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The Virginia Uniform Trust Code

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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 Virginia Attorney General over the past year. The overall purpose of this article is to provide Virginia tax and general practitioners with a concise overview of the recent developments in Virginia taxation most likely to have an impact on their practices. This article will not, however, discuss many of the numerous technical legislative changes to the State Taxation Code of Title 58.1.

PART ONE: TAXES ADMINISTERED BY THE VIRGINIA DEPARTMENT OF TAXATION

II. INCOME TAX

A. *Recent Significant Legislative Activity*

1. Fixed Date Conformity

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

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amended by the General Assembly to advance Virginia's fixed date conformity to federal income tax laws from December 31, 2003 to January 7, 2005.¹ Virginia continues, however, to disallow the federal bonus depreciation deduction and the five-year net operating loss carry-back period for state tax purposes.²

The new conforming date enables the state to adopt the provisions of three federal acts. The first set of provisions is from the Working Families Tax Relief Act of 2004,³ which liberalizes the rules for claiming dependency exemptions, extends the enhanced deduction for certain computer contributions, and continues certain deductions for teacher classroom expenses and clean fuel vehicles.⁴ The second set of provisions is from the American Jobs Creation Act of 2004,⁵ which creates I.R.C. § 199 (deduction for domestic manufacturing and production), increases I.R.C. § 179 expensing, and allows taxpayers to deduct state and local sales taxes in lieu of state income tax in 2004 and 2005.⁶ Finally, the new conforming date also enables the state to adopt the provisions of the Indian Ocean Tsunami Relief Act,⁷ which allows taxpayers to deduct in 2004 charitable contributions made in January 2005 for the relief of victims in areas affected by the December 26, 2004, Indian Ocean tsunami.⁸

2. Conservation Tillage Equipment Tax Credit

The 2005 General Assembly amended Virginia Code sections 58.1-334 and 58.1-432 to expand the definition of "conservation tillage equipment" and increase the maximum amount of the credit from \$2500 to \$4000.⁹ Under this amendment, individuals

1. Act of Mar. 20, 2005, ch. 26, 2005 Va. Acts 90; Act of Feb. 24, 2005, ch. 5, 2005 Va. Acts 27 (codified as amended at VA. CODE ANN. § 58.1-301 (Cum. Supp. 2005)). For additional guidance, see VA. DEPT OF TAX'N, TAX BULLETIN 05-1 (Mar. 7, 2005), available at <http://www.tax.virginia.gov/> (last visited Oct. 1, 2005).

2. VA. CODE ANN. § 58.1-301 (Cum. Supp. 2005).

3. Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, 118 Stat. 1166.

4. *Id.*

5. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

6. *Id.*

7. Indian Ocean Tsunami Relief Act of 2005, Pub. L. No. 109-001, 119 Stat. 3.

8. *Id.*

9. Act of Mar. 20, 2005, ch. 58, 2005 Va. Acts 129 (codified as amended at VA. CODE ANN. §§ 58.1-334, -432 (Cum. Supp. 2005)).

and corporations can claim an income tax credit equal to twenty-five percent of all expenditures for the purchase and installation of certain conservation tillage equipment up to a maximum of \$4000 or the taxpayer's liability, whichever is less.¹⁰ Conservation tillage equipment is now defined in the Virginia Code to mean "a planter, drill, or other equipment used to reduce soil compaction . . . including guidance systems to control traffic patterns that are designed to minimize disturbance of the soil in planting crops."¹¹ The amended sections are effective for tax years beginning on or after January 1, 2005.¹²

3. Land Preservation Tax Credit

The 2005 General Assembly amended the Virginia Land Conservation Incentives Act of 1999¹³ to require the fair market value of qualified donations to be substantiated by a "qualified appraisal," which must be signed by a "qualified appraiser," and a copy of the appraisal must be submitted to the Virginia Department of Taxation.¹⁴ A false or fraudulent appraisal may lead to revocation of the appraiser's license or other disciplinary action, and future appraisals by the same appraiser may be disallowed.¹⁵ The Virginia Department of Taxation may also disregard an appraisal in its entirety if the appraisal is determined to be false or fraudulent.¹⁶

4. Neighborhood Assistance Tax Credit

The 2005 General Assembly amended Virginia Code section 63.2-2006(B) to increase the maximum annual tax credit that in-

10. VA. CODE ANN. §§ 58.1-334, -432 (Cum. Supp. 2005).

11. *Id.*

12. See Act of Mar. 20, 2005, ch. 58, 2005 Va. Acts 129 (codified as amended at VA. CODE ANN. §§ 58.1-334, -432 (Cum. Supp. 2005)).

13. VA. CODE ANN. §§ 58.1-510 to -513, -546 (Cum. Supp. 2005). For a description of this tax credit legislation, see Craig D. Bell, *Annual Survey of Virginia Law: Taxation*, 39 U. RICH. L. REV. 413, 417-18 (2004).

14. Act of Apr. 6, 2005, ch. 940, 2005 Va. Acts 1820 (codified as amended at VA. CODE ANN. § 58.1-512 (Cum. Supp. 2005)).

15. VA. CODE ANN. § 58.1-512(B) (Cum. Supp. 2005).

16. *Id.*

dividuals may receive from \$750 to \$50,000.¹⁷ The Neighborhood Assistance Act grants a tax credit to businesses and individuals who contribute to approved neighborhood assistance organizations designed to benefit impoverished individuals.¹⁸ The credit can be applied against the income tax on individuals, trusts, estates, and corporations; the bank franchise tax; and the gross receipts tax imposed on insurance and public service corporations.¹⁹ Taxpayers are permitted a tax credit equal to forty-five percent of qualified monetary donations.²⁰ The legislation raises the amount of a taxpayer's donation that may qualify for the credit from \$1667 to \$111,111.²¹ The practical result of this legislation, on a state fiscal basis, however, remains the same because only \$8 million per year of maximum credits may be authorized.²²

5. Rent Reduction Tax Credit

The 2005 General Assembly amended Virginia Code section 58.1-339.9 to extend the availability of the rent reductions tax credit until December 31, 2010.²³ The legislation also limits the reduced rents that qualify for the credit between January 1, 2006 and January 1, 2011 to those charged by an individual or corporation that validly claimed the credit for a dwelling unit for all or part of December 1999 and that rents the dwelling unit to the same tenant who occupied such unit on December 31, 2005.²⁴ The tax credit is available to landlords engaged in the business of renting dwelling units that are subject to the Virginia Residential Landlord and Tenant Act.²⁵ If the landlord provides rent reductions to low-income elderly, disabled, or previously homeless tenants and the rent charged is at least fifteen percent less than

17. Act of Mar. 20, 2005, ch. 82, 2005 Va. Acts 156 (codified as amended at VA. CODE ANN. § 63.2-2006(B) (Cum. Supp. 2005)).

18. VA. CODE ANN. §§ 63.2-2002, -2004 (Cum. Supp. 2005).

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

20. *Id.* § 63.2-2006(B) (Cum. Supp. 2005).

21. Virginia Department of Taxation, 2005 Fiscal Impact Statement for House Bill 2041 (Mar. 9, 2005), available at <http://leg1.state.va.us/> (last visited Oct. 1, 2005).

22. *Id.*

23. Act of Mar. 21, 2005, ch. 414, 2005 Va. Acts 550 (codified as amended at VA. CODE ANN. § 58.1-339.9 (Cum. Supp. 2005)).

24. VA. CODE ANN. § 58.1-339.9 (Cum. Supp. 2005).

25. *Id.*

market value, a credit equal to fifty percent of the rental reductions is allowed to the landlord.²⁶

6. Extension for Filing Income Tax Returns

The 2005 General Assembly amended Virginia Code sections 58.1-344, 58.1-393.1, and 58.1-453 to authorize taxpayers to request an extension of six months after the original due date for filing income tax returns.²⁷ The legislation also increases the penalty for failing to pay at least ninety percent of the tax by the extension date from 0.5 percent to two percent.²⁸ Under this new legislation, if the taxpayer does not file on or before the extended due date, he or she will be subject to the existing penalties as if no extension election were taken.²⁹ One of the purposes of this legislation is to encourage electronic filing of tax returns. This legislation prevents the taxpayer from requesting the extension and then filing a paper tax return because the taxpayer attaches the paper extension request form to the actual tax return filed with the Virginia Department of Taxation.

