VIRGINIA STATE TAX DEVELOPMENTS
Fall 2021

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I. INCOME/FRANCHISE TAXES

A. Legislative Developments

2021 Legislative Session

1. IRC Conformity

S.B. 1146, signed on March 15, 2021, advances Virginia's date of conformity to the Internal Revenue Code ("IRC") from December 31, 2019 to December 31, 2020. However, Virginia did not conform to several provisions of the CARES Act. In particular, Virginia did not conform to the changes to the limitations for net operating loss deductions and excess business losses, or the changes to business interest deduction limitations. Furthermore, as a result of this fixed conformity date, Virginia does not currently conform to the federal tax changes included in the American Rescue Plan Act (which was enacted on March 11, 2021).

2. Combined Reporting Work Group

H.J.R. 563 established "a work group to assess the feasibility of transitioning to a unitary combined reporting system for corporate income tax purposes." The work group has held three meetings, and is required to issue "a summary of its findings, recommendations, and a draft of any recommended legislation" by November 1, 2021.

2019 Legislative Session

3. Workgroup to Study Interest Deduction Limitation

H.B. 1700 instructed the Department to form a working group to study the impact of the IRC § 163(j) interest deduction limitation, and to promulgate guidelines regarding the interest deduction limitation by December 1, 2019. Under the statute, the guidelines would take effect for the 2018 tax year.

The Department held a working group meeting on May 20, 2019, and solicited comments from members of the working group. Issues that the Department presented at the working group included the effect of differences between federal consolidated groups and Virginia consolidated or combined groups, Virginia's statutory allowance of a 20% deduction of interest disallowed for federal purposes, and Virginia's addback of related member interest expenses that are related to intellectual property. Members of the working group raised questions such as how to resolve timing differences between federal interest carryforwards and Virginia interest deduction and whether penalties or interest would be abated for taxpayers for the 2018 tax year.

On December 26, 2019, the Department issued draft guidelines (Document Number 19-126) that provide that "the limitation" on the deductibility of business interest "applies for Virginia income tax purposes to the extent a taxpayer's deduction for business interest is limited on its federal income tax return and such deduction impacts . . . federal taxable income. . ." The Department's draft guidelines take the position that a taxpayer must recompute its federal taxable income for purposes of determining the Virginia business interest limitation to account for nonconformity with bonus depreciation, carry back of certain net operating losses, cancellation of debt, and deductions for high yield debt obligations. Additionally, the Department's draft guidelines state that the Department will require taxpayers to reconcile the 20% deduction of interest disallowed for federal purposes on future returns.

B. Judicial Developments

1. Discrimination Against Federal Retirees

Karl E. Beisel v. Virginia Department of Taxation (Richmond City Circuit Court, Docket No. 20-4185-3)

The taxpayer in this appeal is a federal retiree who is challenging Virginia's taxation of his retirement income for the 2016 to 2018 tax years. The taxpayer argues that Virginia's income tax discriminates against him in violation of 4 U.S.C. § 111, by "proportionally discriminat[ing]" in favor of state retirees. The same taxpayer had filed a similar complaint in Chesapeake City Circuit Court for the 2011 through 2013 tax years, which was decided in favor of the Department on April 10, 2015.

On September 29, 2020, the Department filed a demurrer and plea in bar that argues that the taxpayer's complaint is precluded by the Chesapeake City Circuit Court's 2015 decision. The Department asserted that the taxpayer's claim in this case "arises from the same conduct previously challenged by [the taxpayer] in his prior suit, [so] he is barred from pursuing this claim in the current proceeding." The court overruled the Departments demurrer and plea in bar on January 6, 2021.

On September 17, 2021, the taxpayer filed a motion *in limine* to exclude the Department's expert witness, or in the alternative, to limit the expert witness' testimony. The Department has retained a law professor as an expert witness to testify on "the history of federal and state taxation of social security income; the ways in which that tax treatment compares to, and is distinct from, the taxation of income of federal retirees, including that provided by or in accordance with the Civil Service Retirement Program ("CSRS") and the Federal Employee Retirement System ("FERS"); and the legality of Virginia's taxation of the income of federal retirees. . . ." The taxpayer has objected that this expert testimony would be "inadmissible, as it seeks to establish matters of law and express conclusions of law."

The case is currently scheduled for a trial on November 10, 2021.

2. Reasonable Cause for Penalty Waiver

Hunter Lewis v. Virginia Dept. of Taxation, (Richmond City Circuit Court, Docket No. 20-1779-7)

The taxpayer in this appeal is challenging the Department's imposition of late payment and extension penalties on the grounds that he had reasonable cause. In computing his estimated income tax payments for 2018, the taxpayer consulted with a tax attorney who advised him that he had enough basis in property (an interest in an LLC) that he would not recognize gain when it was sold during 2018. This advice was incorrect, and resulted in the taxpayer's estimated payments being insufficient and penalties

being assessed. The taxpayer argues that his reliance on the tax attorney's advice constituted reasonable cause, so penalties should not apply. The taxpayer filed a motion for summary judgment on March 16, 2021. The parties filed an Agreed Order of Nonsuit on September 10, 2021. Based on the procedural posture of this case, it is likely that this nonsuit was implemented as part of a settlement agreement.

