VIRGINIA ASSOCIATION OF LOCAL TAX AUDITORS

VALTA

Assessment of Business Personal Property
and
Machinery & Tools

VAAO EDUCATION SEMINAR
July 15, 2004
Charlottesville, Virginia

VALTA PANEL DISCUSSION HANDBOOK

ASSESSMENT OF BUSINESS PERSONAL PROPERTY
AND
MACHINERY & TOOLS

Welcome VALTA Members,

The Virginia Association of Local Tax Auditors (VALTA) was contacted by the VAAO Education Committee to provide an informative presentation and panel discussion on Business Personal Property and Machinery & Tools for the 49th Annual Education Seminar which was held in Charlottesville on July 15, 2004.

The handout that follows was produced for the seminar and was intended as a guide to focus the attendees attention, highlight general areas and stimulate their involvement in our panel discussion. It is a collaboration of research information, published material, court opinions, previous VALTA presentations, and training material compiled and developed by a volunteer committee of VALTA members.

VALTA is a nonprofit organization comprised of local government tax administrators and auditing professionals. Our association was started ten years ago from a small group of auditors that gathered occasionally in the Hampton Roads metropolitan area to discuss audit procedures and opinions regarding local tax issues. Today, we are a statewide organization with 241 members representing 47 localities. We meet regularly, three times a year, to discuss current local taxation issues, the effects of legislative changes and court rulings on localities and to provide a program of continuing professional education for our members. Our organization continues to be responsive to requests from the Commissioners of the Revenue; to provide a forum for members to discuss ideas; share experiences encountered when auditing business entities for local tax liabilities; promote uniformity in the assessment of local taxes; to consolidate and coordinate resources when researching local tax issues.

This presentation and panel discussion is a sample of what VALTA strives to provide its membership. I hope you will find this handout to be a useful addition to your office collection of reference material and information concerning property tax. Share this with your neighboring locality and assist us in achieving the goal of having members representing all the jurisdictions within the Commonwealth. We look forward to the opportunity of having you and your staff as part of the Virginia Association of Local Tax Auditors.

Sincerely,

Daniel J. Lejman
VALTA President

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VIRGINIA BUSINESS PERSONAL PROPERTY
And
MACHINERY & TOOLS

1. AUTHORITY OVERVIEW

The Commonwealth of Virginia has a classified property tax system as distinguished from a general property tax system. The authority to classify and define taxable subjects resides within the General Assembly as given by the Constitution of Virginia.

Article X, § 1 Mandates that all property shall be taxed and that all taxes must be uniform upon the same class of subjects within the taxing jurisdiction. This section also grants to the General Assembly the power to define and classify subjects of taxation. Subsequent opinions of the Attorney General declare that the General Assembly may not delegate that authority. The importance of Section One is that no property, unless specifically exempted, should escape the burden of taxation and that the tax burden must be fairly distributed upon all those who are liable to bear it.

Article X, § 2 Provides that all assessment of real estate and tangible personal property shall be at their fair market value, to be ascertained as prescribed by law. The General Assembly has not prescribed the means to be used in ascertaining fair market value, except with respect to certain types of property.

Article X, § 4 Segregates real estate, minerals, and tangible personal property for local taxations only, with the stipulation that these classes of property must be assessed in such manner and at such times as the General Assembly may prescribe by general law.

Article X, § 6 Addresses exemptions from property taxation. In addition to those properties owned by the Commonwealth and it political subdivisions, the Constitution exempts properties owned by churches or religious bodies and used for worship or pastoral residence. Nonprofit cemeteries, public libraries, and educational institutions are also generally exempted.

In accordance with these constitutional provisions, the General Assembly has adopted a somewhat scattered array of local taxation laws. All taxable property, as described in Virginia Code § 58.1-3000, is to be assessed on the first day of January in each year, §58.1-3003 and § 58.1-3015 of the Code of Virginia, 1950, as amended. This includes real estate to be assessed at 100 percent of fair market value (§58.1-3200 and § 58.1-

3201) and tangible property, much of which is to be valued by using a percentage of original cost (§58.1-3500 and § 58.1-3503).