7. Personal Exemption Increase Accelerated

The 2005 General Assembly amended Virginia Code section 58.1-322(D)(2)(a) to change the effective date from January 1, 2006 to January 1, 2005, for the increase in the personal exemption deduction from \$800 to \$900.³⁰

8. Federal and State Employees Salary Subtraction Clarified

The 2005 General Assembly amended Virginia Code section 58.1-322(C)(24) to clarify that the individual income tax subtraction for federal and state employees is only available to employees

26. *Id.*

27. See Act of Mar. 20, 2005, ch. 100, 2005 Va. Acts 177 (codified as amended at VA. CODE ANN. §§ 58.1-344, -393.1, -453 (Cum. Supp. 2005)).

28. VA. CODE ANN. § 58.1-453 (Cum. Supp. 2005).

29. *Id.* §§ 58-344(C), -393.1(B), -453(C) (Cum. Supp. 2005).

30. Act of Mar. 20, 2005, ch. 67, 2005 Va. Acts 136 (codified as amended at VA. CODE ANN. § 58.1-322(D)(2)(a) (Cum. Supp. 2005)).

with a total annual salary from all sources of employment of \$15,000 or less for the taxable year.³¹ This change is effective for tax years beginning on or after January 1, 2000.³²

B. *Recent Judicial Decision*

1. Corporate Income—Apportionment

In *General Motors Corp. v. Commonwealth*,³³ the Supreme Court of Virginia reversed and remanded a Fairfax County Circuit Court decision when it held that the Virginia Department of Taxation erred in excluding third-party costs that General Motors had included in calculating the cost of performance ratio used to determine the taxable income of its subsidiary, a financial corporation, General Motors Acceptance Corporation.³⁴ At trial, the Fairfax County Circuit Court upheld the Virginia Department of Taxation regulation, which excluded the costs of activities performed by unrelated third parties from the computation of cost of performance for a financial corporation.³⁵ The Virginia Department of Taxation successfully argued that its regulation was a practical interpretation of Virginia Code section 58.1-418.³⁶

The relevant portion of Virginia Code section 58.1-418(A) states:

The Virginia taxable income of a financial corporation . . . shall be apportioned within and without this Commonwealth in the ratio that the business within this Commonwealth is to the total business of the corporation. Business within this Commonwealth shall be based on cost of performance in the Commonwealth over cost of performance everywhere.³⁷

The implementing regulation for this apportionment statute for financial corporations states that “[f]inancial corporations do not apportion Virginia taxable income using the three factor formula

31. Act of Mar. 20, 2005, ch. 27, 2005 Va. Acts 91 (codified as amended at VA. CODE ANN. § 58.1-322(C)(24) (Cum. Supp. 2005)).

32. VA. CODE ANN. § 58.1-322(C)(24) (Cum. Supp. 2005).

33. 268 Va. 289, 602 S.E.2d 123 (2004).

34. *See id.* at 295, 602 S.E.2d at 126.

35. *Id.* at 292, 602 S.E.2d at 124–25.

36. *Id.*

37. VA. CODE ANN. § 58.1-418(A) (Repl. Vol. 2004 & Cum. Supp. 2005).

but instead apportion income based solely on cost of performance.”³⁸ The regulation provides further that cost of performance is defined as the

cost of all activities directly performed by the taxpayer for the ultimate purpose of obtaining gains or profit . . . [and s]uch activities do not include activities performed on behalf of a taxpayer, such as those performed on its behalf by an independent contractor . . . [or] the cost of funds (interest, etc.), but does include the cost of activities required to procure loans or other financing.³⁹

According to the Supreme Court of Virginia, “[t]he effect of this regulation is to exclude from the cost of performance ratio calculation under [Virginia] Code [section] 58.1-418 all indirect expenses of business operations from both the taxpayer’s cost of performance in the Commonwealth and its total cost of performance everywhere.”⁴⁰

The Fairfax County Circuit Court upheld the Virginia Department of Taxation’s regulation that excludes from the cost of performance computation the costs of activities performed by unrelated vendors for General Motors Acceptance Corporation.⁴¹ The trial court held that the regulation’s restriction, which included direct costs, was not inconsistent with Virginia Code section 58.1-418 and was a reasonable and necessary implementation of the cost of performance requirement contained in the statute.⁴²

On appeal, the Supreme Court of Virginia reversed the decision of the trial court as to the apportionment factor determination and held that “the Department erred in excluding amounts paid

38. 23 VA. ADMIN. CODE § 10-120-250(A)(1) (1996 & Cum. Supp. 2005).

39. *Id.* § 10-120-250(B) (1996 & Cum. Supp. 2005).

40. *Gen. Motors*, 268 Va. at 293, 602 S.E.2d at 125.

41. *Gen. Motors Corp. v. Va. Dep’t of Taxation*, 62 Va. Cir. 4, 10 (Cir. Ct. 2003) (Fairfax County).

42. *Id.* At trial, the Virginia Department of Taxation argued that it would not be able to effectively monitor third party vendors to financial corporations to determine what part of their performance, if any, occurs in Virginia. *Id.* Accordingly, the regulation’s restriction to a financial corporation’s direct costs only was a practical implementation of Virginia Code section 58.1-418. *See id.* The circuit court decision also made rulings on several additional issues that were not the subject of the appeal to the Supreme Court of Virginia. *See id.* at 5–9 (discussing the application of 26 U.S.C. § 6621(c) to Virginia interest rate for corporate underpayment and the exclusion of interest income from statutorily defined taxable income). For a more thorough discussion of the Fairfax County Circuit Court decision, see Bell, *supra* note 13, at 428–30.

by [General Motors Acceptance Corporation] to third parties from the cost of performance ratio."⁴³ The court stated:

The language of [Virginia] Code § 58.1-418 is clear and unambiguous. By its express terms, the ratio to be used to apportion a financial corporation's income for purposes of Virginia taxation is the "cost of performance in the Commonwealth over cost of performance everywhere." Nothing in this language limits costs of performance to direct costs or suggests that the Department may exclude costs incurred for activities performed on behalf of a taxpayer by a third party. Thus, it is self-evident that the narrowed definition of "cost of performance" in the regulation is not consistent with the plain language of the statute.⁴⁴

In reaching this result, the court was cognizant that its decision would provide hardship to the Virginia Department of Taxation in determining "whether third-party costs are to be ascribed to the taxpayer's business operations within Virginia or elsewhere," creating "a degree of practical difficulty for the Department's auditors."⁴⁵ The court, however, mused that the matter was one to be addressed by the General Assembly and not the court.⁴⁶ The court's decision invalidates title 23, section 10-120-250 of the Virginia Administrative Code.⁴⁷

C. Virginia Department of Taxation Provides Guidance on Income Tax Apportionment and Nexus for Financial Corporations

The Virginia Department of Taxation released Tax Bulletin 05-3⁴⁸ to advise that it will not change its interpretation of nexus standards until it has fully implemented policy changes attributable to the Supreme Court of Virginia's decision in *General Motors Corp. v. Commonwealth*.⁴⁹ The Department stated that it is "reviewing its policies relating to financial corporation appor-

43. *Gen. Motors*, 268 Va. at 295, 602 S.E.2d at 126.

44. *Id.* at 294, 602 S.E.2d at 126.

45. *Id.*

46. *Id.*

47. *Id.* at 294-95, 602 S.E.2d at 126.

48. VA. DEPT OF TAX'N, TAX BULLETIN 05-3 (Apr. 18, 2005), available at <http://www.tax.virginia.gov/> (last visited Oct. 1, 2005).