3. Intangible Expense Add-Back

Kohl's Dept. Stores, Inc. v. Virginia Dept. of Taxn., 160681, 2018 WL 1414728 (Va. Mar. 22, 2018)

On August 31, 2017, the Virginia Supreme Court issued a decision holding that a taxpayer can claim an exception to Virginia's intangible expense addback on the basis that the related member receiving the intangible payment is "subject to tax" in another state, only to the extent that the intangible payment is included in the apportioned tax base of the related member in another state.

The taxpayer had argued that because the royalty payments it made to its related member were included in the pre-apportionment income reported on the related member's returns filed in other states, the payments were subject to tax in those other states and, as a consequence, the full amount of the payments qualified for the "subject to tax" exception. The Department countered that a taxpayer was only entitled to claim the "subject to tax" exception to the extent that the royalty payments made by the taxpayer were subject to tax in another state on a post-apportionment basis. The Department also argued that this "pro rata" exception only applied if the related member reported the royalty payments on a separate company return.

The Virginia Supreme Court found that the statutory language setting forth the "subject to tax" exemption was ambiguous as to whether a taxpayer that pays tax to another state should receive a full exception or a pro rata exception, but ultimately determined that the Department's interpretation that the exception as applying on a pro rata basis was entitled to deference. The court also noted that "an interpretation of the subject-to-tax exception that would result in a taxpayer's ability to avoid the addback statute would be unreasonable in light of the statute's purpose and intent." In a footnote, the court acknowledged that in the years following the original enactment of the intangible expense addback provision, the legislature had considered and rejected bills that would have enacted statutory language that unambiguously applied the exception on a pro rata basis. However, the court noted that the

failed bills "provide examples of how the subject-to-tax exception could be unambiguously worded to apply on a post-apportionment basis," but do "not contradict our conclusion that the version of the statute before us is ambiguous."

In a concession to taxpayers, the court rejected the Department's limitation of the "subject to tax" exception to amounts included in returns filed by the related member in separate filing states. The court held that a royalty payment was subject to tax "[t]o the extent that the royalties were actually taxed by the Separate Return States, Combined Return States, or Addback States." The court remanded the case to the circuit court to determine the proper amount of the taxpayer's subject to tax exception determined on a pro rata basis.

Three of the seven justices joined in a dissenting opinion. The dissent argues that the plain language of the statute is unambiguous and supports a full deduction, and that the Department's rulings cannot make an unambiguous statute ambiguous. The dissent tracks the various proposed and adopted legislative changes to the "subject to tax" exception, and argued that this post-enactment history demonstrated that the legislature did not intend for the "subject to tax" exception, as originally enacted, to be applied on a pro rata basis. The dissent also criticizes the majority for using judicial construction to implement what the majority might believe represents good policy, rather than leaving policy issues to the legislature.

On September 25, 2017, Kohl's filed a petition for rehearing, arguing that the Virginia Supreme Court erred by deferring to the Department's position because Virginia statute prohibits courts from giving weight to the Department's interpretation when that position has not been reduced to a regulation. Recognizing that it had improperly relied on the Department's interpretation of Va. Code Sec. 58.1-402(B)(8)(a)(1) in its earlier decision, the Virginia Supreme Court granted the taxpayer's petition for rehearing.

In its revised decision, the Virginia Supreme Court omitted language from the original decision affording deference to the Department's interpretation of the addback statute and focused its statutory construction analysis on deciphering the legislative intent. Based on its revised analysis, the Virginia Supreme Court reached the same conclusion that it reached in its earlier decision; that is, that the "subject to tax" exception is limited to the portion of the intangible expense actually taxed in the other state. In doing so, as three justices pointed out in a revised dissenting opinion, the majority disregarded the canon of statutory construction that an

ambiguity in a taxing statute be resolved in the taxpayer's favor. Importantly, the revised decision leaves intact the concession to taxpayers allowing the exception for intangible expenses paid to related members subject to tax in combined reporting states.

The Virginia Supreme Court remanded this appeal to the Richmond City Circuit Court for further proceedings regarding the computation of the taxpayer's exception to addback.

On remand, the parties could not agree on how to compute the taxpayer's exception to addback pursuant to the Virginia Supreme Court's decision. The taxpayer's position was that it was entitled to an exception to addback for tax paid in combined reporting states, while the Department contended the taxpayer was not entitled to an exception for combined reporting states because the intercompany transactions were eliminated in combination. The Richmond City Circuit Court granted summary judgment in favor of the Department on May 13, 2021, and held that the taxpayer was not entitled to an exception to addback for tax paid in combined reporting states. The taxpayer filed a motion for reconsideration on June 3, 2021, which the Circuit Court granted. The Circuit Court issued a revised opinion on September 9, 2021 that reaffirmed its initial May 13, 2021 decision in favor of the Department.

