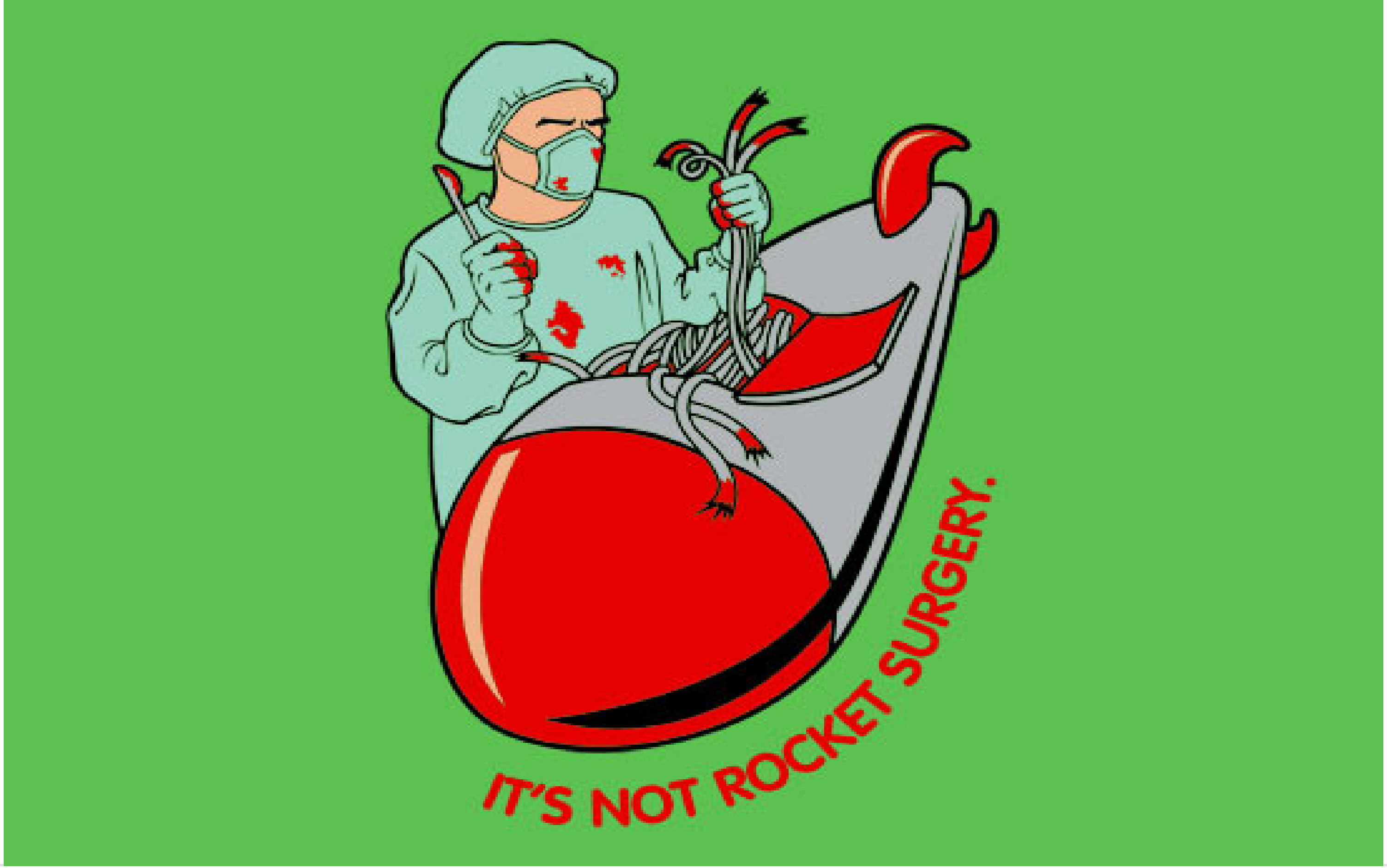
Department of Taxation

Appeals and Rulings

VALTA

August 11, 2017


IT'S NOT ROCKET SURGERY.

Responsibilities

- Administrative appeal of state taxes
- Administrative appeals for BPOL and other local business taxes
- BPOL advisory opinions
- Offers in Compromise – Doubtful Liability
- Rulings Requests
- Litigation support for the Attorney General's Office

14 authorized positions (2 vacancies)

Case Information

- Case inventory as of August 1, 2017: 389 active cases (excludes court cases, protective claims and intents to appeal)
  - 275 appeals (127 income taxes, 135 sales taxes, 13 local taxes)
  - FY2017 – received 489 total cases and closed 407 cases
  - Average number of cases received during the last five years: 468
  - Average number of cases closed during the last ten years: 446
  - Local tax appeals are worked in conjunction with State tax appeals. Workloads have increased significantly over the last several years.

