How Assessors Can Respond and Make Assessment Decisions In Light of the *Nielsen* Case and Existing Guidance from the Department of Taxation

By

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Two Main Issues

- When the deduction is allowed, how is it to be calculated?

1. Strictly follow the instructions contained in the Tax Commissioner's Rulings

   or

2. Follow a modified method that actually makes more sense and utilizes information that is readily available to taxpayers and assessors.

- What is the threshold for allowing the deduction in the first place?

Key Points In Determining How To Measure the Deduction

- The Supreme Court in *Nielsen* did not endorse or mandate any particular method for calculating the deduction. The Court merely decided that in the absence of a legislatively mandated method to calculate it, the Tax Commissioner could mandate a method.

- No parties in the *Nielsen* case (or a similar case in the City of Hampton) has ever advocated or utilized the Tax Commissioner's method *<u>as illustrated</u>* in the Department of Taxation's rulings.

- There are logical flaws in the method outlined in PD14-29 that can only be addressed by modifying the formula.

Key Distinction

- Apportionment refers to where gross receipts are earned.
- The 3732(B)(2) deduction is based on where the business is conducted – which is usually defined as where the customers are located (PD 05-01). Often customers are located in places with no definite place of business.
- The two are actually not always related. Customers may or may not live in states with offices and payroll.

Procedural History Leading to "the formula"

- Key References:
  - Statute: Code of Virginia §58.1-3732(B)(2)

    § 58.1-3732. Exclusions and deductions from "gross receipts."

    B. The following shall be deducted from gross receipts or gross purchases that would otherwise be taxable.

    2. Any receipts attributable to business conducted in another state or foreign country in which the taxpayer (or its shareholders, partners or members in lieu of the taxpayer) is liable for an income or other tax based upon income.

Procedural History Continued

- Virginia Administrative Code: 23VAC10-500-80 contains the only regulatory illustration of the statute.

- Prior Tax Commissioner Rulings:
  - Allusions to the fact that taxpayers can take a deduction for gross receipts attributable to business conducted in other states even when the taxpayer uses payroll apportionment. (But no explanation about how to calculate the deduction) (PD 04-80 and PD 05-18).

  - Taxpayers can take a deduction for business conducted in states where the taxpayer has no definite place of business. (PD 05-01).

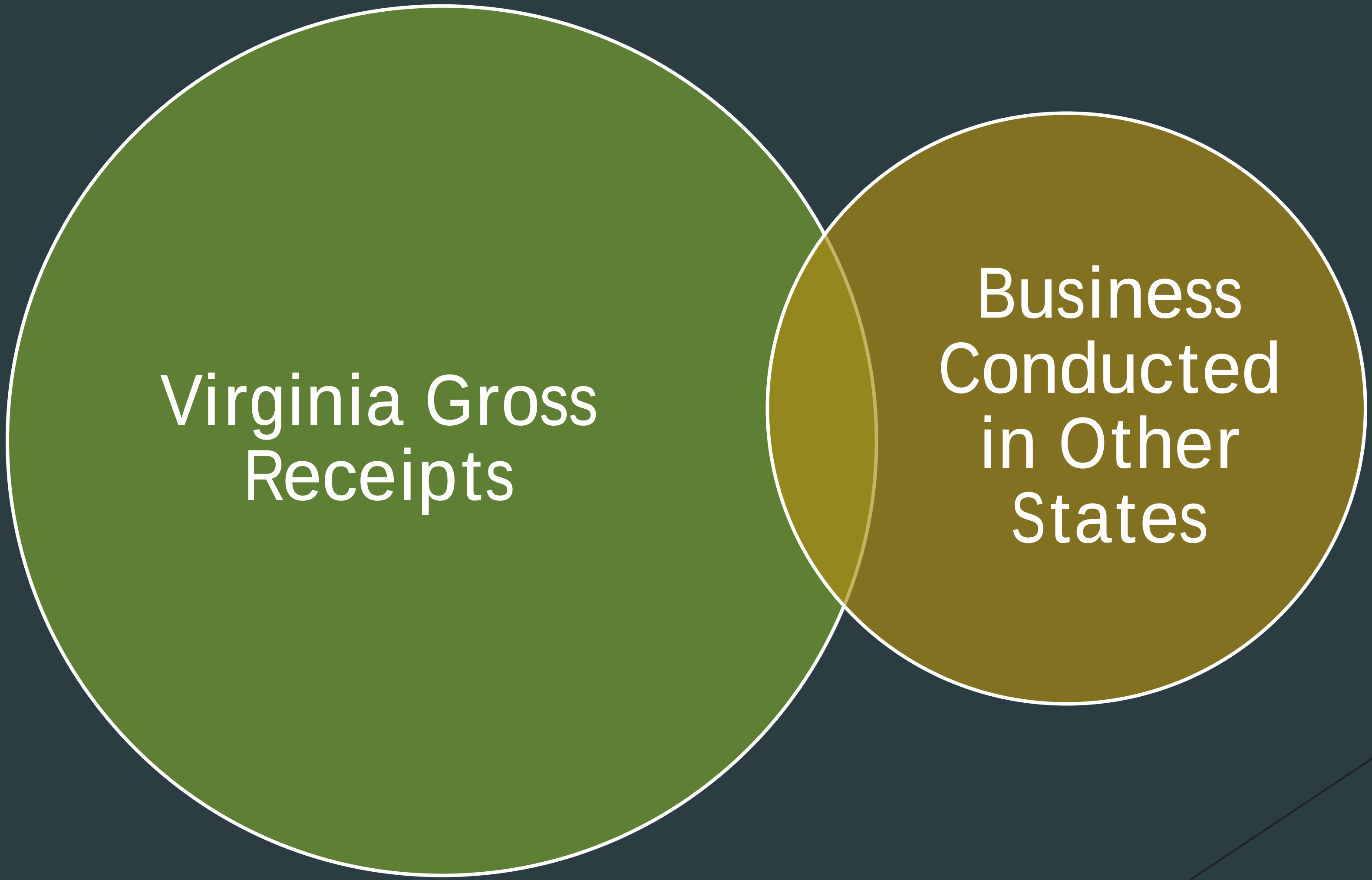
Traditional Requirements to Take the Deduction