49. *Id.*; see discussion *supra* Part II.B.1.

tionment and may amend its regulation or seek legislation,” to address issues from this decision.⁵⁰

The Virginia Department of Taxation stated that until it can develop and implement policies that fully address the issues raised by the *General Motors Corp.* decision, it will apply the following principles to financial corporations:

At the election of the Taxpayer, the [Virginia Department of Taxation] will continue to accept returns prepared in accordance with [title 23, section 10-120-250 of the Virginia Administrative Code], *i.e.*, excluding costs of performance of independent contractors. The Department will not seek to retroactively impose any new policies developed in response to the [*General Motors Corp.*] Decision on returns filed in reliance upon [title 23, section 10-120-250 of the Virginia Administrative Code].⁵¹

Pending adoption of policies in response to the [*General Motors Corp.*] Decision, the Department will not use the [Supreme Court of Virginia’s] interpretation of [Virginia Code section] 58.1-418 to assert that nexus exists solely because of services performed in Virginia by an independent contractor, or the existence of an office of the independent contractor in Virginia.⁵²

Financial corporations that choose to rely on the [*General Motors Corp.*] Decision to ignore [title 23, section 10-120-250 of the Virginia Administrative Code] and include costs attributable to independent contractors in their Virginia apportionment factor must disclose the criteria used to determine the location of such costs. The Department may make audit adjustments to such costs if the final policies adopted in response to the [*General Motors Corp.*] Decision are retroactive.⁵³

D. *Virginia Department of Taxation Rules on Employee Stock Option Withholding Requirements*

The Virginia Department of Taxation released its position regarding withholding requirements applicable to incentive stock options (“ISO”) and nonstatutory stock options (“NSO”) in Public

50. See VA. DEPT OF TAX’N, TAX BULLETIN 05-3 (Apr. 18, 2005), available at <http://www.tax.virginia.gov/> (last visited Oct. 1, 2005).

51. *Id.*

52. *Id.*

53. *Id.*

Document 05-32.⁵⁴ The Virginia Department of Taxation ruled that “no income tax withholding is required for Virginia purposes from the grant, the exercise or the disposition of stock acquired from the exercise of [statutory or incentive stock options] ISOs.”⁵⁵ The Virginia Department of Taxation further ruled that when the fair market value of a NSO is readily ascertainable at the time of grant, employers must “withhold Virginia income tax if the employee resided in Virginia or was employed in Virginia at the time of the grant.”⁵⁶ If the NSO did not have a readily ascertainable fair market value at the time of the grant or if the option was sold prior to exercise, employers must withhold income tax on Virginia source income of nonresidents, which is the appreciation of the value of the stock from the date of grant to the date of exercise or sale.⁵⁷

1. Statutory or Incentive Stock Options

In Public Document 05-32,⁵⁸ the Virginia Tax Commissioner restated the rule that the appreciation in the value of stock from the date of grant to the date of exercise is compensation from Virginia sources for services performed in Virginia by an employee who is granted ISOs.⁵⁹ If the taxpayer moves out of state after the ISOs were granted, the nonresident recipient is taxable on the appreciation of the value of the stock.⁶⁰ The amount taxable is determined at the time the stock is sold and income or gain is recognized for federal income tax purposes.⁶¹

The Virginia Department of Taxation also stated that

there could be a significant administrative burden for both a nonresident taxpayer and the Department in determining whether ISOs held by nonresidents are subject to Virginia income taxation. As such, in the interest of fairness, the compensation earned from the appreciation of stock acquired through ISOs will not be considered

54. VA. DEP'T OF TAX'N, PUB. DOC. 05-32 (Mar. 15, 2005), available at <http://www.tax.virginia.gov/> (last visited Oct. 1, 2005).

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. *See id.*

60. *Id.*

61. *Id.*

Virginia source income for nonresidents provided that the individuals were not residents of Virginia for at least two years prior to the sale of the stock.⁶²

If, however, the two-year holding requirement is not met, the nonresident is subject to Virginia income tax on the appreciation of the stock granted through ISOs.⁶³

2. Withholding Requirements on ISOs

Because wages for purposes of the Virginia income withholding tax follows the federal definition of wages and currently the IRS does not treat the proceeds from the disposition of stock acquired from the exercise of ISOs as income subject to withholding, no income tax withholding is required for Virginia purposes from the grant, the exercise, or the disposition of stock acquired from the exercise of ISOs.⁶⁴

3. NSOs

In Public Document 05-32, the Virginia Department of Taxation stated that for Virginia income tax purposes, a nonresident individual's income from an NSO is recognized at the same time compensation is recognized for federal income tax purposes, which is the earliest point at which a fair market value is readily ascertainable.⁶⁵ Compensation for federal purposes is the fair market value of the option at the time of grant less any amount paid for the option if an NSO has a readily ascertainable fair market value at the time of grant.⁶⁶ Compensation for Virginia purposes includes salaries and wages of nonresident employees and is generally sourced to their state of employment.⁶⁷ If the fair market value of an NSO is not readily ascertainable until the time the NSO is exercised or sold, compensation for Virginia sources is equal to the appreciation of the value of the stock from

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

the date of grant to the date of exercise or sale.⁶⁸ The Virginia Department of Taxation also stated that if an individual

moves out of Virginia after the date the NSOs are granted, Virginia source income would be an amount equal to (1) the amount that the fair market value of the stock exceeded the option price at the date the NSO was exercised, (2) multiplied by the number of days of the taxable year(s) . . . the individual resided in Virginia from the period of the NSO grant date to the date of exercise or sale, and (3) divided by the number of days from the NSO grant date to the date of exercise or sale.⁶⁹

4. Withholding Requirements for NSOs

In the same ruling of the Virginia Tax Commissioner, the Virginia Department of Taxation stated that for Virginia withholding tax purposes, "an employer may be required to withhold Virginia income taxes for an employee who is not a resident of Virginia when that employee earns income from Virginia sources."⁷⁰ Consequently,

[w]hen the fair market value of the [NSO] is readily ascertainable at the time of grant, employers [must] withhold Virginia income tax if the employee resided in Virginia or was employed in Virginia at the time of the grant. If [fair market value of the NSO is not] readily ascertainable . . . at the time of the grant, or if the options were sold prior to exercise, employers [must] withhold income tax on Virginia source income of nonresidents,⁷¹

which is the appreciation of the value of the stock from the date of grant to the date of exercise or sale.⁷²

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

III. RETAIL SALES AND USE TAX

A. *Recent Significant Legislative Activity*

1. Retail Sale and Sale at Retail Definitions Modified

The 2005 General Assembly amended Virginia Code section 58.1-602 to change the definitions of “retail sale” and “sale at retail” to provide that paint and other refinish materials that are permanently applied to or affixed to a motor vehicle during the vehicle’s repair (i.e., paint, primer, clear coat) are subject to sales tax if they are charged for separately on the bill.⁷³ This legislation reflects a change in policy from the long-standing rule of the Virginia Department of Taxation. Previously, automobile painters, repairers, and refinishers provided a nontaxable service because they were deemed to be the users and consumers of tangible personal property and they paid the tax on the items they used at the time of purchase.⁷⁴

2. Gift Transactions to Non-Residents

The 2005 General Assembly enacted a new statute, Virginia Code section 58.1-604.6, to define a “gift transaction” for sales and use tax purposes.⁷⁵ A gift transaction is defined as “a retail sale resulting from an order for tangible personal property placed by any means by any person that is for delivery to a recipient, other than the purchaser, located [outside of Virginia].”⁷⁶ The statute allows the Virginia dealer, the vendor, the option of collecting the tax imposed in the state of the gift recipient or collecting the Virginia tax, provided the dealer is registered in the gift recipient’s state and the goods are shipped out of state.⁷⁷ The statute allows dealers the option of conforming to the destination

73. Act of Mar. 20, 2005, ch. 121, 2005 Va. Acts 217 (codified as amended at VA. CODE ANN. § 58.1-602 (Cum. Supp. 2005)).

74. See 23 VA. ADMIN. CODE § 10-210-1020 (1996); Virginia Department of Taxation, 2005 Fiscal Impact Statement for House Bill 2762, *available at* <http://legl.state.va.us/> (last visited Oct. 1, 2005).

75. Act of Mar. 21, 2005, ch. 355, 2005 Va. Acts 437 (codified as amended at VA. CODE ANN. § 58.1-604.6 (Cum. Supp. 2005)).