2. Alternative Apportionment using Market Sourcing

The Corporate Executive Board Co. v. Virginia Dep't of Taxation, (Va. Feb. 7, 2019)

The Corporate Executive Board Company (CEB) is headquartered in Arlington, Virginia and provides research and advisory services to large businesses around the world. During the 2011 – 2013 tax years, CEB derived over 95 percent of its revenue from sales to customers outside of Virginia. Based on Virginia's statutory method of apportionment, in addition to reporting the majority of property and payroll in the Commonwealth, CEB assigned 100 percent of its sales to Virginia under Virginia's "costs of performance" sourcing rule, which deemed all of CEB's sales to be Virginia sales. CEB also paid tax in dozens of other jurisdictions and assigned a large percentage of its sales to those states, as well.

CEB filed a refund claim requesting to use an alternative method of apportionment that would substitute a market-based rule for sourcing its receipts from sales of services for the statutory costs of performance sourcing rule. The Department of Taxation denied CEB's administrative claim. The Arlington Circuit Court granted

summary judgment in favor of the Department on September 1, 2017. CEB appealed to the Supreme Court of Virginia.

Under Virginia's alternative apportionment regime, the Department will grant permission to use an alternative method of apportionment in two circumstances. First, if the statutory method produces an unconstitutional result under the particular taxpayer's facts and circumstances (i.e., if the statutory method is inapplicable). Second, if the statutory method results in double taxation of the taxpayer's income, and the inequity is attributable to Virginia rather than to the fact that some other state has a unique method of allocation and apportionment (i.e., if the statutory method is inequitable).

CEB argued that Virginia's statutory sourcing rule produced an unfair apportionment under the dormant Commerce Clause because it ignored the existence of interstate commerce, resulted in a significantly higher share of income being apportioned to Virginia than Virginia was entitled to tax, and produced substantial double taxation. However, the Court ruled that the statutory method was externally consistent because it captured, in a reasonable sense, how CEB's income was generated. The Court pointed to the fact that CEB employees working in Virginia developed the content for CEB's products and that the servers on which the products resided were located in Virginia.

With regard to inequity, the Court agreed that CEB satisfied the first prong of the Department's regulation -- the statutory method resulted in double taxation. In fact, the parties stipulated that CEB has paid tax on a multistate basis on an apportioned amount of income that well exceeded 120 percent of CEB's nationwide income. However, the Court found that the double taxation was not attributable to the Commonwealth because Virginia has applied the same costs of performance sourcing rule for decades. Instead, the Court held that it was other states' adoption of market-based sourcing over the years that caused the double taxation. The Court was unable to say whether any of the other states to which CEB assigned sales applied a "unique" method of apportionment. Accordingly, CEB did not meet its burden of showing that the statutory method produced an inequitable result.

Reed Smith's Observations

This case continues the trend of taxpayers being unsuccessful in obtaining alternative apportionment relief, despite the fact that in several recent cases courts have allowed state revenue departments to force taxpayers to use alternative apportionment methods. This

case is especially interesting because the Court actually found double taxation in the record.

Nevertheless, it is not surprising that the Virginia Supreme Court ruled against CEB on the constitutional argument, considering the extremely high burden required for alternative apportionment requests under the Virginia regulations. However, the Court's analysis of the statutory inequity prong is curious. Based on the Court's interpretation of the pertinent regulation, it is unclear how a taxpayer could demonstrate that any particular instance of double taxation is attributable to Virginia.

3. Property "Owned and Used" In Virginia

R.J. Reynolds Tobacco Company (Successor-in-Interest to Lorillard Tobacco Co.) v. Virginia Dep't of Taxation, Case No. CL13000614-00 (Cir. Ct. of the County of Danville)

In addition to requesting relief from an assessment that was based on a partial denial of a claimed exception to the intangible expense addback, Reynolds requested a refund based on an adjustment to its property factor.

Reynolds aged tobacco in Danville, Virginia and included the value of the aging tobacco in computing its property apportionment factor on its original return.

Under Virginia law, the property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned and used or rented and used in Virginia during the tax year, and the denominator of which is the average value of all of the corporation's real and tangible personal property owned and used or rented and used during the taxable year and located everywhere, to the extent such property is used to produce Virginia taxable income. Va. Code § 58.1-409.

Reynolds argued that its aging tobacco should not be included in the property apportionment factor because it was not both "owned and used" by Reynolds in Virginia. The tobacco could only be used when it is aged sufficiently to be transformed into cigarettes. Reynolds argued that the aging tobacco is akin to property "under construction" or that is being "developed to the point where [it] could be placed in production" and, thus, is not inventory.

Reynolds also relied, in part, on previous sales and use tax rulings that the Department issued (to Reynolds' predecessor) holding that

the property Reynolds used in aging tobacco is subject to use tax because aging tobacco is not "processing or treatment."