- Receipts can only be deducted for business conducted in states where the taxpayer is subject to an income (or income like) tax and actually files a tax return.

  And

- The receipts to be deducted must first have been subject to Virginia taxation and earned by Virginia definite places of business.

Only The Area of Overlap Is Deductible

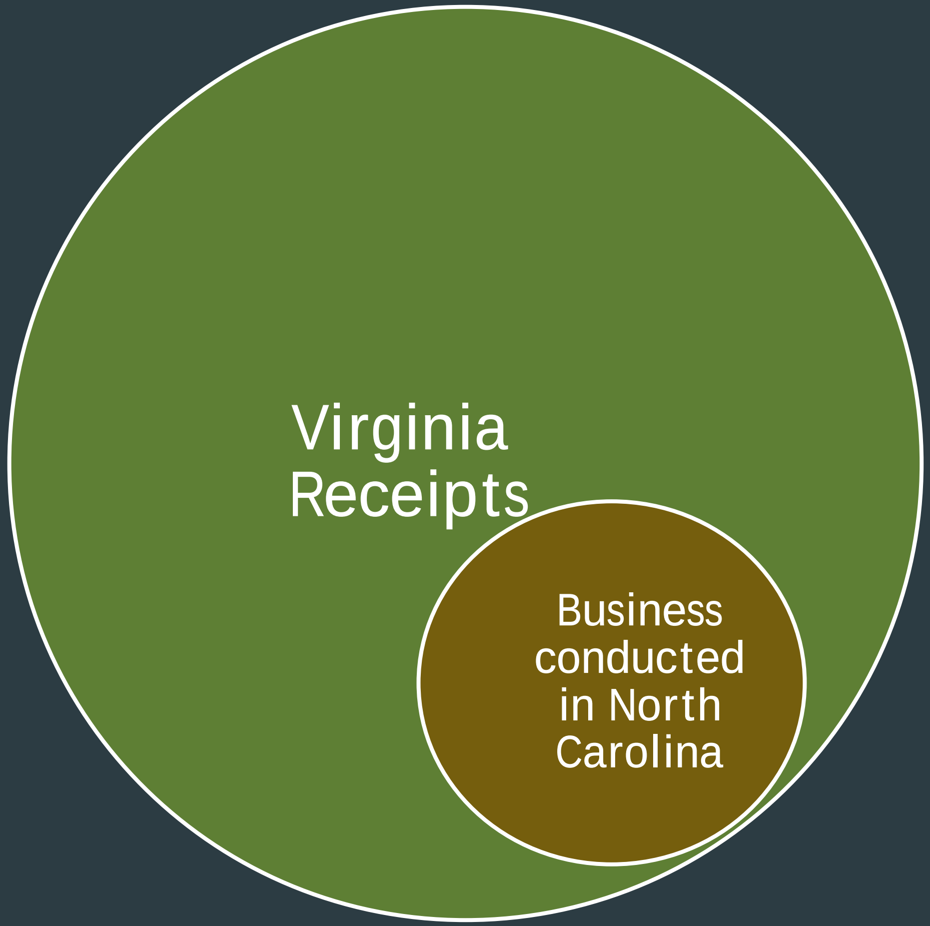


Green = Gross Receipts Assigned to Virginia

Brown = Business conducted in other states

Overlap (business conducted in other states but earned in Virginia) is deductible.