Local Tax Appeals and Advisory Opinions

- Receive approximately 34 local cases per fiscal year since FY09
  - FY 2016 - received 19 cases and closed 24 cases
  - FY 2017 - received 30 cases and closed 49 cases
- Current local case inventory is 13 compared to 32 in April of FY 2010
  - 13 appeals - 9 have been in process for less than 90 days
- Cases received since January 1, 2013 - the average turnaround time is 162 days
  - Average turnaround time has been reduced by 23% compared to cases received prior to 2013

Recent Decisions

BPOL: Nonprofit Exemption P.D. 13-176

- Laundry coop servicing hospitals and some other customers
- Did not qualify for the statutory exemption for nonprofits (Va. Code 58.1-3703 C 18).
- Not determinative that it was created by nonprofits, had nonprofit customers or was not trying to make a profit
- Past treatment by locality immaterial

BPOL: Federal Preemption P.D. 13-191

- Federal law preempted state’s right to impose excise, sales or property taxes on duty free store at airport
- Local BPOL tax not preempted and does not violate Commerce Clause of U.S. Constitution

BPOL: Federal Preemption P.D. 17-94

- Internet Tax Freedom Act (ITFA) has been made permanent
- ITFA applies to BPOL tax
  - Practical effect is BPOL taxation of receipts derived from internet services preempted by the ITFA, unless grandfathered
  - Grandfather protection (if applicable) will expire in 2020
- Cases are still under review, so could be further developments
- Will not be surprised if this ends up in court regardless

BPOL: Engineering Services P.D. 15-68

- Very challenging classification issue concerning the extent engineering services were provided under a government contract to provide: system integration, IT, systems engineering, IT enterprise solution, management of large scale IT programs, simulation and training
- Increasingly digital world presents challenging tax issues, not just for BPOL

BPOL: Manufacturing Exemption 16-118

- Another very challenging classification case concerning whether Taxpayer was exempt manufacturer or service provider
- Number of separate contracts with the military performed under one roof
  - Aspects of manufacturing and servicing
  - Question of wholesale sales (needed for the manufacturing exemption)
- Statute (58.1-3703 C 4) since amended to presumably include such services w/in the exemption

BPOL: Wholesale / Retail P.D. 15-145

- Distributor of HVAC equipment and supplies
- Most of the biggest customers were "contractor" companies doing HVAC work
- Wholesale standard established in P.D. 04-13 included use of equipment/supplies in a commercial business, contrary to result of P.D. 98-160
- Be wary of sales tax concepts. Results could be different.

BPOL: Agency Relationships P.D. 17-8

- "contractual relationships exist between the taxpayer and both the client and the contracted third party, and there is a stated relationship between the client and the contracted third party"
- This standard might be inferred from the circumstances
- **Key is whether taxpayer had a fiduciary obligation** to disperse funds
- It still shouldn't be commingled, and it would normally not be reported as income to the taxpayer

BPOL: Virginia Taxable Income vs. Gross Receipts P.D. 16-175

- Q/A format dealing with questions from small VA locality
- Town was trying to find ways to be business friendly
- Virginia Taxable Income can be substituted for gross receipts, but absent statutory authorization, standard should be the same for all businesses
- Revenue will be a critical factor, obviously

BPOL: Out-of-State Deduction

- Out-of-State Deduction methodology for payroll apportionment was upheld in *Nielsen Company (US), LLC v. County Board of Arlington County, 289 Va. 79, 767 S.E. 2d 1 (2015)*

BPOL: Out-of-State Deduction (cont.)

- 1. Ascertain whether any employees at the Virginia definite place of business participated in interstate transactions. Such recepts must be attributable to customers in other states where the business filed an income tax return. If there has been participation, then;
- 2. Ascertain whether any of this interstate participation can be tied to specific receipts. If so, then those receipts are deducted; If not, payroll apportionment must be used.
- 3. 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.

BPOL: Out-of-State Deduction (cont.)