On April 20, 2020, the Danville Circuit Court issued a decision in favor of Reynolds. The Court agreed with Reynolds that the tobacco in aging was "available-to-be-used." While the Department has promulgated a regulation which states that property "available for use" is included in the property factor, 23 V.A.C. 10-120-160(A)(4)(d), the Court found this is inconstant with the plain language of the statute—which refers to property that is used, not property that could be used. Accordingly, the Court struck the offending portion of the Department's property factor regulation and granted relief to Reynolds

The Department filed a notice of appeal on October 15, 2020. The Virginia Supreme Court granted the appeal on March 25, 2021, The parties have fully briefed the appeal, and the Virginia Supreme Court will likely hold oral argument in Fall 2021.

Reed Smith's Observations

Taxpayers who age goods or raw materials in Virginia (or any other state with a property factor with language similar to Virginia's) prior to manufacture or sale should consider filing refund claims. The longer that the goods are aged in Virginia, the larger an impact this would likely have on the Virginia property apportionment factor.

C. Rulings of the Tax Commissioner

1. Inclusion of Income from Sale of Partnership Interest – P.D. 21-36 (Mar. 16, 2021)

The Department has held that a taxpayer is not entitled to exclude income from the sale of an LLC interest. The Department found that the taxpayer had not proved the LLC was not unitary with the taxpayer because the LLC "was separately managed and generally operated independently of" the taxpayer. Furthermore, the Department suggested that even if the LLC was not unitary with the taxpayer a portion of the income from the sale of the LLC interest would have been attributable to Virginia because the LLC had a manufacturing facility in Virginia.

2. Sourcing of Software Licenses and Technical Support– P.D. 20-128 (July 21, 2020)

The Department has ruled that receipts from software licenses are sourced on a destination basis as receipts from a sale of tangible

personal property while fees for technical support with respect to the software are sourced on a cost of performance basis as receipts from services.

3. Sourcing of Commissions, Advertising, and Background Checks – P.D. 19-2 (January 25, 2019)

The Department ruled that receipts from commissions, advertising, and background checks received pursuant to contracts signed by the taxpayer's employee in Virginia are Virginia-source receipts. The Department appears to have applied the rules for sourcing an individual's income rather than the rules for sourcing a corporation's receipts in this ruling.

Reed Smith's Observations

In this ruling, this sourcing methodology was favorable for Virginia, because it created nexus for the taxpayer under Virginia's factor presence nexus rule (although the Department left open the possibility that the taxpayer's activities in Virginia were protected by P.L. 86-272). However, applying this ruling could produce favorable results for taxpayers with converse facts. For example, this could be beneficial for service providers that have significant costs of performance in Virginia but have salespeople outside the state who enter into contracts with customers.

4. Cost of Performance and Sales Factor – P.D. 18-190 (November 7, 2018)

The Department ruled that, in computing its sales factor, a service provider must analyze costs of performance on a contract-by-contract basis rather than on an aggregate basis. Thus, even though the taxpayer established that its aggregate costs of performance were predominantly outside Virginia, it was not entitled to a reduction in its sales factor because it did not show that the costs of performance were predominantly outside Virginia for the performance of specific contracts. Rather than denying the taxpayer's appeal, the Department provided the taxpayer additional time to submit contract-by-contract substantiation.

5. Taxpayer's Ability to Claim a Subtraction for Expenses Offset by a Credit Claimed at the Federal Level – P.D. 17-192 (November 16, 2017)

The Department ruled that to the extent a taxpayer's payroll expenses may be reduced by claiming a credit against their federal income tax liability pursuant to IRC § 45B for Social Security taxes paid on employee tips, the amount of the reduction may not

be claimed as a subtraction on the Virginia income tax return. This is because Virginia does not allow a taxpayer to claim a subtraction for expenses offset by a credit at the federal level unless allowed by statute.

6. Tax Treatment of Canadian Corporation's Income – P.D. 17-195 (November 16, 2017)

The Department ruled that a Canadian corporation that was subject to the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital (the "Convention"), would not be required to file a Virginia corporate income tax return. For Virginia corporation income tax purposes, the starting point for determining income taxable in Virginia for corporations is identical to that as defined by the IRC. Under the terms of the Convention, the Canadian Corporation had no federal taxable income. Therefore, the Tax Commissioner ruled that the Canadian corporation did not have any Virginia taxable income.

7. Foreign Source Income – P.D. 17-3 (January 19, 2017)

The Department ruled that proceeds from a foreign arbitration is not foreign source income. The taxpayer had sold stock in a subsidiary to a third party, and as part of the sale, retained the right to proceeds from a foreign breach of contract arbitration in which the subsidiary was involved.

On its return, the taxpayer excluded the arbitration proceeds as foreign source income. The Department rejected this exclusion because the settlement proceeds should be treated as gain from sale of the subsidiary. Because the subsidiary was a U.S. corporation, gain from the sale was not gain from the sale of an intangible outside the United States.

The Department's analysis does not acknowledge that the income from the foreign arbitration was, in fact, attributable to an intangible located outside the United States. The subsidiary's breach of contract claim was an intangible asset (a "chose in action"). If the taxpayer had sold the chose in action directly to the third party, it seems that it would be difficult for the Department to contest that this would qualify for the foreign source income subtraction.