Deduction Example from the Virginia Administrative Code. Company with One office in Virginia but business in another state. Virginia Administrative Code: 23VAC10-500-80 (illustration)

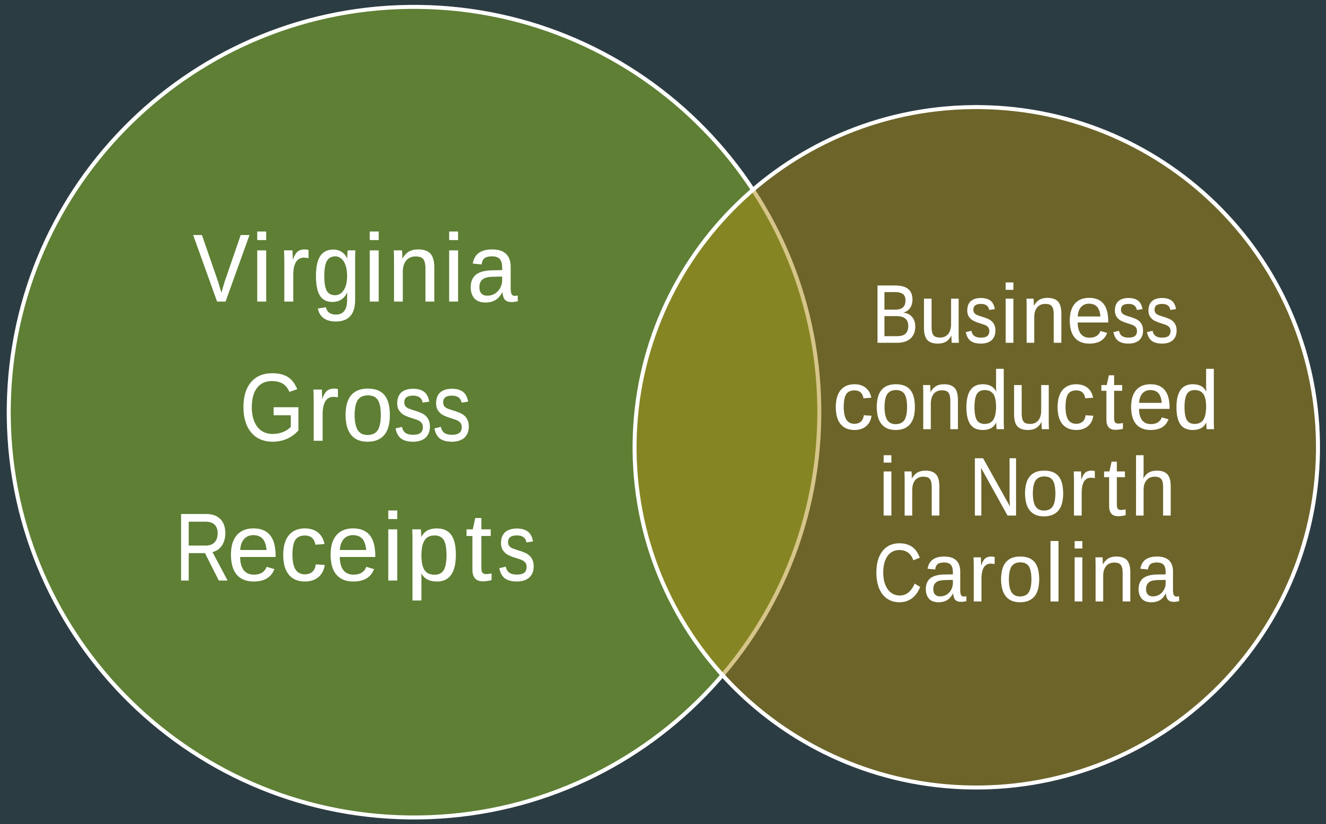


Green = Gross Receipts Assigned to Virginia

Brown = Business conducted in other states

Overlap (100%) is deductible.

Another Deduction Scenario. Company with offices in both Virginia and North Carolina.

