as part of a package of services sold to end-user subscribers."<sup>204</sup> According to the Virginia Tax Commissioner, this definition of "Internet service" is clearly limited to those service providers that provide access to their own proprietary content, e-mail, and the rest of the Internet as part of one package.<sup>205</sup> Based on the circuit court's description of the facts, Cisco does not provide this type of Internet service as it solely provides access to the Internet to other ISPs on a wholesale basis.<sup>206</sup>

So, although the definition of Internet service appears to be restrictive, the wording of the exemption prevents the entire exemption from also being restrictive. Relying on the rules of statutory construction, the circuit court correctly concluded that the exemption should apply to wholesale ISPs such as Cisco as well as end-user retail ISPs.<sup>207</sup>

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201. See *id.* at 387-88.

202. See VA. CODE ANN. § 58.1-602 (Cum. Supp. 2006).

203. *Id.* § 58.1-609.6(2) (Repl. Vol. 2004 & Cum. Supp. 2006) (emphasis added).

204. *Id.* § 58.1-602 (Cum. Supp. 2006) (emphasis added).

205. See *Cisco Sys.*, 68 Va. Cir. at 388.

206. *Id.* at 386.

207. *Id.* at 396.

## PART TWO: TAXES ADMINISTERED BY LOCALITIES

## V. REAL PROPERTY TAX

A. *Recent Significant Legislative Activity*

## 1. Non-Judicial Sale of Tax Delinquent Properties Clarified

The 2006 General Assembly amended Virginia Code sections 58.1-3967 and 58.1-3975 to provide rules with regard to non-judicial sales of tax delinquent real properties of minimal size and value.<sup>208</sup> The new procedures provide that the treasurer shall sell each parcel that has not been redeemed by the owner to the highest bidder at a public auction.<sup>209</sup>

Such sale shall be free and clear of the tax lien, but shall not affect easements recorded prior to the date of sale. The treasurer or other officer responsible for collecting taxes shall tender a treasurer's deed to [convey title in the parcel] to the highest bidder. If the sale proceeds are insufficient to pay the taxes in full, the remaining delinquent tax amount shall remain the personal liability of the former owner. The sale proceeds shall be applied first to the costs of the sale, then to the taxes, penalty and interest due on the parcel, and thereafter to any other taxes or other charges owed by the former owner to the jurisdiction. Any excess proceeds shall remain the property of the former owner and shall be kept by the treasurer in an interest-bearing escrow account. If no claim for payment of excess proceeds is made by the former owner within two years after the date of sale, the treasurer shall deposit the excess proceeds in the jurisdiction's general fund. If the sale does not produce a successful bidder, the treasurer shall add the costs of sale incurred by the jurisdiction to the delinquent real estate account.<sup>210</sup>

The new legislation also amended Virginia Code section 58.1-3967 to declare that judicial sales of real property do not affect easements recorded prior to the date of sale.<sup>211</sup>

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208. Act of Apr. 5, 2006, ch. 616, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. §§ 58.1-3967, -3975 (Cum. Supp. 2006)).

209. VA. CODE ANN. § 58.1-3975 (Cum. Supp. 2006).

210. *Id.*

211. Act of Apr. 5, 2006, ch. 616, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-3967 (Cum. Supp. 2006)).

## 2. Assessments of Affordable Housing Property

The 2006 General Assembly enacted new Virginia Code section 58.1-3295 to mandate that the assessor consider certain characteristics that typically exist with multi-unit residential affordable housing developments.<sup>212</sup> The new law requires that when assessing affordable housing<sup>213</sup> consisting of more than four residential units in an effort to determine the fair market value of the real property, the locality must consider the following four factors as part of the methodology: (1) “[t]he rent and the impact of applicable rent restrictions;”<sup>214</sup> (2) “[t]he operating expenses and expenditures and the impact of any such additional expenses or expenditures;”<sup>215</sup> (3) “[r]estrictions on the transfer of title or other restraints on alienation of the real property;”<sup>216</sup> and (4) any “evidence presented by the property owner of other restrictions imposed by law that impact” the foregoing three factors.<sup>217</sup> The new statute also provides that any federal or state income tax credits with respect to the affordable housing being assessed are not to be considered real property or income attributable to real property.<sup>218</sup> If only a portion of the real property is operated as affordable housing, only that portion determined to be affordable housing is subject to the foregoing factors.<sup>219</sup>

## 3. Roll-Back Tax Valuation Provisions Changed

The 2006 General Assembly amended Virginia Code section 58.1-3241 to eliminate the requirement that, in order to continue to qualify for Virginia land-use property taxation, a landowner that subdivides land into parcels that meet the minimum acreage requirements for land-use taxation must attest that the land is

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212. Act of Apr. 5, 2006, ch. 688, 2006 Va. Acts \_\_\_\_ (codified at VA. CODE ANN. § 58.1-3295 (Cum. Supp. 2006)).