II. TRANSACTIONAL TAXES

A. Legislative Developments

1. Temporary Sales Tax Exemption for Purchases of Personal Protective Equipment by Qualifying Businesses

S.B. 1403, enacted March 11, 2021, temporarily exempts purchases of personal protective equipment ("PPE") by qualifying businesses from sales and use tax. The statute has a broad definition of PPE; in addition to exempting items such as masks, gloves, disinfectants, and testing equipment, the statute also exempts some capital improvements such as HVAC modifications and engineering controls used to reduce the spread of COVID-19. In order to be a qualifying business, a business must adopt a COVID-19 safety protocol. The exemption took effect on March 11, 2021, and expires after the "expiration of the last executive order issued by the Governor related to the COVID-19 pandemic and the termination of the COVID-19 Emergency Temporary Standard and any permanent COVID-19 regulations adopted by the Virginia Safety and Health Codes Board."

2. Remote Seller and Marketplace Nexus

During the 2019 legislative session, the legislature enacted a statute that creates sales and use tax collection obligations for remote sellers and marketplace facilitators, effective July 1, 2019. Under the statute, a remote seller is required to collect tax if it has either $100,000 of gross revenue from retail sales in Virginia in the prior or current calendar year or engages in 200 or more retail sales transactions in Virginia in the prior or current calendar year. The statute also provides procedural rules regarding the timing of local sales tax rate changes. The statute requires a marketplace facilitator to collect tax if it facilitates a certain volume of sales in Virginia (with the same thresholds as for remote sellers) or conducts certain enumerated activities in Virginia. H.B. 1722 (2019).

3. Dealer Registration based on Inventory

During the 2017 legislative session, Virginia passed legislation that clarifies that storage of inventory within the Commonwealth of Virginia is sufficient contact with Virginia to require an out-of-state seller to register as a dealer for the collection of sales and use tax on sales to customers within Virginia. This legislation was aimed at ensuring that the presence of inventory within Virginia in a fulfillment center or warehouse will give rise to an out-of-state

dealer's obligation to collect sales tax on sales to Virginia customers. H.B. 2058 (2017); S.B. 962 (2017); Item 3.5-15 of the 2017 Appropriation Act (H.B. 1500).

B. Judicial Developments

1. Taxation of Equipment and Software Sold to Internet Access Providers

Alcatel-Lucent USA Inc. v. Virginia Department of Taxation (Richmond City Circuit Case No. 20003591-00)

The taxpayer in this pending case is a retailer of equipment and software used in telecommunications that collected tax on equipment and software that it sold to an Internet access provider. The taxpayer filed a refund claim for the tax paid on those transactions, arguing that the sales of equipment were not taxable pursuant to a statutory exemption for broadcasting equipment and that the sales of software were not taxable pursuant to a statutory exemption for "services not involving an exchange of tangible personal property which provide access to or use of the Internet . . . including software . . . delivered electronically via the Internet."

The Department denied the taxpayer's refund claim. For the equipment sales, the Department invoked the doctrine of strict construction, and concluded that the statutory exemption for broadcasting equipment sold to Internet access providers was limited to sales to retail providers of Internet access. Based on the Department's independent research (such as news releases and Google searches), the Department asserted that the taxpayer had not proved that its customer was a retail Internet access provider. For the software sales, the Department concluded that that the taxpayer did not provide adequate documentation to prove that the software was electronically delivered. The taxpayer provided procedures for its customer to download software and software license keys, but the Department rejected this evidence as its policy is that a taxpayer must provide "a sales invoice, contract or other sales agreement" that "expressly certif[ies] the electronic delivery of the software and that no tangible medium for that software has been furnished to the customer."

One interesting point that is not addressed in the complaint is whether the Department needs to pay interest to a retailer on a refund of sales tax that the retailer collected from a customer. In the ruling under appeal in this case, the Department held that it can provide interest on sales tax refunded to a retailer if the retailer

identifies to the Department the customer to whom the interest will be paid. However, the Department reserved the right to verify that the interest was refunded to the customer.

The taxpayer filed a trial memorandum with the Court on August 31, 2021. In the trial memorandum, the Taxpayer pointed out that the Department's position in this case is inconsistent with a prior Attorney General Opinion interpreting the scope of the exemption, as well as the Fairfax County Circuit Court's opinion in *Cisco Systems, Inc. v. Thorsen*. The Circuit Court held a two day trial on September 14 and 15, 2021.

2. Taxation of Internet Access Fees

Central Telephone Co. of Virginia v. Virginia Department of Taxation (Richmond City Circuit Case No. CL17000246-00)

The taxpayer in this pending case provides internet access to its customers. The Department assessed sales tax on the taxpayer's fees for broadband recovery, service activation, and early termination fees. The taxpayer is arguing that these fees are for internet access, so cannot be taxed under state law or the Internet Tax Freedom Act ("ITFA"). The Department's position is that even though the fees "are related to the provision of Internet service," they are taxable communications services because they are not for the direct provision of internet access.