76. VA. CODE ANN. § 58.1-604.6(A) (Cum. Supp. 2005).

77. *Id.* § 58.1-604.6(B) (Cum. Supp. 2005).

sourcing rules or continuing collection of the tax based on the point of sales rules currently in effect.⁷⁸ The statute restricts the destination sourcing option to apply only in the case of gift transactions.⁷⁹

3. Alternative Method for Bad Debt Credit

The 2005 General Assembly amended Virginia Code section 58.1-621 to provide an alternative means for determining the sales tax credit allowed for bad debts when a dealer has a high volume of uncollectible accounts or there is some other impracticable reason a dealer cannot substantiate the credit on an account-by-account basis as required under existing law.⁸⁰ Any alternative method must be approved by the Virginia Department of Taxation in advance of the method's use or application.⁸¹

4. Manufactured Signs are Tangible Personal Property for Sales and Use Tax

In a policy change, the 2005 General Assembly amended Virginia Code section 58.1-602 to classify manufactured signs as tangible personal property for retail sales and use tax purposes.⁸² Prior to this amendment, the Virginia Department of Taxation treated sign manufacturers as contractors with respect to real estate based on Virginia Code section 58.1-610 and Virginia Administrative Code section 10-210-4070.⁸³ As a result of this legislation, manufactured sign contractors will now be treated as retailers when they sell and install manufactured signs regardless of the fact that the sign may be attached to or become part of real property.

78. *See id.*

79. *Id.*

80. Act of Mar. 21, 2005, ch. 355, 2005 Va. Acts 469 (codified as amended at VA. CODE ANN. § 58.1-621(B) (Cum. Supp. 2005)).

81. VA. CODE ANN. § 58.1-621(B) (Cum. Supp. 2005).

82. Act of Mar. 20, 2005, ch. 122, 2005 Va. Acts 220 (codified as amended at VA. CODE ANN. § 58.1-602 (Cum. Supp. 2005)).

83. VA. CODE ANN. § 58.1-610 (Repl. Vol. 2004); 23 VA. ADMIN. CODE § 10-210-4070 (1996).

5. Personal Jurisdiction Over Non-Virginia State Officials

The 2005 General Assembly amended Virginia Code section 8.01-184.1 to provide Virginia courts with authority to exercise personal jurisdiction over officials from other states in declaratory relief actions relating to the collection of sales taxes to the extent permitted by the United States Constitution.⁸⁴ Last year, the legislature enacted Virginia Code section 8.01-184.1 to grant circuit courts jurisdiction over civil actions in which a Virginia business seeks declaratory relief against officials in other states to prevent such other states from forcing the Virginia business to collect and remit retail sales and use taxes to another state.⁸⁵ In making the decision whether to grant declaratory relief, the circuit court must evaluate whether the demand from the other state constitutes an undue burden on interstate commerce under the United States Constitution.⁸⁶

B. *Recent Judicial Decision*

In *LZM, Inc. v. Virginia Department of Taxation*,⁸⁷ the Supreme Court of Virginia affirmed the decision of the Montgomery County Circuit Court when it held that pumping services provided in conjunction with the rental of portable toilets were subject to sales tax.⁸⁸ The appellant-taxpayer, LZM, Inc. ("LZM"), leased portable toilets and offered pumping services to its customers.⁸⁹ When LZM negotiated contracts for the lease and pumping services, it included all charges in a single invoice, but separately stated the rental and pumping charges.⁹⁰ LZM did not

84. Act of Mar. 26, 2005, ch. 800, 2005 Va. Acts 1337; Act of Mar. 26, 2005, ch. 736, 2005 Va. Acts 1146 (codified as amended at VA. CODE ANN. § 8.01-184.1 (Cum. Supp. 2005)).

85. See Act of Apr. 12, 2004, ch. 647, 2004 Va. Acts 932; Act of Apr. 12, 2004, ch. 609, 2004 Va. Acts 896 (codified as amended at VA. CODE ANN. § 8.01-184.1 (Cum. Supp. 2005)).

86. VA. CODE ANN. § 8.01-184.1(B) (Cum. Supp. 2005); see also *Quill Corp. v. North Dakota*, 504 U.S. 298, 309–19 (1992) (holding that the state's enforcement of a use tax against an out-of-state business places an unconstitutional burden on interstate commerce).

87. 269 Va. 105, 606 S.E.2d 797 (2005).

88. *Id.* at 116, 606 S.E.2d at 803.

89. *Id.* at 108, 606 S.E.2d at 798.

90. *Id.*, 606 S.E.2d at 798–99.

require its toilet rental customers to contract for its pumping services, but it charged an additional fee for those services.⁹¹ Consequently, not all of LZM's toilet rental customers elected to contract for pumping services.⁹²

Following an audit by the Virginia Department of Taxation, LZM was assessed sales tax on its charges for pumping services provided in conjunction with its portable toilet rentals.⁹³ The Montgomery County Circuit Court granted summary judgment to the Virginia Department of Taxation, which upheld the sales tax assessment.⁹⁴

Before the Supreme Court of Virginia, LZM argued that the circuit court erred when it applied the true object test under title 23, section 10-210-4040 of the Virginia Administrative Code.⁹⁵

The true object test is the means by which the [Virginia Department of Taxation] determines the dominant purpose of a mixed sales and service transaction in order to determine whether the transaction is subject to sales tax as a sale of tangible personal property or whether it is a sale of services and therefore exempt from tax.⁹⁶

The court held that under the true object test, pumping services were taxable because customers contracted primarily for the portable toilets and the pumping services were needed solely as a result of the lease.⁹⁷ Customers did not rent portable toilets for the waste removal services.⁹⁸ There was no evidence before the court to suggest that LZM provided pumping services as an independent commercial endeavor, but only in conjunction with a lease of a LZM toilet.⁹⁹

91. *Id.*

92. *Id.*, 606 S.E.2d at 799.

93. *Id.* at 108–09, 606 S.E.2d at 799.

94. *Id.* at 109, 606 S.E.2d at 799. For a more thorough discussion of the Montgomery County Circuit Court decision, see Bell, *supra* note 13, at 433–35.

95. *LZM*, 269 Va. at 109–10, 606 S.E.2d at 799–800.

96. *Id.* at 110, 606 S.E.2d at 800. For further discussion of the true object test, see *WTAR Radio-TV Corp. v. Commonwealth*, 217 Va. 877, 883, 234 S.E.2d 245, 249 (1977). Virginia Code section 58.1-603 imposes the sales tax on the sale or rental of tangible personal property. See VA. CODE ANN. § 58.1-603 (Repl. Vol. 2004). A lease or rental is included within the definition of “sale” in Virginia Code section 58.1-602. See *id.* § 58.1-602 (Cum. Supp. 2005). Services are generally exempt from the sales tax. See *id.* § 58.1-609.5 (Repl. Vol. 2004 & Cum. Supp. 2005).

97. *LZM*, 269 Va. at 112, 606 S.E.2d at 801.

98. *Id.*

99. *Id.* at 112–13, 606 S.E.2d at 801.

The court also rejected LZM's contention that listing rental and pumping services separately on the invoice was determinative.¹⁰⁰ The court also held that the pumping services did not fall under the maintenance contract sales tax exemption provided by Virginia Code section 58.1-609.5.¹⁰¹

PART TWO: TAXES ADMINISTERED BY LOCALITIES

IV. REAL PROPERTY TAX

A. *Recent Significant Legislative Activity*

1. Recordation Tax Exemption

The 2005 General Assembly amended Virginia Code sections 58.1-811(10) and (11) to modify the exemptions from recordation taxes for deeds conveying real estate to and from partnerships and limited liability companies ("LLC"), by excluding transfers that are precursors to a transfer of control of the partnership, LLC, or its assets with the intent to avoid recordation taxes.¹⁰² A recordation tax is imposed on the privilege of using the statute's deed recording system to protect interests in real estate.¹⁰³ The recordation tax does not apply to transactions for which a deed is not recorded.¹⁰⁴ Generally, no deed is recorded when an interest to an entity such as an LLC, partnership, or corporation is transferred, so no recordation tax is imposed.¹⁰⁵ For example, a typical transaction consists of a seller who conveys property to a newly organized LLC whose sole asset is the real property. The membership interest in the LLC is then sold directly to the purchaser instead of the real property. The property could then be conveyed from the LLC to the purchaser or retained in the LLC.¹⁰⁶ Prior to

100. *Id.* at 113, 606 S.E.2d at 801.

101. *Id.* at 113-14, 606 S.E.2d at 801-02.

102. Act of Mar. 20, 2005, ch. 93, 2005 Va. Acts 172 (codified as amended at VA. CODE ANN. § 58.1-811(A)(10)-(11) (Cum. Supp. 2005)).