2. DISCUSSION OF TERMS AND DEFINITIONS

1. *Fair Market Value* (FMV) The legal definition is one that has evolved through our court system. It is:

> "… The price which it will bring when offered for sale by one who desires, but is not obligated, to sell it, and is bought by one who is under no necessity of having it." See City of Norfolk v. L. Snyder, 161 Va. 288, (1933); Tochahoe Woman's Club v. City of Richmond, 199 Va. 734, (1958).

This definition has been applied in numerous individual litigations and successfully stood the test of time. The Assessing Officer, in valuing property, is not prevented from taking into account the condition of the property. In 1993, the Virginia Supreme Court heard a personal property valuation case, Fairfax County, et al v. Telecommunications Industries, Inc., Va. 472 (1993). The county had assessed computer equipment at various percentages of original cost of the equipment and that method conformed to the valuation method used on other business personal property in the same category. The taxpayer was able to prove that the assessment, while uniform in its application among other business taxpayers within the same class of property, exceeded the fair market value.

The court agreed with the taxpayer, as in real estate valuation cases, that the assessor must not stand merely on its application of uniformity when evidence exists that assessments should be adjusted further for economic or technological obsolescence. This court case broadened the scope of analysis that must be done when considering "appeals" for computer equipment. An actual market analysis needs to be done to determine if a specific type of computer is out of line with the market value for computer equipment in general. The court also ruled that, upon request, the Assessor is required to make available a reasonable description of his valuation methods.

The court has previously stated in Smith v. Fairfax Co., 234 Va 250, (1987) that property must not be assessed in excess of its fair market value. If it is impossible or impractical to enforce both the standard of true value and the standard of uniformity, the latter provision is to be preferred as the ultimate end to be attained.

Under the provisions of Virginia Code §58.1-3519, when a taxpayer fails to file a personal property tax return, the commissioner of the revenue "shall, from the best information he can obtain, enter the fair market value of such property and assess the same as if it had been reported to him" (Rulings of the Tax Commissioner, PD03-96). If the assessor is unable to determine the original cost of the property, he must choose an alternative valuation method reasonably expected to determine fair market value. The assessor may not rely solely on estimated values submitted by the taxpayer (1987-1988, Opinion Virginia Attorney General, 579). He may have to use market analysis or hire a professional appraisal firm.

2. *Situs* - The actual or assumed location of a property for purpose of taxation. International Association of Assessment Officers-Property Assessment Valuation, 2nd Edition, 1996.

"Situs of property, for tax purposes, is determined by whether the taxing state has sufficient contact with the personal property to be taxed to justify in fairness the particular tax." Black's Law Dictionary, 6th Edition, 1995.

Under Va. Code §58.1-3511, "shall in all cases be the county, district, town or city in which such property may be physically located on the tax day." Tax day for tangible personal property is January 1. VA. Code §58.1-3515.

The common law rule that the situs of personal property for taxation follows the owner (mobilia sequuntur personam) has been changed in Virginia by 58.1-3511. See Hogan v. County of Norfolk, 198 Va. 733, 735 (1957). As the Supreme Court in Hogan qualified, if property is simply casually or incidentally in a locality on January 1, it would not be taxable there. In such a case, factors such as the property's "usual location" before and after January 2 as well as over the past years should be considered in determining where property is "ordinarily situated." The situs, by statute, is where the property is physically located on January 1 of the tax year.

CITY OF VIRGINIA BEACH

v. Record No. 011307 OPINION BY JUSTICE LEROY R. HASSELL, SR
April 19, 2002

INTERNATIONAL FAMILY ENTERTAINMENT, INC.

"We reject the City's argument that the common law doctrine of mobilia sequuntur personam permits the City to tax the transponders. This doctrine is based on the common law principle that the rights of ownership and the transfer of movable property must be determined by the law of the owner's domicile. In Hogan, 198 Va. at 735, 96 S.E.2d at 745, we stated that

"[a]t the present day, the separation of the situs of personal property from the domicil of the owner for the purposes of taxation is a familiar doctrine, and the maxim 'mobilia sequuntur personam' is no longer controlling on the question of taxation of personal property which has an actual situs elsewhere than at the owner's domicil. It may be taxed where it is situated or located, although the domicil of the owner is elsewhere. The test of situs for taxation purposes is the place of its location and use."