3. Tangible Personal Property vs. Nontaxable Services

Kangaroo Jac's [sic], Inc. v. Virginia Department of Taxation (Chesapeake City Circuit Case NO. CL14003139-00)

The taxpayer in this case provides children's birthday party packages. A typical birthday party package consists of an hour-and-a-half of playtime on inflatables and half-an-hour of pizza and cake. On its invoices for these packages, the taxpayer does not separately state the charges for the use of the inflatables and the food.

The taxpayer filed a refund for Virginia sales tax collected on its birthday party packages. Initially, the Department ruled that the true object of the taxpayer's transactions was the party services, not the food provided at the party. However, the Department also determined that because the taxpayer had collected Virginia sales tax on the birthday party packages from its customers, it was not entitled to a refund unless it also provided a refund of the tax collected to its customers.

Three years later, the Department rescinded its ruling and found that the taxpayer's entire charge for its party packages was taxable. The new ruling relied on the Department's regulation, which says that "'cover charges' or 'minimum charges' which include the provision of or the entitlement to food, drinks, or other tangible property" are taxable. The Department also cited a ruling that held that the entire admission charges to dinner theatre show was taxable because the charges entitled the payor to a meal.

The taxpayer filed a suit for refund in Chesapeake Circuit Court on December 31, 2014. The Department filed a demurrer and plea in bar on February 5, 2015. The Department's demurrer argued that the taxpayer's suit was defective because the taxpayer had not refunded the taxes it collected from its customers. The Circuit Court dismissed the appeal in November 2018.

C. Rulings of the Tax Commissioner

1. Taxation of Return Shipping Labels – P.D. (May 25, 2021)

The Department ruled that return shipping labels that a retailer sent to its customers to allow "easy returns" were subject to sales and use tax. The Department found that the return shipping labels were not used or consumed outside Virginia, relying on P.D. 19-115.

Reed Smith's Observations

The return shipping labels at issue in this case may qualify for exemption as packaging materials, a question which the Department did not address in this ruling. Packaging materials are exempt from sales and use tax "when marketed with the product being sold," and are defined as "items which are used to package products for sale and which become the property of the purchaser subsequent to the sale." *See* 23 VAC 10-210-400. In fact, the Department's regulation lists labels as an example of a type of packaging material in its own regulation.

2. Taxation of Bundled Transactions – P.D. 20-16 (January 31, 2020)

On reconsideration of a prior determination, the Department ruled that a taxpayer that provided both interior design services and rented tangible personal property to its customers and separately itemized the charges for the services and property on a single invoice was not taxable on the services. While the Department's regulation on interior design requires the services to be "billed separately," the Department concluded that a single invoice that separately itemizes the services and property is sufficient to satisfy this test.

3. Taxation of Lease-to-Own Transactions - P.D. 20-123 (July 14, 2020)

The Department ruled that a taxpayer who "provides third-party financing to customers for purchases of tangible personal property from dealers" in the form of a lease-to-own agreement must collect tax on the lease payments. The Department rejected the taxpayer's argument that the taxpayer was only providing financing and that liability for sales tax fell on the dealer rather than the taxpayer. The Department's conclusion seemed to rest on the fact that the taxpayer's agreement was in the form of a lease, although the taxpayer asserted that other states had concluded that it was a finance lease.

III. LOCAL TAXES

A. Judicial Developments

1. Short-Term Lodging

Norton v. Board of Supervisors of Fairfax County (Virginia Supreme Court 2021)

The Virginia Supreme Court held that Fairfax County had statutory authority to impose "a transient occupancy tax on residential properties" that were rented by individuals to third-parties for "short periods of time." The court found that the statute that authorized local transient occupancy taxes allowed localities to impose transient occupancy taxes on any property that was 'used in the same manner as 'hotels, motels, boarding houses [and/or] travel campgrounds.'" While the court recognized that the residential properties at issue in this case were "clearly distinguishable from hotels, motels, boarding houses and travel campgrounds in many respects," it found that the residential properties at issue in this case were used in the same manner as hotels and could thus be subjected to tax.

2. Uniformity of Machinery & Tools Tax

International Paper Co. v. County of Isle of Wight (Virginia Supreme Court 2020).

The Virginia Supreme Court held that a taxpayer presented a prima facie case that a county violated the Virginia constitution's uniformity clause when the county raised the machinery and tools ("M&T") tax rate on all taxpayers, and used the increased tax

revenue to fund grants that were provided to other M&T taxpayers in an amount that correlated strongly with the amount of the tax increase. The county did not provide a grant to the taxpayer in this case, who had received a refund of M&T tax for prior periods. The court concluded, viewed in the light most favorable to the taxpayer, the evidence was sufficient to show that the county's goal in increasing the tax rate followed by providing grants to some taxpayers was "to directly reduce a specific tax obligation" for a subclass of taxpayers in contravention of the uniformity clause. The court remanded to the circuit court for further proceedings.

3. BPOL and Internet Tax Freedom Act

Cox Communications Hampton Roads LLC v. King (Chesapeake Circuit Court Aug. 14, 2020).

The Chesapeake Circuit Court has held that the ITFA preempts the City of Chesapeake's business, professional and occupational license ("BPOL") tax as applied to internet access charges. The court concluded that the BPOL is a tax for purposes of ITFA (which was consistent with the Tax Commissioner's determination), and that the City's BPOL was not grandfathered under ITFA (which reversed the Tax Commissioner's determination).