103. *See generally* VA. CODE ANN. §§ 58.1-800 to -817 (Repl. Vol. 2004 & Cum. Supp. 2005).

104. *See id.* § 58.1-801(A) (Repl. Vol. 2004 & Cum. Supp. 2005).

105. *See id.* § 58.1-811(C)(1) (Cum. Supp. 2005).

106. *See id.* § 58.1-811(A)(10)-(11) (Cum. Supp. 2005).

this legislation, both conveyances involving the LLC were exempt from the recordation tax. This transaction also deprives the local government tax authority of data on the true consideration for the sale of the underlying real property.

2. Interest on Deferred Real Estate Tax

The 2005 General Assembly amended Virginia Code section 58.1-3219.1 to limit the interest rate localities charge on deferred real estate taxes to a rate that does not exceed the rate established by I.R.C. § 6621 for underpayments of federal taxes.¹⁰⁷ Localities are authorized to adopt a program that allows taxpayers the option of deferring all or part of their real estate tax that exceeds 105 percent of their real estate tax in the immediately preceding year.¹⁰⁸ The statute also authorizes localities to adopt a higher minimum percentage increase.¹⁰⁹

B. *Recent Judicial Decisions*

The Supreme Court of Virginia affirmed the decision of the Chesterfield County Circuit Court when it sustained the county's assessment of real property taxes on a landfill in *Shoosmith Bros. v. County of Chesterfield*.¹¹⁰ The landowner, Shoosmith Bros., Inc. ("Shoosmith"), owned a 1163 acre parcel of land in Chesterfield County.¹¹¹ One portion of the parcel, consisting of approximately 200 acres, was operated as a sanitary landfill by Shoosmith under a conditional use permit obtained from the county and a Solid Waste Facility Permit granted by the Virginia Department of Environmental Quality.¹¹² Chesterfield County assessed the 1163 acre parcel at \$19,859,935 for the 2001 tax year.¹¹³ The county applied the income capitalization method (income method) of as-

107. Act of Mar. 22, 2005, ch. 561, 2005 Va. Acts 737; Act of Mar. 22, 2005, ch. 502, 2005 Va. Acts 676 (codified as amended at VA. CODE ANN. § 58.1-3219.1 (Cum. Supp. 2005)).

108. VA. CODE ANN. § 58.1-3219.1 (Cum. Supp. 2005).

109. *Id.*

110. 268 Va. 241, 248, 601 S.E.2d 641, 645 (2004).

111. *Id.* at 243, 601 S.E.2d at 642.

112. *Id.*

113. *Id.*

assessment to the 200-acre landfill portion of the parcel, which produced an assessment of \$12,987,600.¹¹⁴

Shoosmith initiated its challenge of the assessment for the landfill parcel “asserting that the property was not assessed at its fair market value because ‘business income [was] used rather than the real estate’s rental income to estimate real estate value.’”¹¹⁵ Shoosmith’s expert witness testified that the county’s assessment included the value of the landfill property and of Shoosmith’s ongoing landfill business.¹¹⁶ Shoosmith alleged that the county’s assessment improperly included the value of the landfill operating permits.¹¹⁷

Chesterfield County asserted at trial that the “highest and best use of the property was that of a landfill” requiring fair market value to be based on the present worth of the income stream.¹¹⁸ The trial court “concluded that [Chesterfield] County had used an appropriate assessment methodology and that the assessment was a ‘reasonable assessment of the fair market value of the landfill property’” as required by Article X, section 2 of the Constitution of Virginia.¹¹⁹

On appeal, Shoosmith asserted that the county “committed manifest error by using the income method of assessment in assessing the landfill property.”¹²⁰ Specifically, Shoosmith argued that the county’s income method had the effect of including the value of the two landfill permits, both intangible personal property assets, as part of the real property.¹²¹ The landowner stated that these two permits are non-transferable use permits that are not subject to assessment and taxation as real estate.¹²² Shoosmith maintained that “if the use of the real property requires a permit which does not run with the land, any assessment of that property that is based on the permitted use is manifestly erroneous because such an assessment includes an assessment of an in-

114. *Id.*

115. *Id.* (alteration in original).

116. *Id.*

117. *Id.*

118. *Id.* at 244, 601 S.E.2d at 642.

119. *Id.* at 245–46, 601 S.E.2d at 643.

120. *Id.* at 245, 601 S.E.2d at 643.

121. *Id.*, 601 S.E.2d at 643–44.

122. *Id.* at 246, 601 S.E.2d at 643.

tangible asset the permit represents.”¹²³ The landowner asserted that the county’s method of assessment improperly used the permits to determine the “income generated by a use of the land that Shoosmith enjoyed only by virtue of the non-transferable permits.”¹²⁴

The Supreme Court of Virginia rejected the premise of Shoosmith’s argument “that consideration of the use of property when permits are required for that use is improper because it constitutes assessment of the permits themselves.”¹²⁵ The court reasoned that to determine the fair market value of the property for assessment purposes it is proper to consider the use of the property by the landowner, even if such use requires non-transferable government permits.¹²⁶ The court concluded that such a result is not the assessment of an intangible asset and upheld the county’s assessment.¹²⁷

The court also rejected Shoosmith’s other argument that the county should not have used Shoosmith’s business income from operating the landfill for purposes of its income method of assessment of the landfill.¹²⁸ Shoosmith asserted that the county should have used lease rents from comparable landfills.¹²⁹ The court noted that Shoosmith’s landfill was owner-operated and not leased.¹³⁰ Therefore, use of leased landfills was not required.¹³¹

In *City of Martinsville v. Commonwealth Boulevard Associates, LLC*,¹³² the Supreme Court of Virginia affirmed the Martinsville City Circuit Court’s ruling that a taxpayer was entitled to relief from the annual levy of taxes even though the taxpayer did not challenge the accuracy of the general assessment upon which the annual assessment levy was based.¹³³ The issue presented to the court on appeal was whether a taxpayer may “challenge an annual levy of taxes without showing that the previous general re-

123. *Id.*

124. *Id.*, 601 S.E.2d at 643–44.

125. *Id.*, 601 S.E.2d at 644.

126. *Id.*, 601 S.E.2d at 644.

127. *Id.* at 248, 601 S.E.2d at 645.

128. *Id.*

129. *See id.* at 247–48, 604 S.E.2d at 644–45.

130. *Id.* at 243, 248, 604 S.E.2d at 642, 644.

131. *Id.*, 601 S.E.2d at 645.

132. 268 Va. 697, 604 S.E.2d 69 (2004).

133. *Id.* at 699–700, 604 S.E.2d at 70–71.

assessment, upon which the annual levy was based, was erroneous.”¹³⁴

Martinsville City reassesses the value of real estate located within its geographical boundaries every two years.¹³⁵ For the non-general reassessment tax years, the city makes annual levies that are based upon valuations set by the previous general reassessment.¹³⁶ The real property at issue in this case was an industrial tract of land consisting of about twenty-three acres “improved by a large manufacturing plant formerly owned by the Tultex Corporation.”¹³⁷ On January 1, 1999, the city conducted a general reassessment of the property and valued it at \$12,408,700.¹³⁸ “The January 1, 1999 assessment set the valuation that would govern the annual levies of taxes from July 1, 1999 to June 30, 2001.”¹³⁹

Commonwealth Boulevard Associates, LLC (“CBA”) purchased the Tultex Corporation manufacturing facility out of Tultex Corporation’s Chapter 11 bankruptcy proceeding.¹⁴⁰ The purchase price for the property was \$750,000.¹⁴¹ In connection with the purchase, CBA obtained a professional appraisal for the property as a financing requirement.¹⁴² CBA’s appraiser determined the fair market value of the property at \$2,375,000 as of December 5, 2000.¹⁴³ The appraiser’s report noted that the facility was vacant and “essentially gutted.”¹⁴⁴ CBA closed on its purchase of the property from Tultex Corporation, with the approval of the bankruptcy court, on January 4, 2001.¹⁴⁵

The city conducted its general reassessment for the period from July 1, 2001 until June 30, 2003, four days before the sale of the

134. *Id.* at 698, 604 S.E.2d at 69.

135. *Id.*, 604 S.E.2d at 69–70.

136. *Id.*, 604 S.E.2d at 70.

