VIRGINIA STATE TAX DEVELOPMENTS
Fall 2022

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TAXATION GENERALLY

Legislative Developments

2022 Legislative Session

Notices for Tax Assessments

HB 1083 requires the Virginia Department of Taxation (the "Department") to identify on bills for omitted tax assessments the date the initial tax return or payment was received by the Department, any payment amounts received from the taxpayer, and an explanation of the taxes, penalties, and interest related to such assessment.

INCOME/FRANCHISE TAXES

Legislative Developments

2022 Legislative Session

Business Interest Deduction

HB 1006 increases from 20 percent to 30 percent the Virginia individual and corporate income tax deduction for business interest disallowed as a deduction under § 163(j) of the Internal Revenue Code for taxable years beginning on and after January 1, 2022.

Qualified Pass-Through Entities Permitted to Pay an Elective Income Tax

HB 1121/SB 692 permit a qualifying pass-through entity to make an annual election in TYs 2021-2025 to pay an elective income tax of 5.75% at the entity level for the taxable period covered by the return. This legislation also creates a corresponding refundable income tax credit for TY 2021-2025 for any amount of income derived from a pass-through entity having Virginia taxable income if such pass-through entity makes such election and pays the elective income tax imposed at the entity level, and also allows an individual to claim a credit for similar taxes paid to other states for the same tax years.

Filing of Returns for Affiliated Corporations

HB 348 decreases from 20 to 12 years the time period for which an affiliated group of corporations must file on the same basis before it may apply to the Tax Commissioner for permission to change the basis of the type of return filed (i) from consolidated to separate or (ii) from separate or combined to consolidated.

Filing of Returns for Affiliated Corporations that Include a Bank

HB 224/SB 386 provides that an affiliated group of corporations may elect to change the basis of the type of return filed from combined to consolidated if: (1) the affiliated group of which they are members has filed on the same basis for at least the preceding 20 years; and (2) on or before January 1, 2022, at least one member of the affiliated group is a state or national bank that is exempt from filing a Virginia corporate tax income return because it is instead subject to the Virginia Bank Franchise Tax. This bill is effective for taxable years beginning on and after January 1, 2023, but before January 1, 2025.

Major Business Facility Job Tax Credit Sunset Date Extension

HB 269/SB 185 extends the sunset of the major business facility job tax credit from July 1, 2022, to July 1, 2025.

Market-Based Sourcing Allowed for Certain Property Information and Analytics Firms

HB 453/SB 346 allows property information and analytics firms that meet certain job creation and investment criteria to use market-based sourcing for receipts from the sale of services to compute their sales factor for apportionment purposes.

Rulings of the Tax Commissioner

Subtraction of Subpart F Income from S Corp – P.D. 22-97 (May 26, 2022)

The Commissioner determined that the Department properly disallowed a claimed subtraction for deferred foreign income by a nonresident with an ownership interest in an S corporation with state taxable income during the 2017 tax year, finding that the income was included in the taxpayer's federal adjusted gross income under the Tax Cuts and Jobs Act and that Virginia law does not provide a subtraction from the individual income tax for subpart F income.

TRANSACTIONAL TAXES

Legislative Developments

Exemption for Internet-Related Equipment

HB 1155/SB 683 expands the sales tax exemption for amplification, transmission, and distribution equipment used to provide Internet services to include network equipment used to provide Internet service, regardless of whether the provider of such service is also a telephone common carrier or whether such network is also used to provide services other than Internet services.

Exemption for Certain Solar Farms

HB 1087/SB 502 expands the current local property tax exemption for pollution control equipment and facilities relevant to solar photovoltaic projects, i.e., solar farms, to include all projects with a generating capacity of five megawatts or less.