4. 4-R Act and Stormwater Management Charges

Norfolk Southern Railway Co. v. City of Roanoke (4th Cir. Feb. 15, 2019).

The United States Court of Appeals for the Fourth Circuit held that the City of Roanoke's stormwater management charges are fees rather than taxes and, therefore, are not subject to the federal 4-R Act (which preempts taxes that discriminate against railroads). In this case, a railroad alleged that the City of Roanoke's stormwater management charges were discriminatory because Roanoke exempted lawns from the charge but not ballast, even though lawns and ballast are equally permeable by stormwater runoff.

The court found that the charges were fees rather than taxes, primarily because it viewed the charge as "part of a comprehensive regulatory scheme." Due to its finding that the charges are fees rather than taxes, the court did not reach the question of discrimination on the merits.

Reed Smith's Observations

The Fourth Circuit's decision in this case acknowledged that whether Roanoke's stormwater management charge was a tax or a fee was a "close question," and recognized that several other courts have held that stormwater management charges are taxes, not fees.

5. Dulles Duty Free, LLC v. County of Loudon (Virginia Supreme Court, Aug. 24, 2017)

The Virginia Supreme Court ruled that, under the Import-Export Clause of the United States Constitution, the BPOL tax imposed by Loudon County could not be imposed on a duty-free store's receipts from sales of goods that are destined for export. The Court reasoned that the BPOL tax is functionally indistinguishable from a sales tax on goods that are destined for export, which the United States Supreme Court has previously struck down.

Loudon County filed a petition for a writ of certiorari to the U.S. Supreme Court on December 19, 2017. The petition for certiorari was denied on April 2, 2018.

B. Rulings of the Tax Commissioner

1. Appealable Event for BPOL Tax - P.D. 18-211 & 18-213 (December 18, 2018)

In a pair of rulings, the Department has clarified the definition of what is and is not an appealable event for BPOL tax purposes.

In P.D. 18-211, the taxpayer received a decision from a locality that it was subject to the locality's BPOL tax, and attempted to appeal the decision to the Department. The Department found that the locality's decision was not an appealable event because "[n]o assessment was issued or increased, no refund has been denied, and the case did not involve a classification issue."

In P.D. 18-213, a locality partially allowed a deduction that the taxpayer had claimed on its returns and that the locality had previously fully denied as a result of the Virginia Supreme Court's decision in *Nielsen*. The taxpayer attempted to appeal the partial allowance of the deduction to the Department. The locality argued that the partial allowance was not an appealable event because it "was not an increase in the assessment of" BPOL tax, "the denial of a refund, or the assessment of [BPOL tax] where none was previously assessed." The Department agreed with the locality and found that the partial allowance of the deductions was not an appealable event.

2. BPOL Tax on Internet Access - P.D. 18-88 (May 16, 2018)

The Department ruled that the ITFA does not preempt imposition of a Virginia locality's BPOL tax because the BPOL tax was grandfathered. The Department found that, as a matter of fact, the locality was permitted to impose BPOL tax on gross receipts from Internet access under the grandfather clause because it submitted evidence that it collected BPOL tax on charges for internet access prior to October 1, 1998. Accordingly, the Department upheld a taxpayer's assessment for unreported gross receipts on gross receipts attributable to internet access services. The Department pointed to a recent Supreme Court of Virginia case, *Dulles Duty Free, LLC vs. County of Loudoun*, 294 Va. 9 (2017), as providing additional authority that BPOL tax was within the scope of ITFA. In *Dulles Duty Free*, the court rejected the county's argument that the BPOL tax was a tax on the privilege of doing business and was not the same as a tax on goods. The Department took the position that *Dulles Duty Free* indicates that Virginia courts may look more to the operation and effect of a tax rather than its state law characterization in determining whether it is preempted by a federal law.

Reed Smith's Observations

This ruling's reliance on the ITFA is interesting for two reasons. First, counties that did not impose tax on gross receipts from providing Internet access prior to October 1, 1998 (or that cannot establish that they imposed tax prior to that date) do not qualify for the grandfather clause, so cannot tax those receipts. Second, Congress has enacted a statute that eliminates ITFA's grandfather clause on June 30, 2020, so the county in this ruling and other similarly situated counties are no longer able to impose BPOL tax on gross receipts from providing Internet access.

3. Burden of Proof in BPOL Tax on Internet Access Administrative Appeals – P.D. 18-24 (March 14, 2018)

   In response to the taxpayer's request for reconsideration of P.D. 17-94, contending that the Department's determination failed to demonstrate that the City met its burden of proving it qualified for grandfather protection under ITFA, the Department ruled that the administrative appeals process does not require a Virginia locality to act as a party bearing the burden of proof. As such, the locality's BPOL tax assessment on internet access services stood.