213. For purposes of this statute, affordable housing pertains to those residential housing units operated in whole or part as affordable housing in accordance with the provisions of 26 U.S.C. § 42, 26 U.S.C. § 142(d), 24 C.F.R. § 983, 24 C.F.R. § 236, 24 C.F.R. § 241(f), 24 C.F.R. § 221(d)(3), or applicable state law or local ordinance. See VA. CODE ANN. § 58.1-3295(A) (Cum. Supp. 2006).

214. VA. CODE ANN. § 58.1-3295(A)(1) (Cum. Supp. 2006).

215. *Id.* § 58.1-3295(A)(2) (Cum. Supp. 2006).

216. *Id.* § 58.1-3295(A)(3) (Cum. Supp. 2006).

217. *Id.* § 58.1-3295(A) (Cum. Supp. 2006).

218. *Id.* § 58.1-3295(B) (Cum. Supp. 2006).

219. *Id.* § 58.1-3295(C) (Cum. Supp. 2006).



still devoted solely to agricultural, horticultural, forest, or open-space use.<sup>220</sup> However, the requirement that the land must be devoted solely to agricultural, horticultural, forest, or open-space use in order to continue to qualify for land use taxation is not eliminated.<sup>221</sup>

In addition, localities are authorized not to impose roll-back taxes when real estate subject to use valuation is subdivided, separated, or split-off pursuant to a locality's subdivision ordinance into parcels that do not meet the minimum acreage requirements for land-use taxation, if title to the resulting parcels is held in the name of an immediate family member for the first sixty months following the subdivision, separation, or split-off.<sup>222</sup> An "immediate family member" means any person that is defined as such in the locality's subdivision ordinance."<sup>223</sup>

#### 4. Open-Space Land Classification Includes Golf Courses

The 2006 General Assembly amended the term "real estate devoted to open-space use" to specifically include public and private golf courses.<sup>224</sup> This designation is important for purposes of real estate tax assessments for open-space property as the fair market value of the land at its most profitable use is not considered for purposes of valuation. Rather, the assessing officer need only consider the value of the real estate in its current use.<sup>225</sup>

### B. *Recent Judicial Decision*

#### 1. Incorporated Religious Entity Qualifies as Exempt Religious Association

The Rockbridge County Circuit Court held that Young Life, Inc., a non-profit incorporated entity, is a religious association as described in Virginia Code sections 58.1-3609 and 58.1-3617, and

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220. Act of Mar. 24, 2006, ch. 221, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-3241 (Cum. Supp. 2006)).

221. *Id.*

222. VA. CODE ANN. § 58.1-3241(B)(2) (Cum. Supp. 2006).

223. *Id.*

224. Act of Apr. 6, 2006, ch. 817, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-3230 (Cum Supp. 2006)).

225. *See* VA. CODE ANN. § 58.1-3230 (Cum. Supp. 2006).

its real and tangible property is exempt from ad valorem property taxation.<sup>226</sup> Young Life operates a summer camp in Rockbridge County, where young Christian adolescents spend time doing a variety of physical activities that are consistent with other summer camps, but also spend time learning about and expanding their Christian faith.<sup>227</sup> Originally, Rockbridge County had argued that Young Life did not qualify as a religious association and was not exempt from taxes.<sup>228</sup> However, upon a demonstration by Young Life that the primary focus of the camp was for religious purposes, the circuit court held Young Life is an exempt religious organization.<sup>229</sup>