2021 Legislative Session

Biennial Report on Data Center Sales and Use Tax Exemption

HB 2273/SB 1423 instructed the Department and the Virginia Economic Development Partnership Authority to submit a biennial report to the Virginia General Assembly on the sales and use tax exemption for data centers, including aggregate information on qualifying expenses claimed under this exemption, the total value of the tax benefit, a return on investment analysis that includes direct and indirect jobs created by data center investment, state and local tax revenues generated, and any other relevant information appropriate to demonstrate the costs and benefits of the exemption.

This report is due to the Virginia General Assembly by October 1, 2022.

Judicial Developments

1. Situs of Sales of Ready-Mix Concrete

Mechanicsville Concrete LLC v. Virginia Department of Taxation (Richmond City Circuit Case No. CL20-2971)

This case involves the situsing of sales by a taxpayer that delivers tangible personal property from a permanent place of business in a locality that imposes local sales tax to other locations that do not impose local sales tax. The taxpayer sold ready-mix concrete, and took the position that the situs for these sales was the location where the concrete mixer reached its destination; according to the taxpayer, the concrete was not ready for sale until delivery. The Department's position was that the sale must be sitused to the taxpayer's permanent place of business, because that was where the order for the concrete was first taken.

The circuit court had granted summary judgment in favor of the Department, holding that the situs for sales of ready-mix concrete is the location where the order is taken rather than the location of delivery. The taxpayer filed an appeal to the Virginia Supreme Court, which was denied.

Rulings of the Tax Commissioner

Business Taxed On Purchased Materials Deemed to Be Inconsequential to their Provided Services – P.D. 22-95 (May 11, 2022)

In this case, the taxpayer provided industrial saw blade sharpening services and, in some cases, used a metal alloy and plastic in their sharpening process. The taxpayer had not paid a sales or use tax when purchasing either the metal alloy or the plastic. The taxpayer was assessed use tax on the purchases of these materials following an audit by the Department. The taxpayer appealed, asserting that the materials were not taxable supplies used in its business.

Under Virginia's sales and use tax statutes, tax does not apply to certain service transactions, including "professional,… or personal service transaction which involve sales as inconsequential elements for which no separate charges are made" and "services rendered by repairmen for which a separate charge is made.

The Commissioner ruled that the materials were not consequential to the service provided and that there was no separate charge for the materials to the customer. As a result, the taxpayer was the ultimate consumer of the materials and was required to pay the tax, unless it was passed on to customers.

Wireless Boosters Deemed Not to Be Real Property – P.D. 22-88 (May 5, 2022)

This ruling holds that bidirectional amplifiers installed in buildings by a Virginia wireless communications company to boost wireless signals are personal property, because they may be removed from the buildings in which they are installed and are not attached to buildings to carry out the purposes for which the buildings were constructed.

Bulk Purchase of Durable Medical Equipment and Prosthetic Devices By Surgery Center Not Exempt From Sales and Use Tax – P.D. 22-70 (April 13, 2022)

A Virginia ambulatory and surgery center's purchases of durable medical equipment and prosthetic devices were deemed to be taxable by the Commissioner. Virginia exempts the purchase of certain durable medical equipment and prosthetic devices from the state's sales and use taxes. However, these items were not purchased with the intention of being bought by a specific individual. Additionally, there was no consideration of individual patients when these items were taken out of inventory.

Note that nonprofit hospitals and licensed nonprofit nursing homes are exempt from retail sales and use taxes for items bought in bulk. However, the taxpayer in this instance did not meet the requirements to be considered a nonprofit hospital or nursing home.

Information Available May Be Used to Calculate Taxpayer Sales and Use Tax Liability if Taxpayer Fails to Keep Adequate Records – P.D. 22-59 (April 5, 2022)

The Commissioner ruled that sales tax was correctly assessed against a cabinet wholesaler by using the wholesaler's profit and loss statement as a method to determine liability. The method used by the auditor was approved to estimate sales tax liability because the wholesaler failed to maintain adequate records. If adequate records are not available, the department is allowed to use the information available in order to calculate the liability of the taxpayer.