   Reed Smith's Observations

   The locality's assessment stood on the basis that the locality's assessment is deemed prima facie correct. In other words, a locality's' claim that its BPOL tax was grandfathered was sufficient. Although the taxpayer presented cases from other states that stood for the proposition that the party asserting an exception to a federal statute bears the burden of proving the exception applies, the Department determined that the burden shifting caused by the ITFA is incompatible with Commonwealth's administrative appeals process. Thus, in order to prevail in one of these cases, a taxpayer will need to provide evidence that a locality does not qualify for grandfather protection under ITFA.

4. BPOL tax exemption for ancillary warehousing activities – P.D. 16-87 (May 19, 2016)

   The Department has provided additional guidance on when a taxpayer qualifies for the exemption for ancillary warehousing activities conducted at a manufacturing site. The taxpayer in the ruling had manufacturing facilities located outside of a city imposing the BPOL tax and a warehouse located in the city. Under Virginia law, ancillary warehousing activities conducted at a manufacturing site are exempt from the BPOL tax. The Department ruled that the taxpayer's warehousing activities were not ancillary because the taxpayer had salespeople who were based at the warehouse, even though the salespeople spent less than 5% of their time at the warehouse.

5. Method of apportioning BPOL tax base - P.D. 15-170 (August 18, 2015)

In this ruling, the Department followed up on the Virginia Supreme Court's decision in *Nielsen* and provided further guidance to taxpayers on how to apportion their BPOL tax base. The Department emphasized that taxpayers should apportion the base using "the best data available." It cautioned against using the income tax sales factor to apportion the BPOL tax base because the sales factor "may include goods shipped and services rendered from definite places of business in states other than the state in question"

Reed Smith's Observations

This ruling tells taxpayers what they cannot do. Unfortunately, it provides little insight into how taxpayers should actually go about apportioning their gross receipts for BPOL tax purposes.

IV. PROVIDERS' BRIEF BIOGRAPHIES

A. DeAndré Morrow

DeAndré is a member in the State Tax Group. He focuses his practice on Maryland, Virginia, and DC taxes. In 2017, The National Black Lawyers recognized DeAndré as a Top 40 Under 40 attorney.

DeAndré currently serves as Chair of the District of Columbia Bar Tax Section's State and Local Tax Committee and a Council Member of the Maryland State Bar Association's Taxation Law Section. His previous experience involves counselling clients on a full range of state and local tax matters including income, property, franchise, and sales and use taxes. Prior to going into private practice, DeAndré was a tax attorney for the Revenue Administration Division of the Comptroller of Maryland, where he was responsible for providing legal services to the legislative and executive branches of state government, and to attorneys, tax professionals and taxpayers requesting information or guidance on state tax revenue laws, regulations and policies.

Recent Publications

"Supreme Court of Virginia denies taxpayer's request for alternative apportionment"
Reed Smith Client Alerts; February 11, 2019
Co-Authors: Jeremy Abrams, Michael A. Jacobs, Michael I. Lurie

"Maryland adopts emergency economic nexus regulation"
Reed Smith Client Alerts; August 30, 2018
Co-Author: Jeremy Abrams

"Reed Smith's Relationships: An Interview with Peter Franchot, Comptroller of Maryland"
Bloomberg Tax; May 24, 2018
Co-Author: Jeremy Abrams

B. Michael I. Lurie

Michael has been a member of Reed Smith's State Tax Group since 2013. He currently focuses his practice on Pennsylvania, Virginia, and New Jersey taxes, and unclaimed property. He represents clients in state tax return position evaluation, audit defense, administrative appeals, and litigation.

Recent Publications

"Supreme Court of Virginia denies taxpayer's request for alternative apportionment"

Reed Smith Client Alerts; February 11, 2019
Co-Authors: Jeremy Abrams, Michael A. Jacobs, DeAndré R. Morrow

"Supreme Court to Consider Due Process Nexus"
Reed Smith Client Alerts, 11 January 2019
Co-Authors: Mike Shaikh, Megan Q. Miller

"They killed *Quill*. What's next?"
Reed Smith Client Alerts, 22 June, 2018
Co-Authors: Michael A. Jacobs, Jeremy Abrams, Jonathan E. Maddison

C. **Michael A. Jacobs**

Michael's practice runs the gamut from state corporate income tax assessment appeals and refund claims to state tax planning in connection with business and real estate transactions. Michael has represented dozens of clients in the administrative and judicial appeals of state income tax issues, with particular experience in Pennsylvania, Massachusetts, Michigan, Texas, and Virginia.

Recent Publications

"Ending Some State- and City-Level Opportunity Zone Tax Benefits in New York"
New York Law Journal, June 18, 2021
Co-Authors: Joseph M. Marger, Michael Meyers

"Massachusetts Supreme Judicial Court Allows Refunds of Sales Tax Paid on Software Used Outside Massachusetts"
Reed Smith Client Alerts, May 24, 2021
Co-Authors: Brent K. Beissel, Sebastian C. Watt

"Virginia to Study Mandatory Unitary Combined Reporting, Taxpayers May be Required to File Informational Reports as Early as June 1, 2021"
Reed Smith In-depth, March 22, 2021
Co-Authors: Edward A. Mullen, Jeffrey S. Palmore