137. *Id.*

138. *Id.*

139. *Id.* at 698–99, 604 S.E.2d at 70. Tax years for the City of Martinsville run from July 1 to the following June 30. See VA. CODE ANN. § 15.2-2500 (Repl. Vol. 2003) (prescribing uniform fiscal year for localities from July 1 to June 30).

140. *City of Martinsville*, 268 Va. at 699, 604 S.E.2d at 70.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*

Tultex property.¹⁴⁶ The city assigned a fair market value of \$4,128,386 to the property.¹⁴⁷ CBA acquired the property on January 4, 2001.¹⁴⁸ From that date until June 30, 2001 when the new tax year began, the city continued to base its levy on the 1999 general reassessment valuation of \$12,408,700.¹⁴⁹

CBA paid the real property taxes due on this annual levy and initiated suit seeking relief for an erroneous assessment of taxes.¹⁵⁰ "The trial court granted summary judgment in CBA's favor and reduced the assessed valuation of the Tultex property for that period to \$2,375,000, based upon the evidence of the independent appraisal" CBA obtained in connection with its bank financing to purchase the property.¹⁵¹

On appeal, the city argued "that annual levies of taxes must be based only on valuations established by the previous general reassessment."¹⁵² Implicit in this argument is that the city believed CBA must prove that the previous general reassessment was erroneous when it was originally made. The city pointed out that CBA made no contention that the 1999 general reassessment was erroneous when made.¹⁵³ "CBA contended . . . that the annual levy for the first half of 2001, based on the 1999 valuation of \$12.4 million, was clearly erroneous based on the city's own valuation of \$4.1 million as of January 1, 2001 and the independent appraisal of \$2.3 million made [in December 2000]."¹⁵⁴

The Supreme Court of Virginia noted the term "assessment" as used in the statute providing jurisdiction to initiate suits to recover from erroneous assessments, Virginia Code section 58.1-3984(A), refers to either a general reassessment or to the annual levy of taxes based upon that valuation.¹⁵⁵ The court stated:

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.* at 699-700, 604 S.E.2d at 70.

155. *Id.* at 700, 604 S.E.2d at 70-71 (citing *Hoffman v. Augusta County*, 206 Va. 799, 146 S.E.2d 249 (1966)).

A taxpayer is entitled to relief under Code § 58.1-3984 if he carries his burden of proving that in either the general reassessment or in the annual levy of taxes “the property in question is valued at more than its fair market value or that the assessment is not uniform in its application, or that the assessment is otherwise invalid or illegal.”¹⁵⁶

The court held that the trial court correctly evaluated the conflicting evidence of value and “found that the property was valued for tax purposes at more than its fair market value for the first half of 2001.”¹⁵⁷ The court also noted that the trial court had the authority to reduce the assessment to an amount that the court deemed to be proper based on the evidence presented and to order a refund of the overpaid taxes.¹⁵⁸

IV. TANGIBLE PERSONAL PROPERTY TAX

A. *Recent Significant Legislative Activity*

1. Notice Required for Machinery and Tools Tax Valuation Change

The 2005 General Assembly amended Virginia Code section 58.1-3507(B) to require any proposed changes in the valuation method used for machinery and tools to be published by a notice appearing in a newspaper of general circulation in the locality proposing the valuation method change at least thirty days prior to the date the change is to take effect.¹⁵⁹ The amendment also requires the Commissioner of the Revenue of the locality to receive public comments during the thirty-day notice period.¹⁶⁰

2. Separate Classification for Specific Machinery and Tools

The 2005 General Assembly enacted new Virginia Code section 58.1-3508.2 to provide a separate classification of tangible per-

156. *Id.*, 604 S.E.2d at 71 (quoting VA. CODE ANN. § 58.1-3984 (Repl. Vol. 2004 & Cum. Supp. 2005)).

157. *Id.*

158. *Id.*

159. See Act of Mar. 20, 2005, ch. 108, 2005 Va. Acts 198 (codified as amended at VA. CODE ANN. § 58.1-3507(B) (Cum. Supp. 2005)).

160. See VA. CODE ANN. § 58.1-3507(B) (Cum. Supp. 2005).

sonal property for certain heavy construction machinery (e.g., “land movers, bulldozers, front-end loaders, graders, packers, power shovels, cranes, pile drivers, forest harvesting and silvicultural activity equipment”) as a separate classification of property.¹⁶¹ The tax rate to be imposed by the locality must not exceed “the rate imposed upon the general class of tangible personal property.”¹⁶²

3. Separate Classification for Business Use Boats

The 2005 General Assembly also enacted new Virginia Code section 58.1-3506(A)(33) to create a separate classification of tangible personal property for boats weighing less than five tons used only for business purposes.¹⁶³ Prior to this legislation, there were separate classifications for boats weighing five tons or more and for privately-owned pleasure boats, eighteen feet and over, used for recreational purposes.¹⁶⁴ The new legislation provides localities with flexibility to apply a different tax rate to each of three classes of boats.

V. MISCELLANEOUS PROCEDURAL AND LOCAL TAX REFORMS

A. *Recent Significant Legislative Activity*

1. Local Business Tax and Business, Professional, and Occupational License Tax Appeals

The 2005 General Assembly significantly changed the administrative appeals process for local business taxes and for business, professional, and occupational license (“BPOL”) taxes when it amended Virginia Code sections 58.1-3703.1 and 58.1-3983.1.¹⁶⁵

161. See Act of Mar. 21, 2005, ch. 357, 2005 Va. Acts 473 (codified as amended at VA. CODE ANN. § 58.1-3508.2 (Cum. Supp. 2005)).

162. VA. CODE ANN. § 58.1-3508.2 (Cum. Supp. 2005).

163. See Act of Mar. 20, 2005, ch. 325, 2005 Va. Acts 419; Act of Mar. 20, 2005, ch. 271, 2005 Va. Acts 365 (codified as VA. CODE ANN. § 58.1-3506(A)(33) (Cum. Supp. 2005)).

164. See VA. CODE ANN. § 58.1-3506(A)(1), (10) (Repl. Vol. 2004).

165. See Act of Apr. 6, 2005, ch. 927, 2005 Va. Acts 1725 (codified as amended at VA. CODE ANN. §§ 58.1-3703.1, -3983.1 (Cum. Supp. 2005)).

The amendments make several changes to the administrative process related to the BPOL tax; the machinery and tools tax, the merchants' capital tax and the business tangible personal property tax (collectively referred to as the "local business tax"); and the tangible personal property tax on airplanes, boats, campers, recreational vehicles, and trailers (collectively referred to as the "local mobile property tax").¹⁶⁶ The law now provides that when a taxpayer appeals an assessment of BPOL taxes to the Commissioner of the Revenue or to the Virginia Tax Commissioner, collection activity will only be suspended with respect to the amount of the assessment that is in dispute.¹⁶⁷ Furthermore, with respect to appeals of BPOL, local business, and local mobile property tax assessments, the law now provides that the locality must suspend collection activity when the taxpayer appeals a determination of the Virginia Tax Commissioner to the appropriate circuit court.¹⁶⁸

The new law expands the number of local taxes that are included within the scope of the local business tax appeals procedures. Local consumer utility taxes, except for the consumer utility tax on mobile telecommunications, where the amount in dispute exceeds \$2500, are now subject to appeal under the local business tax appeals procedures.¹⁶⁹

A revised procedure has been put in place in the event of a non-decision by the Commissioner of the Revenue.

Any taxpayer whose administrative appeal to the [local tax assessing official] . . . has been pending for more than one year without the issuance of a final determination may, upon not less than thirty days' written notice to the [local tax assessing official], . . . elect to treat the application as denied and appeal the assessment to the [Virginia] Tax Commissioner.¹⁷⁰

Upon receipt of the final decision of the Virginia Tax Commissioner with respect to a BPOL tax, a local business tax, or local mobile property tax appeal, the new law requires the Commissioner of the Revenue to promptly certify the amount of any tax due to the treasurer or other official responsible for collection.¹⁷¹

166. See VA. CODE ANN. §§ 58.1-3703.1, -3983.1 (Cum. Supp. 2005).

167. See *id.* §§ 58.1-3703.1(A)(5)(a), (d), (6)(b), -3983.1(A), (C), (E) (Cum. Supp. 2005).

168. See *id.* §§ 58.1-3703.1(A)(7)(b)(1), -3983.1(H)(1) (Cum. Supp. 2005).

169. *Id.* § 58.1-3983.1(A)-(B) (Cum. Supp. 2005).