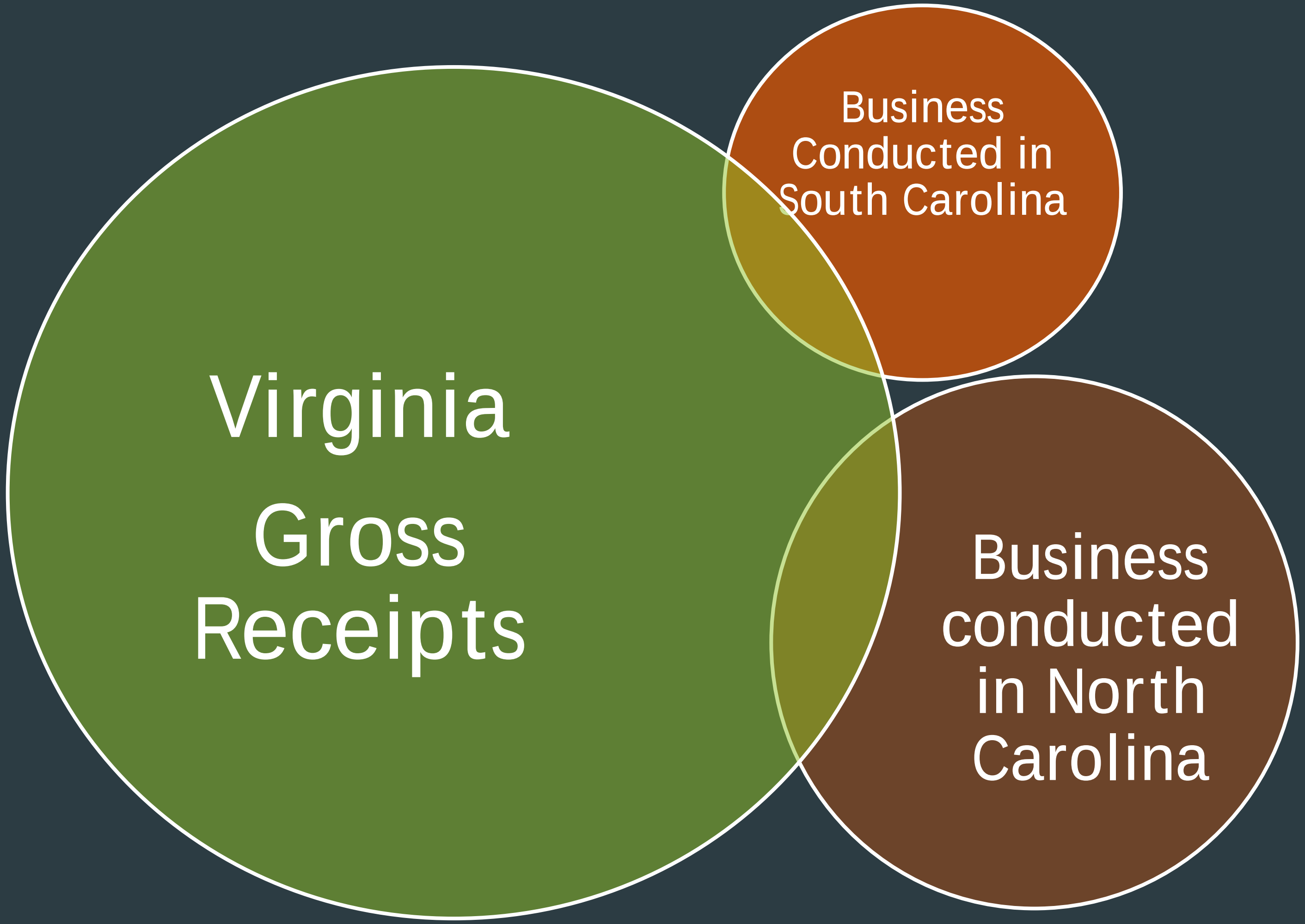


Green = Gross Receipts Assigned to Virginia

Brown = Business conducted in other state.

Overlap only is deductible.

Deduction Example. Offices in VA and NC. No office in SC but business conducted there.