We also stated in Hogan that the common law rule that the situs of personal property for taxation follows the owner may be changed by the General Assembly, and we held that this rule had been changed in Virginia by former Code 58-834, which was a precursor to Code 58.1-3511(A). Id. at 735, 96 S.E.2d at 745-46. Accordingly, to the extent any ambiguity exists, we hold that this common law rule does not apply to the taxing scheme at issue in this case."

The Chesterfield administrative interpretation of "permanency" was not accepted by its own Circuit Court. In Star Equipment v. Chesterfield County, 10 Va. Cir. Ct. 226 (1987), an air compressor was rented by Star to a customer in Chesterfield County from October 16, 1985, to April 22, 1986, less than six months. The compressor was removed from Chesterfield on December 31, 1985 and returned to Chesterfield on January 2, 1986. Star contended that the compressor was not subject to tax by Chesterfield. The Court Agreed.

1983-1984 AG at 401-402. In determining the "usual location," location in one jurisdiction for a significant portion of the year may be considered. You may consider where the property is generally returned when not in use. 1982-1983 AG 615. If the "usual location" cannot be determined, the domicile of the owner may be considered. 1959-1960 AG 354.

For merchants' capital the Virginia Supreme Court has clearly announced that the taxation situs of any type of merchants' capital is bound by VA. Code §58.1-3511

SHELOR MOTOR COMPANY, INC.,
D/B/A HOMER COX FORD, ET AL.

v. Record No. 001073 OPINION BY JUSTICE BARBARA MILANO KEENAN

April 20, 2001

NANCY W. MILLER, COMMISSIONER OF
THE REVENUE FOR MONTGOMERY COUNTY

The language of Code § 58.1-3511(A) is plain and unambiguous, and provides a single directive for determining the taxation situs of merchants' capital of any type. Under the statutory language, this taxation situs "shall in all cases be the county, district, town or city in which such property may be physically located on the tax day." Code § 58.1-3511(A). This language does not provide for a determination of where the merchants' capital is "ordinarily" or "normally" kept, but requires that the situs be determined by the physical location of the merchants' capital on one particular day of each year.

The second sentence of Code § 58.1-3511(A), which applies only to the taxation situs of certain types of mobile personal property, provides a distinct contrast to the statutory provisions that govern the taxation situs for merchants' capital. The taxation situs for those types of mobile personal property is where the vehicle is "normally garaged, docked or parked. . . ." The Commissioner's argument effectively asks us to add qualifying language such as "normally" or "ordinarily" to the first sentence of the statute. However, we are not permitted to add language to a statute. When the legislature has used words of a plain and definite meaning, courts cannot accord those words a meaning that amounts to holding that the legislature did not mean what it actually expressed. Jan Paul Fruiterman, M.D. and Assocs. v. Waziri, 259 Va. 540, 544, 525 S.E.2d 552, 554 (2000); Haislip v. Southern Heritage Ins. Co., 254 Va. 265, 268, 492 S.E.2d 135, 137 (1997); Davis v. Tazewell Place Assocs., 254 Va. 257, 260-61, 492 S.E.2d 162, 164 (1997).

Pertinent references and opinions

OAG 02141973-Serviceman
58.1-3516-Proration
23VAX10-240-410-Situs of Sale
OAG 08201984-Equipment Used in Multi locations
23VAC10-340-70-Situs, nonresidents
58.1-3514-Cargo
58.1-1106-Situs, nonresidents
58.1-3511-Situs for assessment
58.1-3513-imports
58.1-3512-Vessels and containers
OAG 07181974-Tax Situs
OAG 11091966-Situs of Property
OAG 01101991-Forest Products Tax
OAG 0801975-Cargo Containers