Prior to this holding, the Rockbridge County Circuit Court denied a demurrer by Rockbridge County and held the following: (1) the enactment of an amendment to the Constitution of Virginia effective January 1, 2003, authorizing the exemption of property by classification, applied on a prospective basis only and did not repeal previously enacted exemptions; (2) the enactment of Virginia Code section 58.1-3651(D) to implement the constitutional amendment extended previously enacted exemptions and did not preclude any properly challenged claims based on this amendment; and (3) Young Life was not precluded from being classified as a religious association due to the fact that it is an incorporated entity.<sup>230</sup>

## VI. TANGIBLE PERSONAL PROPERTY TAX

### A. *Recent Significant Legislative Activity*

#### 1. Separate Classification Created for Certain Aircraft

The 2006 General Assembly created a separate classification of tangible personal property for local property tax purposes for “[a]ircraft having a registered empty gross weight equal to or

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226. *Young Life, Inc. v. Rockbridge County*, No. CH 3000048-00 (Va. Cir. Ct. Apr. 5, 2006) (Rockbridge County) (unpublished decision).

227. See Application of Correct Erroneous Assessments of Local Taxes for 2000–2002 at 2–3, *Young Life*, No. CH 3000048-00.

228. See Demurrers of Rockbridge County at 2, *Young Life*, No. CH 3000048-00.

229. *Young Life*, No. CH 3000048-00, at 2.

230. *Young Life, Inc. v. Rockbridge County*, No. CH 3000048-00 (Va. Cir. Ct. Oct. 30, 2003) (Rockbridge County) (order denying defendant’s demurrers).

greater than 20,000 pounds that are not owned and operated by scheduled air carriers recognized under federal law.”<sup>231</sup> There already existed separate classifications for “[a]ircraft having a maximum passenger seating capacity of no more than 50 that are owned and operated by scheduled air carriers under certificates of public convenience and necessity issued by the State Corporation Commission or the Civil Aeronautics Board,”<sup>232</sup> and for all other aircraft and flight simulators.<sup>233</sup>

## 2. Additional Classifications Created for Boats and Watercraft

The 2006 General Assembly created three additional separate property tax classifications of boats and watercraft when it amended Virginia Code section 58.1-3506(A)(1) and (34).<sup>234</sup> The amended statute now authorizes localities to classify and tax boats and watercraft used solely for business purposes differently than boats and watercraft not used solely for business purposes.<sup>235</sup> Boats and watercraft weighing five tons or more may be taxed differently than boats and watercraft weighing less than five tons under the revised statute.<sup>236</sup>

## 3. Pollution Control Equipment Exemption Expanded

The 2006 General Assembly amended Virginia Code section 58.1-3660 to provide a local real and personal property tax exemption for certified pollution control equipment and facilities placed in service on or after July 1, 2006 that consist of:

[E]quipment used in collecting, processing, and distributing, or generating electricity from, landfill gas or synthetic or natural gas recovered from waste, including equipment used to grind, chip, or mulch trees, tree stumps, underbrush, and other vegetative cover for reuse as landfill gas or synthetic or natural gas recovered from waste.<sup>237</sup>

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231. Act of Mar. 24, 2006, ch. 200, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-3506(A)(3) (Cum. Supp. 2006)); Act of Mar. 24, 2006, ch. 231, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-3506(A)(3) (Cum. Supp. 2006)).

232. VA. CODE ANN. § 58.1-3506(A)(2) (Cum. Supp. 2006).

233. *Id.* § 58.1-3506(A)(4) (Cum. Supp. 2006).

234. Act of Mar. 31, 2006, ch. 400, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-3506(A)(1), (34) (Cum. Supp. 2006)).

235. *See* VA. CODE ANN. § 58.1-3506(A)(1), (34) (Cum. Supp. 2006).

236. *See id.* § 58.1-3506(A)(1), (34)–(35) (Cum. Supp. 2006).

237. Act of Apr. 3, 2006, ch. 375, 2006 Va. Acts \_\_\_ (codified as amended VA. CODE

The exemption for certified pollution control equipment and facilities creates a separate class of property. Localities may, by ordinance, exempt or partially exempt such property from tangible personal property and real property taxation.<sup>238</sup>

## VII. MISCELLANEOUS PROCEDURAL AND LOCAL TAX REFORMS

### A. *Recent Significant Legislative Activity*

#### 1. Taxpayer's Willful Failure to Provide Information Precludes Judicial Relief

The 2006 General Assembly amended Virginia Code section 58.1-1826 to preclude circuit courts from granting relief to taxpayers seeking correction of erroneous tax assessments in cases in which the erroneous assessment is attributable to the taxpayer's willful failure or refusal to provide the Virginia Department of Taxation with the necessary information as required by law.<sup>239</sup>