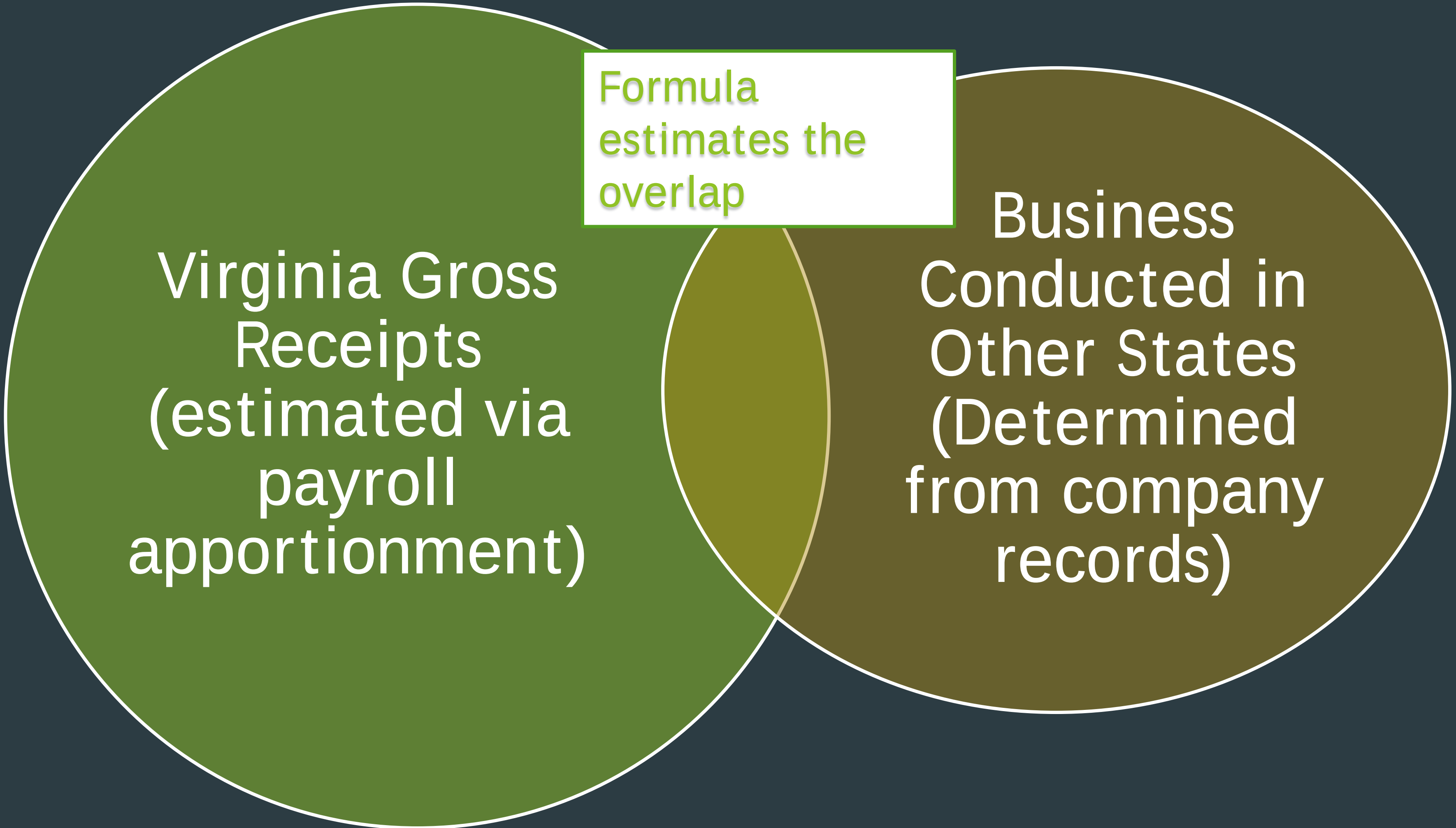


Green = Gross Receipts Assigned to Virginia

Brown and Rust = Business conducted in other states

Overlaps only are deductible.

Taxpayers DO know How Much Business they conduct in other states but not always which office *earned* that business. The Tax Commissioner's formula is used to estimate the second variable.



The Ruling Trail to "The Formula"

- PD 09- 56 - The Tax Commissioner basically upheld Arlington County's audit that denied the deduction but left the window open for the company to prove entitlement to a deduction.
- Company asked for rehearing instead of presenting evidence about deduction.
- In the Fall of 2010 in PD 10-229 (and 10-228, a parallel case from the City of Hampton) the Department determined that the company need only show that it had made some effort toward earning gross receipts in a given state. Once that threshold was met a new formula was decreed for determining how much of the gross receipts would be deductible.

After PDs 10-228 and 10-229
Arlington and Hampton Attempt to Comply based on this language in the rulings:

- "*the burden of proof is upon the taxpayer to demonstrate that the* [original payroll apportionment] *formula <u>assigns less than the full value</u> of the receipts in other states or foreign countries for which it is entitled a deduction. If a taxpayer can demonstrate <u>a difference between the two</u>, it is entitled to <u>deduct the difference</u> from its taxable gross receipts in the County.*"

- Commissioners issued revised assessments that allowed additional deductions ONLY when the business conducted in a state exceeded the amount of gross receipts already assigned to that state (and removed from Virginia taxation.)