OAG 09201988-Business not yet open
OAG 0911989-Nonprofit organizations
OAG 12161998-Taxable situs of property
23VAC10-210-2070-Place of business in VA
PD 97-410-Procedure for determining situs
PD 85-90-Atlernative method of apportion
58.1-3709-Business located in more than one locality
58.1-541-Residency
23VAC10-240-320-Place of Business
OAG 01-099-Taxable situs
OAG 01091995-Situs of property
OAG 12061972-Used in Manufacturing
PD 99-134-Situs
PD 02-2-Manufacturing
PD 02-88 M&T

3. *Real Estate -* is defined in the Virginia Code § 1-13.12. Land; real estate. “The word "land" or "lands" and the words "real estate" shall be construed to include lands, tenements and hereditaments, and all rights and appurtenances thereto and interests therein, other than a chattel interest. “

   By excluding “chattel” from the definition of real estate, the General Assembly clearly intended such items be assessed as personal property.

4. *Chattel* or *Personal Property -* is an article of personal, movable property. Unfortunately, the General Assembly does not specifically define the “personal property” or “chattel.” The only statutory guidance provided is found in §58.1-3500 of the Code of Virginia which states that [taxable] tangible personal property shall consist of all property not classified as intangible personal property under §58.1-1100 or as merchants’ capital under §58.1-3510.

   Personal property generally consists of movable items, that is, those not permanently affixed to and a part of real estate. In deciding whether something is personal property or real estate, usually the three-prong rule must be considered:

   The manner in which it is annexed or attached;
   The intent of the party who made the annexation; and

The purpose for which the premises are used.

Generally, but with exceptions, items remain personal property if they can be removed without serious injury either to the real estate or to the items themselves.

Personal property can be broken down into two categories:

a. Tangible personal property and intangible personal property. In general, tangible personal property can be thought of as moveable goods that are real, material, and substantive, for example, automobiles, boats, jewelry, and furniture.

b. Intangible personal property, on the other hand, has no substantive value in and of itself. Examples include money, stock, bonds, and evidences of debt.

Code of Virginia § 58.1-3500 defines Tangible personal property as all personal property not otherwise classified by § 58.1-1100 as intangible personal property, or by §58.1-3510, as merchant's capital. Such Tangible Personal Property is hereby segregated for and made subject to local taxation only pursuant to Article X, § 4 of the Constitution of Virginia. Having been segregated for local taxation only, §58.1-3503 separates tangible personal property into eighteen basic categories. These categories have been separated for valuation purposes only, and are not separate classifications for rate purposes.

Article X, §6 addresses exemptions from property taxation. In addition to those properties owned by the Commonwealth and it political subdivisions, the Constitution exempts properties owned by churches or religious bodies and used for worship or pastoral residence. Nonprofit cemeteries, public libraries, and educational institutions are also generally exempted.

Prior to January 1, 2003, a three-fourths affirmative vote of the General Assembly served to designate and classify a property as used by its owner for certain benevolent purposes and thus exempted such property from taxation.

However, House Bill 1750 (Chapter 1032) established the process localities must follow when exempting from real or personal property taxes property that is owned by nonprofit organizations and used for religious, charitable, patriotic, benevolent, cultural or public park or playground purposes. This legislation also requires local governing bodies to consider the same issues, as the General Assembly was required to consider, when determining whether to pass a resolution supporting an exemption request. This legislation clarifies that exemptions granted by the General Assembly prior to January 1, 2003 remain in effect as long as the ownership and use of the property do not change.

5. *Original Cost* - Total of all cost associated with acquisition of an asset. Black's Law Dictionary, 6th Edition, 1995

§ 58.1-3503. General classification of tangible personal property.

A. Tangible personal property is classified for valuation purposes according to the following separate categories which are not to be considered separate classes for rate purposes:

> *17. All tangible personal property employed in a trade or business other than that described in subdivisions 1 through 16 of this subsection, which shall be valued by means of a percentage or percentages of* ***original cost****.*

§ 58.1-3518. Taxpayers to file returns.