- A taxpayer need only show that gross receipts are included in gross income or federal taxable income reported on another state's return to show it actually reports those receipts such state's return (P.D. 17-93)

BTPP: P.D. 15-17 Nonprofit Hospitals

- Healthcare system exempt from federal income taxation under IRC 501(c)(3)
- Not required to have religious affiliation to be exempt from personal property tax under *Va. Code* 58.1-3606 A 5

BTPP: *Horbal vs. Commissioner*

- The saga of the set-top boxes appears to be over
- Set-top boxes are not machines and thus are not subject to BTPP tax
  - Personal property of a cable television business is generally deemed intangible under 58.1-1101 2a, but certain items – including machines and tools – remain taxable.
- Brief summary of the torturous history of this issue can be found in P.D. 17-38

BTPP: Fixtures

- Worthwhile to review the three factors carefully if you have one of these cases
- Annexation, Adaptation, **<u>Intent</u>**
- Recent examples: P.D. 13-47, 14-53, 14-90, 14-182
- Facts and circumstances tests based on intent mean that categorical treatment of equipment types may not always lead to the right result

M&T: Metal Casting P.D. 15-212

- Equipment used in a multi-stage manufacturing operation was M&T, even though some equipment was not directly involved in creating the final product for sale
- Key was different products were being manufactured at each stage of the process (even though ultimately consumed in later steps)
- This is a pretty unique fact pattern, so be careful reading too much into this case

M&T: Valuation

- Original total capitalized cost is what the original buyer paid for the equipment, not the taxpayer's cost on a subsequent purchase
- P.D. 12-27, Op. Va. Att'y Gen. 8-109, P.D. 13-20, P.D. 14-55
- However, need to consider any subsequent appraisals - the ultimate standard is fair market value

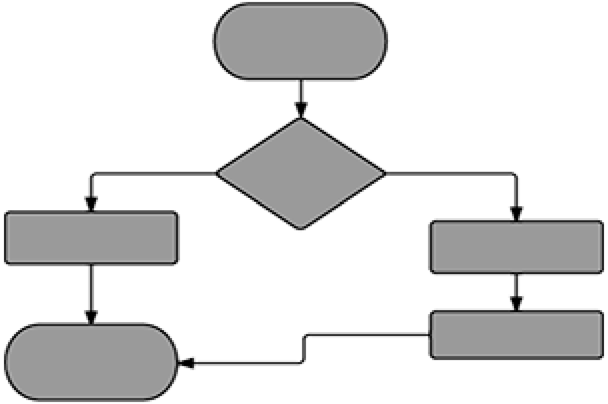
M&T: Packaging

- General rule: packaging and shipping equipment is not used in the manufacturing process
- "to the extent that packaging has to meet performance (industry standards), sanitation (government regulations), or product quality (consumer demands) standards, equipment used for such packaging is considered to be used directly in the manufacturing process" P.D. 13-63, P.D. 15-7
- Be wary of applying these same principles outside the food industry: packaging is uniquely connected to the manufacture of food products in ways that may not be applicable to other industries

M&T: Packaging (cont.)

- This argument will be examined with skepticism:
  - "widget A has to be packaged to ensure product quality" or "widget A has to be packaged to meet the customer's demand"
- This is probably true in most, if not all, cases when making a product. If that's the case, the all packaging equipment is taxable and the general rule might as well not exist.

Local Appeals Process



BPOL: Appealable Event

- **Increase** in the assessment of a local license tax
- **Denial** of a refund
- The assessment of a local license tax **where none was previously assessed**
- *Va. Code* § 58.1-3703.1 A 5 a
  - *One exception: appeal of classification*

BPOL: Local Appeal Time Limits

- <u>One year</u> from the last day of the tax year at issue OR
- <u>One year</u> from the date of the appealable event
- *Va. Code* § 58.1-3703.1 A 5 b.
- Notice how a proper application of the appeal deadline requires correctly identifying when the appealable event occurred

BPOL: Local Appeal Contents

- Identify the taxpayer
- The tax periods covered by the assessment
- The amount in dispute
- The remedy sought
- Each alleged error in the assessment
- The grounds on which the taxpayer relies
- Facts relevant to the contention
- *Va. Code* § 58.1-3703.1 A 5 a

BPOL: Final Determination

- 23 VAC 10-500-710
- Full review of facts, assertions and authorities
- Issue a signed and dated final local determination setting forth the facts and arguments in support
- Local assessing officer: Commissioner of the Revenue, chief assessing officer (if not a COR) or designee
- Notice is required to be included re: right to fie an appeal with the Department. 23 VAC 10-500-710 D has the verbatim language.

BPOL: Final Determination (cont.)

This much should be clear from the final determination:

- What are the alleged errors (i.e., what are the issues)?
- What are the relevant facts?
- How does the law (statutes, regulations, cases, AG's opinions, PDs, etc.) apply to the facts to confirm or refute the alleged errors?

BPOL: Final Determination (cont.)

- In a properly developed appeal, there should be no guess-work by the time it reaches the Department.