#### 2. Limitations on Use of Collection Agents

Prior to July 1, 2006, localities were authorized to utilize the local sheriff, an attorney, or a private collection agent to assist with the collection of local taxes which remained delinquent for a period of six months or more.<sup>240</sup> The 2006 General Assembly amended Virginia Code sections 58.1-3919.1 and 58.1-3934 to prohibit a locality from utilizing the local sheriff, an attorney, or a private collection agent to assist with collection of a delinquent local tax unless the locality has first attempted to send written notification of the delinquency to the taxpayer at the address contained in its tax records.<sup>241</sup> If the locality has reason to believe the taxpayer's address contained in its tax records is no longer cur-

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ANN. § 58.1-3660(A) (Cum. Supp. 2006)).

238. VA. CODE ANN. § 58.1-3660(A) (Cum. Supp. 2006).

239. Act of Mar. 30, 2006, ch. 342, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-1826 (Cum. Supp. 2006)).

240. See VA. CODE ANN. §§ 58.1-3919.1, -3934(A)-(B) (Repl. Vol. 2004).

241. Act of Mar. 30, 2006, ch. 372, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. §§ 58.1-3919.1, -3934(B) (Cum. Supp. 2006)).

rent, the locality may send its notification at such other address, if any, as the locality may obtain from sources available to it, including the Virginia Employment Commission, the Virginia Department of Motor Vehicles, or the Virginia Department of Taxation.<sup>242</sup>

### 3. Cap on Penalty for Failure to Pay Local Tax Enacted

The 2006 General Assembly amended Virginia Code section 58.1-3916 to provide that no local tax penalty for failure to pay a tax may exceed the amount of the tax assessable.<sup>243</sup> Prior to this amendment the only local tax penalty that could exceed the amount of the tax was the minimum ten-dollar penalty.<sup>244</sup>

### 4. Transient Occupancy Tax Requires Overnight Accommodations

The 2006 General Assembly enacted new Virginia Code section 58.1-3843, which limits the imposition of the transient occupancy tax imposed by cities and towns to charges for rooms or spaces occupied by transients that are intended or suitable for dwelling, sleeping, or lodging purposes.<sup>245</sup> Last year this same limitation was enacted for the transient occupancy tax that could be imposed by counties.<sup>246</sup> The effect of these two legislative actions is to effectively prohibit the imposition of a county, city, or town's transient occupancy tax on the charge for rooms or space rented for meetings, conferences, and purposes other than sleeping, dwelling, or lodging.<sup>247</sup>

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242. See VA. CODE ANN. §§ 58.1-3919.1, -3934(B) (Cum. Supp. 2006).

243. Act of Mar. 31, 2006, ch. 459, 2006 Va. Acts \_\_\_ (codified as amended at VA. CODE ANN. § 58.1-3916 (Cum. Supp. 2006)).

244. See VA. CODE ANN. § 58.1-3916 (Repl. Vol. 2004).

245. Act of Mar. 24, 2006, ch. 216, 2006 Va. Acts \_\_\_ (codified at VA. CODE ANN. § 58.1-3843 (Cum. Supp. 2006)).

246. See Act of Mar. 20, 2005, ch. 20, 2005 Va. Acts 37 (codified at VA. CODE ANN. § 58.1-3826 (Cum. Supp. 2006)).

247. See Craig D. Bell, *Annual Survey of Virginia Law: Taxation*, 40 U. RICH. L. REV. 291, 318-19 (2005).

## B. *Recent Judicial Decision*

### 1. Certain Specialized Printing Services Constitute Manufacturing for Business, Professional, and Occupational License Purposes

The Roanoke City Circuit Court held in a letter opinion that a business that manipulates photographic images to meet customer specifications qualifies as a manufacturing business under Virginia Code section 58.1-3703(C)(4) and accordingly is not liable for a business, professional, and occupational license ("BPOL") tax.<sup>248</sup> The taxpayer, Moody Graphic Color Service, Inc. ("Moody"), was in the business of creating and selling specialized printing services and products within the City of Roanoke.<sup>249</sup>