Virginia Sales Tax Applies to Transformer Installations – P.D. 22-48 (March 22, 2022)

The Commissioner ruled that a utility company providing electric services to Virginia residents must collect sales tax on the

installation of a transformer. It was ruled that the real transaction is the procurement of the transformer, the installation and reassembly fee for the transformer would be subject to tax when separately stated on the invoice. The installation and reassembly wouldn't be of value unless the customer was also buying the transformer, so the services are subject to tax. It was noted that transportation charges separately stated on an invoice would not be subject to tax.

Applicability of Sales and Use Tax and the "True Object" Test – P.D. 21-157 (December 29, 2021)

The Commissioner issued a ruling explaining that a mural painted on three separate canvasses and installed into the subframe of a refurbished train station would be subject to retail sales and use tax because according to the "true object" test, the mural would be of no value to the train station without the transfer of the canvasses. The "true object" test states that if an object of the transaction is to secure service and the tangible personal property which is transferred to the customer is not critical to the transaction, then the transaction may constitute an exempt service. However, if the object of the property is to secure the property which it produces, then the entire charge, including the charge for any services provided, is taxable.

LOCAL TAXES

Legislative Developments

County Assessment Cycles

HB 951/SB 77 authorizes counties to reassess real estate every three years if determined by a majority vote of the county's board of supervisors.

Challenging Local Tax Assessments

HB 226 changes the procedures for taxpayer appeals of local tax assessments to the circuit court. It clarifies provisions regarding the necessary parties, the proper form of naming the locality in the

pleadings, and allowances for rebutting the presumption of correction accorded to the locality's assessment.

Data Center Fixtures

HB 791/SB 513 provides that if a locality taxes certain fixtures located in a data center as real property, the fixtures will be valued based on depreciated reproduction or replacement cost.

Land Use Assessment for Multiple Owners

HB 996 allows the owner of a majority interest in an undivided parcel of real estate that is eligible for land use assessment to file an application on behalf of himself and for owners of any minority interest.

Prohibition of License Tax on Bank Director

HB 1084/SB 385 prohibits a locality from imposing a license tax on a director of a bank or trust company that is subject to the bank franchise tax.

Sale for Delinquent Taxes

HB 298/SB 142 authorizes localities to have a special commissioner appointed to convey certain real estate having delinquent taxes or liens to the locality's land bank entity or to an existing nonprofit entity designated by the locality to carry out the functions of a land bank entity.

Vehicle Classification

HB 1239/SB 771 authorizes localities to create a new class of tangible personal property for rate purposes. This new class includes most automobiles, passenger trucks, motor vehicles with specially designed equipment for use by the handicapped, motorcycles, mopeds, all-terrain vehicles, and off- road motorcycles, campers, and other recreational vehicles. Localities may assign a rate of tax or rate of assessment to this class different from the rate applicable to the general class of tangible personal property. This legislation is effective for taxable years beginning on or after January 1, 2022, but before January 1, 2025.

Judicial Developments

1. Preemption of BPOL Tax on the Sale of Internet Services

Coxcom v. Fairfax Cnty., 875 S.E.2d 75 (Va. 2022)

In this case, the Court ruled that federal law preempted Virginia's largest jurisdiction from imposing its local gross receipts tax on Cox Communications for the sale of internet access services. It was remanded back to the trial court to determine the amount of refund owed to Cox for BPOL license taxes for TYs 2013-2015.

The Internet Tax Freedom Act (ITFA) bars state and local governments from imposing "taxes on internet access." However, IFTA included a grandfather clause for existing taxes. The grandfather clause allowed the continued levy of existing Internet access taxes if: the tax was authorized by statute; and either the provider of the Internet access services had a reasonable opportunity to know, by virtue of a rule or proclamation made by the relevant state or local administrative agency, that the agency had interpreted and applied the tax or the state or localities were generally collecting those taxes.