170. *Id.* §§ 58.1-3703.1(A)(5)(e), -3983.1(B)(6) (Cum. Supp. 2005).

171. See *id.* §§ 58.1-3703.1(A)(6)(C), -3983.1(F) (Cum. Supp. 2005).

The collection official shall issue a bill to the taxpayer for the amount of tax due, together with penalty and accrued interest, within thirty days of the Virginia Tax Commissioner's determination.¹⁷² The same procedures and thirty-day rule apply if the Virginia Tax Commissioner's determination results in a refund to the taxpayer.¹⁷³ The locality must issue the refund payment, together with accrued interest.¹⁷⁴ Special rules apply if a determination issued by the Virginia Tax Commissioner requires the Commissioner of the Revenue to undertake a new or revised assessment to either pay a refund or obligate the payment of a tax that has not previously been paid in full.¹⁷⁵ These rules are designed to provide short time requirements to get the Virginia Tax Commissioner's determination implemented on a timely basis.¹⁷⁶

Another important provision of the new legislation pertains to the judicial review of the determination issued by the Virginia Tax Commissioner. Both the taxpayer and the Commissioner of the Revenue may apply to the appropriate circuit court for judicial review of the determination pursuant to Virginia Code section 58.1-3984.¹⁷⁷ In any proceeding for judicial review of a determination of the Virginia Tax Commissioner, the burden of proof is on the party challenging the Virginia Tax Commissioner's ruling to show that it is erroneous.¹⁷⁸ The legislation specifically provides that neither the Virginia Tax Commissioner nor the Virginia Department of Taxation shall be made a party to the lawsuit merely because the Virginia Tax Commissioner has made a ruling.¹⁷⁹ The taxpayer is also not required to pay the disputed amount of tax alleged to be due at the time an application for judicial review of a determination of the Virginia Tax Commissioner is filed by the taxpayer.¹⁸⁰ There is a procedure built into the statute if the locality believes the judicial application for review is frivolous, collection would be jeopardized by delay, or suspension would cause substantial economic hardship to the local-

172. *Id.*

173. *See id.* §§ 58.1-3703.1(A)(6)(C)(2), -3983.1(F)(2) (Cum. Supp. 2005).

174. *Id.*

175. *See id.* §§ 58.1-3703.1(A)(6)(c)(3), (4), -3983.1(F)(3), (4) (Cum. Supp. 2005).

176. *See id.*

177. *Id.* §§ 58.1-3703.1(A)(7)(a), -3983.1(G) (Cum. Supp. 2005).

178. *Id.*

179. *See id.*

180. *See id.* §§ 58.1-3703.1(A)(7)(b)(1), -3983.1(H)(1) (Cum. Supp. 2005).

ity.¹⁸¹ This procedure requires the court to determine that one of the foregoing three criteria has been met.¹⁸²

If the local tax jurisdiction is filing the judicial review application of a determination by the Virginia Tax Commissioner, the new legislation allows the locality to retain any tax refund the Virginia Tax Commissioner determined the taxpayer was entitled to receive until the court rules on the judicial review application.¹⁸³ The statute permits the locality to serve the taxpayer with a notice of intent to file a judicial application for review within sixty days of the Virginia Tax Commissioner's determination.¹⁸⁴ During this time period, no refund is required to be paid by the locality.¹⁸⁵ The newly revised local business tax, local mobile property tax, and BPOL appeals procedures "apply to administrative appeals filed with commissioners of the revenue[,] . . . appeals filed with the [Virginia] Tax Commissioner, and applications for judicial review filed in circuit courts on or after July 1, 2005."¹⁸⁶

2. Tax Return Preparer Penalty for Fraudulent Returns

The 2005 General Assembly amended Virginia Code section 58.1-302 and enacted new Virginia Code sections 58.1-348.1 and 58.1-348.2 that cumulatively create a Class 6 felony for knowingly and willfully aiding, assisting in, counseling, or advising the preparation or presentation of a fraudulent tax return, affidavit, claim, or other document that the income tax return preparer knows is fraudulent or false as to any material error.¹⁸⁷ A Class 6 felony carries a penalty of imprisonment for not less than one year nor more than five years, or confinement in jail for up to twelve months and a fine of not more than \$2500, or both.¹⁸⁸ The amended sections also authorize the Virginia Tax Commissioner to initiate injunctive action against a fraudulent income tax re-

181. *See id.*

182. *See id.*

183. *See id.* §§ 58.1-3703.1(A)(7)(c)(1), -3983.1(I)(1) (Cum. Supp. 2005).

184. *See id.*

185. *Id.*

186. Act of Apr. 6, 2005, ch. 927, 2005 Va. Acts 1725 (codified as amended at VA. CODE ANN. §§ 58.1-3703.1, -3983.1 (Cum. Supp. 2005)).

187. *See* Act of Mar. 20, 2005, ch. 48, 2005 Va. Acts 120 (codified as amended at VA. CODE ANN. §§ 58.1-302, -348.1, -348.2 (Cum. Supp. 2005)).

188. VA. CODE ANN. § 18.2-10(f) (Repl. Vol. 2004 & Cum. Supp. 2005).

turn preparer.¹⁸⁹ The new law defines an income tax return preparer as a person who prepares for compensation, any portion of an income tax return or a claim for refund.¹⁹⁰ The statute expressly excludes from the definition a person who merely furnished typing, reproducing, or other mechanical assistance, prepared a return or refund claim for his or her employer, or prepared a return or refund claim as a fiduciary.¹⁹¹

3. Motor Vehicle Sales and Use Tax—LLC Exemption

The 2005 General Assembly amended Virginia Code section 58.1-2403(8) to add LLCs to the existing motor vehicles sales and to use tax exemption for certain transfers from individuals or partnerships to corporations or from corporations to individuals or partnerships.¹⁹²

4. Limited Family Gift Exemption from Motor Vehicle Sales and Use Tax

The 2005 General Assembly amended Virginia Code section 58.1-2403(7) to provide that a gift of a motor vehicle to a spouse, son, or daughter shall be exempt from motor vehicle sales and use taxes.¹⁹³ Prior to this amendment, such gifts were exempt unless the person receiving the motor vehicle assumed an unpaid obligation relating to the vehicle.¹⁹⁴ The amended statute exempts the gift of a vehicle to a spouse even if there remains an unpaid obligation assumed by the transferee spouse.¹⁹⁵

5. Transient Occupancy Tax Requires Overnight Accommodations

The 2005 General Assembly enacted new Virginia Code section 58.1-3826 to limit the imposition of the transient occupancy tax to

189. *See id.* § 58.1-348.2 (Cum. Supp. 2005).

190. *Id.* § 58.1-302 (Cum. Supp. 2005).

191. *See id.*

192. *See* Act of Mar. 20, 2005, ch. 274, 2005 Va. Acts 370 (codified as amended at VA. CODE ANN. § 58.1-2403(8) (Cum. Supp. 2005)).

193. Act of Mar. 20, 2005, ch. 246, 2005 Va. Acts 335 (codified as amended at VA. CODE ANN. § 58.1-2403(7) (Cum. Supp. 2005)).