Companies and Localities Had Similar Approaches

- Without going into detail, the Arlington and Hampton Commissioners of Revenue attempted to give meaning to the language "*assigns less than the full value of the receipts in other states*" and "*If a taxpayer can demonstrate a difference between the two, it is entitled to deduct the difference*" by limiting the deduction determined by formula to any "excess" receipts that had not already been excluded from Virginia taxation. This was subsequently disallowed by the Tax Commissioner
- BUT, ***importantly,*** the localities and the companies involved did not differ in one important aspect. The starting point for determining the Virginia deduction should be the business ***actually*** conducted in other states. All parties understood that this is an easily ascertainable figure.

The Unnoticed Change in Tax Commissioner's Wording

PDs 10-228 and 10-229 (first instruction on "the formula"):

- *"the amount of any deduction would be determined by multiplying* ***the total out-of-state tax receipts*** *by the same payroll factor used to determine situs of gross receipts."*

- **PDs 12-88 and 12-89 and 12 -146 (affirming "the formula" and disavowing the revised assessments in Hampton and Arlington):**

- *"the payroll factor used for the Virginia definite place of business would be applied to* ***the gross receipts assigned to definite places of business*** *in states in which the taxpayer filed an income tax return."*

The VA. Supreme Court Did NOT Address "The Formula" In Detail.

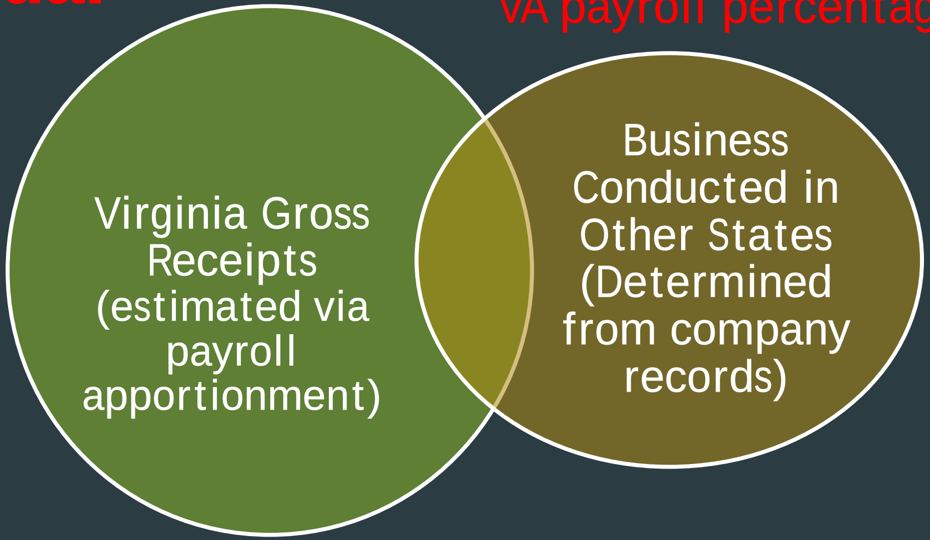
The Virginia Supreme Court Decision in *County Board of Arlington County, Virginia, et al v. The Nielsen Company (US), LLC:*

- When the legislature grants a deduction but does not say how to measure it, it is within the power of the Tax Commissioner to mandate how to measure it.
- The Court did not endorse any particular method. It merely said the Tax Commissioner can require a method.
- The Tax Commissioner can modify or alter his mandate. The Court did not really address the merits of the Tax Commissioner's PDs other than to say they were not beyond his authority.
- There was no illustration of how to apply the formula.

Post Nielsen Locality Responses

- Arlington and Hampton settle their court cases with agreed orders that utilize the actual amount of business conduced in states to measure the deduction. (Deduction = business conducted X Virginia payroll percentage.)
- VA. Gross Receipts derived from payroll apportioinment
- Business conducted derived from **actual** company records.
- “Overlap” was ***estimated*** using VA payroll percentage.

Overlap Estimated using VA payroll percentage



The Two Ways to Calculate The Deduction Illustrated – Example 1

States	Gross Receipts Based on Payroll	Reported Business conducted by the Company	Strict Tax Commissioner Method	Modified Method Using Actual Business Numbers
California 45%	**$45,000,000.00**	**$ 38,554,079.00**	**$11,250,000.00**	**$9,638,519.75**
Connecticut 30%	**$30,000,000.00**	**$ 21,388,076.00**	**$7,500,000.00**	**$5,347,019.00**
States with Tax Return and No Office 0%	**No Def Pl of Bus**	**$ 3,194,294.00**		**$798,573.50**
Virginia 25%	**$25,000,000.00**	**$ 30,000,000.00**		
States with no tax returns		**$ 6,863,551.00**		
Totals	**$100,000,000.00**	**$ 100,000,000.00**	**$18,750,000.00**	**$15,784,112.25**
Taxable Receipts			**$6,250,000.00**	**$9,215,887.75**