- Discussion: what are some likely outcomes if the Department has to develop the case?

BPOL: State Appeal

- A taxpayer must file appeal w/in 90 days of final local determination. See *Va. Code* § 58.1-3703.1 A 6 a.

- A taxpayer can also treat the appeal as denied if it has been with the locality more than 1 year. It must give locality 30 days written notice. See *Va. Code* § 58.1-3703.1 A 5 e.

BPOL: State Appeal (cont.)

- Acknowledgment letter is sent to the taxpayer, copied to the locality
- 30 days (from the date of the acknowledgment) to file a response to the taxpayer's appeal
  - Provide additional information
  - Request case be returned to address new issues
  - See 23 VAC 10-500-760

BPOL: State Review of Appeal

- Exact process may vary considerably from case-to-case
- Large information requests are generally avoided, but information requests are generally allowed under 23 VAC 10-500-770
  - The function of an appeal is to review the application of law to facts
  - The Department is not another audit level

BPOL: State Review of Appeal (cont.)

- The Department notifies both parties of information requests/exchanges. The taxpayer or the locality has to notify the other party of communications with the Department. See 23 VAC 10-500-700 E and F.

BPOL: State Review of Appeal (cont.)

- Extensive review process, up to and including the Tax Commissioner (5 levels, including the Tax Commissioner)
- Neutrality
  - The Department is not on the taxpayer's or the locality's "side"
  - Process is supposed to relieve the burden on the court system and provide uniform state policy on local taxation

BPOL: Beyond the State Appeal

- Appeal to the circuit court w/in one year of the final state determination per *Va. Code* 58.1-3703.1 A 7.
  - OR within three years of the last day of the tax year of the assessment
  - OR one year from the date of assessment
  - OR one year from the date of the final local determination (whichever is later)

Other Local Appeals

- Local Business Taxes: machinery & tools, business tangible personal property, merchant's capital, and consumer utility (under certain conditions)
- Local Mobile Property: tangible personal property tax on airplanes, boats, campers, recreational vehicles, and trailers
  - No valuation issues except for local business tax
- *Va. Code* § 58.1-3983.1
- No regulations governing these appeals, rather guidelines issued as P.D. 04-28

Facilitating the Appeals Process

Facilitating the Appeals Process: Cause of Delays

- Disputed or incomplete facts are primary reason for delay in resolving an appeal
- Need for additional information and requests for reconsideration slow down the process as well
- Administrative Appeal Guidelines published November 2006 and adopted as regulation – Title 23 VAC 10-20-165

Facilitating the Appeals Process: Basic Flow

- Appealable event → local appeal review + final determination → appeal to the Department
  - We have been seeing an increase in arguments concerning procedural issues
  - It is incumbant on localities to follow established procedures and assist taxpayers in doing the same.
  - jurisdictional notices / remands ultimately look bad

Facilitating the Appeals Process: Information Requests

- Information Requests
  - The key is **relevance**
    - How will this information establish the necessary facts?
  - Recipe for quick remand / jurisdictional notice: withholding a determination on one tax type because information related to another tax type audit is pending

Facilitating the Appeals Process: Evidence

- Evidence can take widely different forms.
- Auditors may be used to seeing particular forms but ask if facts can be shown in other ways.
- This advice is to help everyone involved in the process: you, TPs and us. The more thoroughly the facts are developed, there is a better chance of making good policy. Good policy drives good tax administration. It is a healthy cycle where everyone wins in the long run.

Local Appeals Procedures: Recent Cases

- Local Commissioner of Revenue letter that does not provide rational for decision or provide required appeal notice is not a final local determination (P.D. 14-96)
- Commissioners must adjust assessments pursuant to final local determinations, not request taxpayers file amended returns (P.D. 15-105)
- Local Commissioner of Revenue that issues final local determination letter barred from claiming it lacked jurisdiction for local appeal (P.D. 16-37)

Local Appeals Procedures: Recent Cases

- Dispute of out-of-state deduction amount resulting in reduction of refund is an appealable event (P.D. 17-79)
- A taxpayer must file an appeal with a locality prior to appealing to the Department (P.D. 17-80)
- The Department will not act on a case once it has been decided by a circuit court (P.D. 17-90)

Laws, Rules & Decisions (formerly the Tax Policy Library)

- Online research tool – tax policy information readily available
- Available at www.tax.virginia.gov/laws-rules-decisions
- Contains Rulings and Appeals Responses, Tax Bulletins, and links to Code of Virginia, Virginia Administrative Code Regulations, and Opinions of the Attorney General related to tax issues