194. VA. CODE ANN. § 58.1-2403(7) (Repl. Vol. 2004).

195. *Id.* (Cum. Supp. 2005).

charges for rooms or spaces occupied by transients that are intended or suitable for dwelling, sleeping, or lodging purposes.¹⁹⁶ Any county may impose a transient occupancy tax at a maximum rate of two percent, upon adoption of an ordinance, “on hotels, motels, boarding houses, travel campgrounds, and other facilities offering guest rooms” for periods of less than thirty consecutive days.¹⁹⁷ This new legislation is intended to codify the interpretation of the meaning of the transient occupancy statute by the Virginia Attorney General in Opinion 04-063.¹⁹⁸

6. Excise Tax Late Payment Penalty

The 2005 General Assembly amended Virginia Code section 58.1-3916 to authorize localities to impose by ordinance a penalty for the “delinquent remittance of excise taxes on meals, lodging, or admissions collected from consumers, [not to exceed] 10 percent for the first month the taxes are past due, and five percent for each month thereafter, up to a maximum of 25 percent of the taxes collected but not remitted.”¹⁹⁹ The new penalty rates took effect on July 1, 2005.²⁰⁰ Prior to this amendment, the penalty for delinquent remittance of these taxes was limited to ten percent.²⁰¹

B. Recent Judicial Decision

In a matter of first impression in Virginia, the Richmond City Circuit Court held in *Circuit City, Inc. v. Virginia Department of Taxation*²⁰² that the Virginia Department of Taxation has the

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

197. VA. CODE ANN. § 58.1-3819 (Cum. Supp. 2005).

198. See Op. to Hon. John C. Watkins (Sept. 7, 2004), available at <http://www.oag.state.va.us/> (last visited Oct. 1, 2005). A county has no authority to levy the transient occupancy lodging tax on the amount a hotel charges transients for the rental of banquet facilities to accommodate events of limited duration. *Id.* The ordinance references to “room or space rental” apply only to the amount a hotel charges for living accommodations and not to charges for meeting rooms and banquet facilities. *Id.* Virginia Code section 58.1-3819 evidences no legislative intent to apply the transient occupancy tax to such non-living rooms or accommodations. *Id.*

199. Act of Mar. 22, 2005, ch. 501, 2005 Va. Acts 675 (codified as amended at VA. CODE ANN. § 58.1-3916 (Cum. Supp. 2005)).

200. *Id.*

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

202. 65 Va. Cir. 260, 261 (Cir. Ct. 2004) (Richmond City).

burden of proving that they mailed a formal "Notice of Assessment" to a taxpayer.²⁰³ The Virginia Department of Taxation failed to meet that burden in this case.²⁰⁴

In *Circuit City*, the Virginia Department of Taxation was conducting a sales and use tax field audit for the period from September 1994 through the end of August 1997.²⁰⁵ On April 27, 2000, Circuit City received a field audit report (Department Form ST-48) showing a multi-million dollar deficiency and indicating in the top right hand corner an assessment date of April 30, 1999.²⁰⁶ On November 7, 2000, the Virginia Department of Taxation sent Circuit City a revised Report of Field Audit proposing an additional tax, penalty, and interest in the amount of \$821,177.88.²⁰⁷

"After the audit, Circuit City applied to the [Virginia Department of Taxation] for a correction of the audit findings as relates to the method by which payments were applied to delinquent consumer credit accounts as eligible for Bad Debt Credit under Virginia Code § 58.1-621."²⁰⁸ Addressing the points raised by Circuit City on the Bad Debt Credit issue, the Virginia Department of Taxation issued an initial opinion on May 29, 2002, stating that payments from customers must be credited first to the original debt.²⁰⁹ Circuit City applied for reconsideration of the Virginia Department of Taxation's decision and as a result, the department "issued a second opinion on May 14, 2003, reiterating its initial opinion."²¹⁰

Circuit City initiated suit pursuant to Virginia Code section 58.1-1825(A) as a person aggrieved by an assessment issued by the Virginia Department of Taxation.²¹¹ Circuit City challenged the positions taken by the Virginia Department of Taxation in its two administrative opinions addressing the Bad Debt Credit, as well as alleging for the first time that "the [Virginia Department of Taxation] erred in failing to assess the sales and use tax

203. *Id.*

204. *Id.*

205. *Id.* at 260.

206. *Id.* at 260-62.

207. *Id.* at 260.

208. *Id.*

209. *Id.* The Virginia Department of Taxation's initial opinion issued was Public Document 02-85 (May 29, 2002), which may be reviewed at <http://www.tax.virginia.gov/> (last visited Oct. 1, 2005).

210. *Id.*

211. *Id.* at 261.

against Circuit City for the Audit Period involved prior to the expiration of the statute of limitations.”²¹² By consent order, the statute of limitations in Virginia Code section 58.1-1820(2) was severed and remained the sole issue before the trial court.²¹³

Virginia Code section 58.1-634 requires the Virginia Department of Taxation to assess a deficiency in sales and use taxes within three years of the date a taxpayer files its return.²¹⁴ Circuit City filed its final return for the audit period on September 20, 1997.²¹⁵ Under the statute of limitations provision, the Virginia Department of Taxation would be required to assess any deficiency for the audit period by September 20, 2000.²¹⁶ Circuit City asserted “that it never received a written notice of assessment as required by Virginia Code § 58.1-1820(2).”²¹⁷

Virginia Code section 58.1-1820(2) defines how an assessment of tax is to be made. This statute provides that “[a]ssessments made by the Department of Taxation shall be deemed to be made when a written notice of assessment is delivered to the taxpayer by an employee of the Department of Taxation, or mailed to the taxpayer at his last known address.”²¹⁸ The Richmond City Circuit Court held “that the burden of proving that the written notice of assessment was delivered rests upon the [Virginia Department of Taxation], that party which last had control over the [Notice of Assessment] in question.”²¹⁹ The trial court found that the Virginia Department of Taxation failed to meet this burden.²²⁰

The circuit court noted that the Virginia Department of Taxation provided no proof that the “Notice of Assessment was ever delivered to Circuit City or even to the post office for mailing.”²²¹ The Virginia Department of Taxation’s testimony at trial only established how assessment notices are handled in a typical scenario.²²² There was no evidence presented as to how Circuit City’s

212. *Id.*

213. *Id.*

214. VA. CODE ANN. § 58.1-634 (Repl. Vol. 2004 & Cum. Supp. 2005).

215. *Circuit City*, 65 Va. Cir. at 261.

216. *Id.*

217. *Id.*

218. VA. CODE ANN. § 58.1-1820(2) (Repl. Vol. 2004 & Cum. Supp. 2005).

219. *Circuit City*, 65 Va. Cir. at 261.

220. *Id.*

221. *Id.*

222. *Id.*

Notice of Assessment was actually handled.²²³ The Virginia Department of Taxation neither could produce a copy of the Notice of Assessment, nor show that any physical record that the Notice of Assessment was “printed, pre-sorted, reviewed, inserted into envelopes, postage applied, or deposited into the custody of the United States Postal Service.”²²⁴

The Virginia Department of Taxation did not produce a receipt issued or bearing a post-mark of the United States Postal Service.²²⁵ The Virginia Department of Taxation argued that Circuit City must have received the Notice of Assessment because it filed an administrative appeal on the Bad Debt Credit issue raised in the audit.²²⁶ Therefore, the Virginia Department of Taxation asserted Circuit City must have received the Notice of Assessment.²²⁷ The trial court disagreed and stated that the administrative protest of the sales tax audit only shows that Circuit City was aware that an assessment was made.²²⁸ The protest letter provided no evidence or support as to whether the Virginia Department of Taxation actually delivered a document entitled Notice of Assessment to the taxpayer.²²⁹

The circuit court also rejected the Virginia Department of Taxation’s argument that it could rely on its own computer system that showed a computer entry with an assessment date of April 30, 1999 in an attempt to prove that the notice was delivered.²³⁰ Again, the court disagreed. The computer entry was irrelevant as to whether the “Notice of Assessment” form was physically delivered to Circuit City.²³¹ The Virginia Department of Taxation’s regulations implementing Virginia Code section 58.1-1820(2) provide that “[t]he written notice of assessment made by the Department is made on a form clearly labeled ‘Notice of Assessment’ which sets forth the date of the assessment, amount of assessment, the tax type, taxable period and tax-

223. *Id.* at 261–62.

224. *Id.* at 262.

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. *Id.*

payer.”²³² The court noted that the Virginia Department of Taxation’s regulation “further provides that payment reports or additional statements following a notice or correspondence proposing adjustments preceding a notice do not constitute a ‘written notice of assessment’ as required by Virginia Code § 58.1-1820(2).”²³³ Thus, based on the lack of evidence produced at trial by the Virginia Department of Taxation, the trial court entered judgment for Circuit City on the basis that the statute of limitations expired on September 20, 2000.²³⁴

232. 23 VA. ADMIN. CODE § 10-20-160(E)(3) (1996).

233. *Circuit City*, Va. Cir. at 261 (citing 23 VA. ADMIN. CODE § 10-20-160(E)(3) (1996)).

234. *Id.* at 262.