The Two Ways to Calculate The Deduction Illustrated –Example 2

States	Gross Receipts Based on Payroll	Reported Business conducted by the Company	Strict Tax Commissioner Method	Modified Method Using Actual Business Numbers
California 45%	**$45,000,000.00**	**$ 8,554,079.00**	**$11,250,000.00**	**$2,138,519.75**
Connecticut 30%	**$30,000,000.00**	**$ 1,388,076.00**	**$7,500,000.00**	**$347,019.00**
States Tax Return and No Office 0%	**No Def Pl of Bus**	**$ 71,194,294.00**	**-**	**$17,798,573.50**
Virginia 25%	**$25,000,000.00**	**$ 15,000,000.00**		
States with no tax returns		**$ 3,863,551.00**		
Totals	**$100,000,000.00**	**$ 100,000,000.00**	**$18,750,000.00**	**$20,284,112.25**
Taxable Receipts			**$6,250,000.00**	**$4,715,887.75**

The Current Question (How to calculate the deduction)

Locality and Company Way

VA Payroll Percentage X Actual Business Conducted

Tax Commissioner Illustration in PDs

VA Payroll Percentage X Amount Apportioned by Payroll

Attempts to get Clarification For Going Forward

- On January 30, 2015 Arlington Commissioner of Revenue Ingrid H. Morroy formally requested an advisory opinion as to how to proceed and whether using the actual amount of gross receipts attributable to business conducted in other states is an acceptable method to determine the deduction. No response as of late July, 2015

- On June 15, 2015 Isle of Wight Commissioner of Revenue Gerald Gwaltney also requested clarification of the formula. Commissioner Gwaltney has been assured of a speedy response from the Department of Taxation. But as of late July 2015 no response has been received.

Example from Commissioner Gwaltney's Letter

- A company has 1,000,000 in total Gross Receipts
- With two offices – Virginia and Georgia, 50% payroll in each state
  - $500,000 gross receipts assigned to Virginia, $500,000 to Georgia
- Company files income tax in Georgia.
- 90% of company business is actually conducted in states other than Virginia or Georgia where the company also files income tax returns. (Only 10% is conducted in those two states.)
- $500,000 (Georgia apportioned amount) x 50% (Va. Payroll percentage) = $250,000 deduction.
- Virginia localities would be able to tax $250,000 (25% of total gross receipts) even though 90% of the company's business was conducted in neither Virginia nor Georgia.

Commissioner Gwaltney's Example Illustrated

States	Gross Receipts Based on Payroll	Reported Business conducted by the Company	Strict Tax Commissioner Method	Modified Method Using Actual Business Numbers
Virginia 50%	**$ 500,000.00**	**$ 50,000.00**		
Georgia 50%	**$ 500,000.00**	**$ 50,000.00**	**$ 250,000.00**	**$ 25,000.00**
States With Tax Return - No Office 0%		**$ 900,000.00**	**$ -**	**$ 450,000.00**
Totals		**$ 1,000,000.00**	**$ 250,000.00**	**$ 475,000.00**
Taxable Receipts			**$ 250,000.00**	**$ 25,000.00**

Which Way To Calculate: Why It Matters

- Formulas such as payroll apportionment should only be used when it is "impossible or impractical" to derive an amount directly. But it is almost always possible for a company to know where its customers are located.

- Using the Tax Commissioner formula exactly as outlined conflicts with prior rulings that a company can take a deduction for business conducted in states where there is no office. The formula does not account for that possibility.

- The formula as outlined in PD 14-29 will "cheat" a company that conducts a lot of business out of state but does not have a lot of out of state payroll.

Why It Matters - Continued

- The formula in 14 -29 can vastly overestimate the deduction for a company with substantial payroll out of state if the company’s customers aren’t also in the states with payroll.
- The swings between such extremes are totally unnecessary since it is very possible to identify exactly the amount of gross receipts to which to apply the Virginia payroll percentage.
- The formula actually makes more sense if applied to the actual amount of business conducted instead of to the amount initially apportioned. In that case, only the percent of the out of state business originally generated in Virginia is estimated. *The rest of the formula is based on known and auditable factors.*

Option One: Apply 14 -29 Strictly

- Apply the formula strictly as outlined in Tax Commissioner's rulings. The entails ignoring previous Tax Commissioner Rulings (PD 05-01) that a company can take a deduction for business conducted in a state without a definite place of business. It also means ignoring the actual amount of business company records show as having been conducted in the various states in favor of a flat calculation.

- The formula is **Deduction =** Virginia payroll percentage x the amount of gross receipts assigned by payroll apportionment to states where an income tax return is filed**.** No provision is made for business conducted in states without a definite place of business.