The City of Fairfax adopted a BPOL ordinance in 1994. The ordinance provided that "business service occupations," including online computer services and computer time share services, would be subject to the BPOL tax. The County's tax was implemented during a time when AOL was headquartered in Fairfax and may have been seen as a ripe source for local revenue. After the BPOL tax was implemented, AOL paid the tax and those proceeds were classified as "online service revenue."

Years later, Cox filed for a BPOL tax refund, asserting that ITFA preempted the tax. Cox further asserted that the BPOL tax did not qualify for ITFA's grandfather clause because, prior to October 1, 1998, Cox had no reasonable opportunity to know that the tax was applicable to them. The County's Department of Tax Administration denied Cox's request for a refund

The refund denial was then appealed to the Fairfax Circuit Court, which held that the BPOL tax was indeed a tax on internet services, but that it qualified for ITFA's grandfather clause exemption. The circuit court reasoned that the ordinance's language relevant to "online computer services" and "computer time share services" gave Internet service providers a reasonable opportunity to know that the tax was applicable. Cox appealed that ruling to the Supreme Court of Virginia.

The Court first confirmed that ITFA applied to Fairfax's BPOL tax, but used a different rationale than the lower court. It held that the definitions in the federal statute, rather than state case law, were

controlling because the tax moratorium was imposed by federal statute. The Court explained that the application of relevant federal definitions led to the same conclusion as the lower court.

The Court then held that the BPOL tax did not fall within ITFA's grandfather clause. First, ITFA's grandfather clause applies only if the Internet provider had a reasonable opportunity to know about the tax, which must be accomplished through a rule or other public proclamation made by the appropriate administrative agency that the tax applies to Internet access services.

The Court held that Fairfax failed to satisfy these requirements, because the appropriate administrative agency never provided a reasonable opportunity for Cox to know about the tax. Also, the Court emphasized that mere publication of the ordinance is not the same as a proclamation clarifying the meaning of the ordinance.

In conclusion, the Court held that ITFA prohibited the Fairfax BPOL tax from being imposed on gross receipts generated from the provision of Internet services. The case was remanded to the lower court for a determination of the refund due to Cox.

Please note that the scope of this case is relatively narrow. The interplay between ITFA and Fairfax's BPOL tax limits the applicability of the holding to companies that provide internet services and localities with relevant statutes introduced before 1998.

Reed Smith's Observation

ITFA was initially enacted in 1998 as a temporary moratorium on taxing Internet access. It was implemented at a time when the Internet was a relatively new service with incredible potential, but was prevalent enough to catch the eye of legislators and regulators. At the time of ITFA's enactment, six states were already taxing Internet access services, along with some localities, and there were concerns that these taxes would prohibit the growth of the Internet. ITFA was a protective measure in response to these taxes. Policymakers chose to provide a carve-out for those states and localities that were early to tax Internet services through that grandfather provision.

ITFA was renewed eight separate times before it was made permanent in 2015. In 2020, Congress repealed ITFA's grandfather provision to prevent any tax on Internet access, nullifying those taxes implemented before the enactment of ITFA. As a result, the

impacted state and local governments lost a revenue stream while impacted Internet service providers received a benefit.

Interestingly, the elimination of the grandfather clause means that the holding in *Coxcom* will only be relevant to returns up to FY 2020, because taxes on Internet services will be prohibited as of June 30, 2020.

2. Local Income Tax Inapplicable to Certain Business Activities That Do Not Provide a Service

City of Charlottesville v. Regulus Books, LLC, 873 S.E.2d 81 (Va. 2022)

In this case, the Virginia Supreme Court analyzed whether a business service, in this case freelance writing, was a "service" as defined by a local BPOL tax. The Court also contemplated whether a broad catchall provision included in the ordinance language was sufficient to allow for the assessment of the BPOL tax.

The taxpayer in this case is Regulus Books, which is solely owned by a freelance writer who generates income from entering into contracts with grant publishers for licenses to produce, publish, distribute, and sell some of his works.