Moody essentially takes an image provided to it, such as a photograph or transparency, and breaks the image down into the four colors used by printers: cyan, magenta, yellow, and black. Using computers, Moody digitally alters and modifies the images to meet customer specifications. Such modification includes, among other issues, changing position, shade, or color of an image. By this process, the subject of the original image may be changed to a different image with a different background.<sup>250</sup>

The City of Roanoke claimed Moody failed to pay the 1996 and 1997 BPOL tax to the City.<sup>251</sup> Moody asserted it was not liable for the tax because it was a "manufacturer within the meaning of Virginia Code § 58.1-3703(C)(4), and consequently exempt from levy of the BPOL tax."<sup>252</sup> Each party filed a motion for summary judgment on the issue of whether Moody was a manufacturer within the meaning of Virginia Code section 58.1-3703(C)(4).<sup>253</sup>

Moody relied principally upon four rulings issued by the Virginia Tax Commissioner. Three rulings held that photo processing services constituted manufacturing for purposes of the manufacturing exemption from the sale and use tax and the fourth

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248. See *City of Roanoke v. Moody Graphic Color Serv., Inc.*, No. CL98-279, 2006 Va. Cir. LEXIS 24, at \*1-2, \*10 (Cir. Ct. Feb. 8, 2006) (Roanoke City).

249. *Id.* at \*1.

250. *Id.* at \*1-2.

251. *Id.* at \*2.

252. *Id.*

253. See *id.* at \*1.

ruling reached the same conclusion for purposes of the same statute at issue before the Roanoke City Circuit Court.<sup>254</sup>

The circuit court looked closely at the effect that tax rulings issued by the Virginia Tax Commissioner should have in court. The circuit court noted that the Supreme Court of Virginia, in *Chesapeake Hospital Authority v. Commonwealth*,<sup>255</sup> stated that a tax assessment is entitled only to a presumption of correctness.<sup>256</sup> Accordingly, the Virginia Department of Taxation “may not bootstrap itself into having an assessment accorded great weight solely because the assessment is based on prior rulings which are, in the [Virginia] Tax Commissioner’s view, entitled to great weight.”<sup>257</sup> Writing for the Supreme Court of Virginia, Chief Justice Carrico stated that “the [Virginia] Tax Commissioner’s prior rulings and policies themselves are not entitled to great weight, unless expressed in regulations.”<sup>258</sup>

The Roanoke City Circuit Court stated that it viewed the Virginia Tax Commissioner’s rulings put forth by Moody to be in accord with the principles of case law cited by the City of Roanoke in its memorandum in support of summary judgment, and such rulings were held to be persuasive by the circuit court.<sup>259</sup> The circuit court held that Moody is a manufacturer within the meaning of Virginia Code section 58.1-3703(C)(4) and accordingly not liable for the BPOL tax on its sales.<sup>260</sup>

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254. See *id.* at \*3–5 (citing VA. DEPT OF TAX’N, PUB. DOC. 05-2 (Jan. 19, 2005), available at <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow “Searching by Number” hyperlink) (garnering manufacturing exemption to business primarily engaged in processing customer film); VA. DEPT OF TAX’N, PUB. DOC. 02-12 (Feb. 19, 2002), available at <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow “Searching by Number” hyperlink) (garnering exemption software used to configure information provided by customers); VA. DEPT OF TAX’N, PUB. DOC. 99-200 (July 23, 1999), available at <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow “Searching by Number” hyperlink) (garnering exemption to customer who garners conversion of manuscript into camera-ready proof of a book); VA. DEPT OF TAX’N, PUB. DOC. 86-73 (Apr. 22, 1986), available at <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf> (follow “Searching by Number” hyperlink) (garnering exemption to photo processing vital to business).

255. 262 Va. 551, 554 S.E.2d 55 (2001).

256. *Moody Graphic*, 2006 Va. Cir. LEXIS 24, at \*6 (citing *Chesapeake*, 262 Va. at 560, 554 S.E.2d at 59).

257. *Id.* at \*7 (citing *Chesapeake*, 262 Va. at 560, 554 S.E.2d at 59).

258. *Chesapeake*, 262 Va. at 560, 554 S.E.2d at 59.

259. See *Moody Graphic*, 2006 Va. Cir. LEXIS 24, at \*10.

260. See *id.* at \*10–11.