Option Two: Apply The VA. Payroll Percentage to the Known Amount of Business Conducted in Other States

- Apply the Virginia payroll percentage to the actual amount of business shown by company records to have been conducted in states where a tax return is filed. This does not strictly follow the illustrated formula in PD 14-29 but it does follow what is known and easily auditable and it has a logical basis.

- The Formula is **Deduction = Actual Amount of Business Conducted In State Where a Tax Return is Filed x Virginia Payroll Percentage**

Arlington's Position

Since the Supreme Court did not endorse a particular formula (or mandate its use), and since the Tax Commissioner has never answered the question as to whether the second approach is or is not acceptable, Arlington has chosen to utilize the second option. This is not intended as defiance of the Tax Commissioner. Indeed, if the Department orders localities to strictly adhere to the formula as outlined in PD 14-29 we will do so. But so long as the rationale for not using actual sales figures is unexplained, and the alternate formula not proscribed, it is our opinion that option two more consistently estimates the deduction

Don’t Forget That There Is Still An Important Threshold Question (that might save having to choose a formula at all.)

- Although Tax Commissioner seems to have abandoned the connection between Virginia efforts to earn deductible receipts (PD 14-29: *“it is not necessary for a business to demonstrate that income earned by the Virginia definite place of business or any of its transactions are included in the taxable income shown on the return filed with any other state, or caused the corporation to be subject to tax in any other state”),* the Courts have not.
- A threshold question remains – Did the Virginia office in some way contribute to earning receipts attributable to business conducted in other states?

Assessors Must Now Contend With Shifting Interpretations of the Law from the Tax Commissioner

- PD 09-56 (2009): *"the deduction is allowed to the extent that the receipts to be deducted were assigned to a Virginia office in the first step* [payroll apportionment]*."*

- PD 14-29 (2014): *"it is not necessary for a business to demonstrate that income earned by the Virginia definite place of business or any of its transactions are included in the taxable income shown on the return filed with any other state, or caused the corporation to be subject to tax in any other state."*

View From the Circuit Court of Chesterfield County

In a letter opinion dated June 19, 2015 the Honorable Stephen McCallum ruled that *Nielsen* did not dispense with the requirement to show a connection between Virginia efforts and receipts to be deducted. In his view *Nielsen* merely dealt with the way to measure the deduction if the entitlement to a deduction is proven. *Nielsen* did not create a right to the deduction if some connection between Virginia efforts to earn the receipts taxed elsewhere is not found (Ford Motor Credit Company v. Chesterfield County, CL07-418, Chesterfield Circuit Court, letter opinion dated June 19, 2015.)

No Virginia Connection = No Deduction

Companies may argue that merely using payroll apportionment and paying income tax in other states entitles them to utilize the formula to estimate their deduction. But, notwithstanding the loose language in PD 14-29, it remains good law (according to the Chesterfield County Circuit Court) that some Virginia effort toward earning gross receipts in *each of the states* from which deductions are sought is necessary. The Circuit Court judge found that the company had conceded that "it is unable to trace any specific receipt to any income tax return in the United States."

Based on that the Judge denied the deduction entirely.

Example from One Jurisdiction

- In one Virginia jurisdiction the Commissioner of Revenue was able to dispose of several requests for refunds by simply asking *"does the place of business in our locality serve only customers in Virginia?"* When the companies answered "yes" the deduction was denied because no connection between Virginia offices and the gross receipts in other states had been established.

- ***<u>Merely using payroll apportionment and filing income taxes in other states does not entitle one to a 58.1-3732(B)(2) deduction (of any sort) without a showing that Virginia efforts helped earn the gross receipts in the other jurisdiction.</u>***

What To Ask For

Ask for company records showing phone calls, correspondence or some other indicator that Virginia personnel specifically helped earn gross receipts in each state where a deduction is sought. If the company cannot supply such information you can deny the deduction without having to determine the proper way to *measure* it. This is the prudent course for any assessor seeking to protect locality revenue and consistent with the latest judicial interpretation out of Chesterfield County

To Reiterate: IF *Some* Virginia Involvement is Shown

- Two options:
  - Strict adherence to the Tax Commissioner’s formula outlined in PD 14-29:
  - Modify the stated formula to utilize information that is readily available (actual business conducted in the other states).
- Be consistent in whichever of the options you choose.
- Monitor the situation for further developments in the Chesterfield County (Ford Motor Credit) case or an answer from the Tax Commissioner to the inquiries made by two different Commissioners of Revenue. Right now assessors are having to guess at the proper method in a vacuum of no guidance. Once guidance is received this may entail changes in the selected approach.

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