In 2018, the taxpayer filed an income tax return that indicated he derived business income in the City of Charlottesville, Virginia. This led to the City discovering that the taxpayer did not have a business license and was not paying the associated BPOL tax, which was required for "those engaging in a business, trade, profession, occupation, or calling" in the City.

When the City inquired about the Regulus Books' income, the taxpayer asserted that the BPOL tax was not applicable because Regulus Books was not statutorily required to be licensed. The City argued that Regulus Books fell into the ordinance's catchall provision as "any other… business service." There was no dispute that Regulus was conducting a business, but there was disagreement about whether the licensure and tax language was applicable. This dispute eventually made its way to the courts.

The lower court found in favor of Regulus Books on the following grounds: the City's BPOL ordinance was unconstitutionally vague; the production of books does not constitute the provision of a service; and that Regulus' business activities did not fall into the

catchall provision. The City appealed the case to the Supreme Court of Virginia.

The Court upheld the decision of the lower court, holding that Regulus Books did not provide a service that would be subject to the BPOL tax. The Court relied on the City's definition of "service," along with the definitions in Black's Law Dictionary and Webster's Dictionary. The Court held that the definition of "service" as set forth in the dictionaries did not capture the business activities of Regulus Books. Therefore, Regulus Books was not subject to the BPOL tax.

Reed Smith's Observation

This opinion highlights the basic rule that an undefined term in a statute or ordinance generally only encompasses its ordinary meaning. In this case, the Virginia Supreme Court declined to construe the meaning of a "service" beyond its ordinary meaning, and rejected the municipality's argument that the BPOL was intended to apply to nearly all business receipts.

Although Virginia Supreme Court's decision in *Regulus Books* only addresses freelance writing, its logic suggests that some offerings that do not involve the provision of personal services--such as remote access to software or licensing of intellectual property—may not fall within the BPOL. Businesses with operations in Virginia may want to evaluate whether their offerings are within the scope of the the BPOL

Based on *Regulus Books*, some taxpayers may find that their offerings are not subject to their local BPOL tax.

Rulings of the Tax Commissioner

Situs of Gross Receipts Using Payroll Apportionment to Claim an Out-of-State Deduction – P.D. 22-66 (April 5, 2022)

The Commissioner ruled that a taxpayer business was eligible to apportion its gross receipts using a payroll method after a locality denied the business' refund request. The taxpayer business was a provider of professional and information technology services. The taxpayer sought a refund of BPOL taxes paid to a Virginia county for TYs 2013-2016. That refund was based on changing the situs of the gross receipts to the county by using payroll apportionment and claiming an out-of-state deduction.

After the refund was denied and later appealed, the county rules that the original method of establishing situs for gross receipts was in

accordance with general statutory methods and the taxpayer had not provided sufficient information to substantiate the out-of-state deduction. The taxpayer appealed that decision to the Department, arguing that its cost tracking system didn't accurately establish situs for gross receipts and that it wasn't otherwise possible to establish situs for the receipts using general methods and that the out-of-state deduction should be computed using the payroll apportionment method.

The Commissioner determined that the business was eligible to apportion its gross receipts using a payroll-based method. The case was then returned to the local taxing authority to determe whether the business should be allowed to claim an out-of-state deduction when applying payroll apportionment.

PROVIDERS' BRIEF BIOGRAPHIES/RESUMES

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Mike is a member of Reed Smith's state and local tax practice. He takes pride in helping his clients navigate the complexities of the state tax and unclaimed property landscape, with a focus on high-stakes and novel controversies. Mike represents clients at all points in the state tax lifecycle, starting with return position evaluation, planning, audit defense, administrative appeals, and proceeding through litigation. Mike's multistate practice spans the country, with a concentration on Pennsylvania, New Jersey, Virginia, and Hawaii and on issues that impact banks and retailers. Mike has also represented taxpayers in controversies in Delaware, Louisiana, Massachusetts, Ohio, Rhode Island, Tennessee, Texas, and Wisconsin.

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