Every taxpayer owning machinery and tools or business personal property, if requested by the commissioner of the revenue, shall include on his annual return of such property information as to the ***total of original cost*** *by year of purchase. The cost should be the original capitalized cost or the cost that would have been capitalized if the expense deduction in lieu of depreciation was elected under § 179 of the Internal Revenue Code.*

The original cost of any machine is the cost to acquire, the cost of transportation, and installation. Many localities use a flat percentage of original cost. Others may apply a descending scale to original cost to determine an assessed value by age.

Present conditions and projected developments, as well as actual physical deterioration will play a role in determining value. Functional obsolescence is a major factor affecting the value because of advances in technology. Functional obsolescence is loss in value due to design shortcomings inherent in machinery and equipment brought about from technological innovations.

U.S. Industry and Trade Outlook 1999 one factor that sets computers apart from most other products is their constantly improving ratio of price to performance.

To determine current market trends and values for equipment, information obtained from dealers in used equipment to should be considered. A survey of pricing guides for market adjustments should be used to arrive at the rate. The rates when applied to the original cost of equipment will yield an estimate of the fair market value of the equipment including functional obsolescence.

Depreciation must recognize loss in value from all causes including obsolescence.

Pertinent references and opinions
PD 97-112 Audit, Direct and indirect
23VAX10-120-170-Valuation of property
PD 93-226-Repair parts

6. *Methodology of Assessment Taxation*- The listing and valuation of property for the purpose of apportioning a tax upon it, either according to value alone or in proportion to benefit received. Also, determining the share of a tax to be paid by each of many persons; or apportioning the entire tax to be levied among the different taxable persons, establishing the proportion due from each. Black's Law Dictionary, 6 Edition, 1995.

Pertinent references and opinions
D 95-95 Assessments
OAG 03121974-Method of Assessment
58.1-207-Taxation, Collection
58.1-2604-Increase in assessed valuation
OAG 11171978-Appraisal Techniques
OAG 02281987-Taxing Special Districts
OAG 03171995-Generation and co generating equipment
PD 04-9-Modified accelerated cost
PD 03-96-Business Tangible Personal Property
OAG 09151997-Constitutional authorization of property

7. *Uniformity –*

Virginia Code § 58.1-3503 requires uniformity by a method reasonably expected to determine actual fair market value.

"A. Tangible personal property is classified for valuation purposes according to the following separate categories which are not to be considered separate classes for rate purposes:….

B. Methods of valuing property may differ among the separate categories, so long as each method used is uniform within each category, is consistent with requirements of this section and may reasonably be expected to determine actual fair market value as determined by the commissioner of revenue or other assessing official; however, assessment ratios shall only be used with the concurrence of the local governing body. A commissioner of revenue shall upon request take into account the condition of the property. The term "condition of the property" includes, but is not limited to, technological obsolescence of property where technological obsolescence is an appropriate factor for valuing such property. The commissioner of revenue shall make available to taxpayers on request a reasonable description of his valuation methods. Such commissioner, or other assessing officer, or his authorized agent, when using a recognized pricing guide as provided for in this section, may automatically extend the assessment if the pricing information is stored in a computer.

The Constitution of Virginia Article X, 1, provides that all taxes must be levied and collected under general laws and must be uniform upon the same class of subjects within the territorial limits of the authority leavening the tax. The General Assembly, may provide for differences in the rate of taxation to be imposed upon real estate by a city or town within all or parts of areas added to its territorial limits, or by a new unit of general government, within its area, created by or encompassing two or more, or parts of two or more, existing unit of general government. Such differences in the rate of taxation will bear a reasonable relationship to differences between non-revenue producing governmental services giving land urban character, which are furnished in one or several areas in contrast to the services furnished in other areas of such unit of government. The same Constitution section states, that the General Assembly may by general law authorize the governing body of any county, city, town or regional government to provide for differences in the rate of taxation imposed upon tangible personal property owned by persons not less than 65 years old, or persons permanently and totally disabled as established by general law, who are deemed by the General Assembly to bear an extraordinary tax burden of tangible personal property in relation to their income and financial worth.

3. DISCUSSION OF *"ORIGINAL COST"* AND THE PURCHASE OF ASSETS

Title 58.1-3503(A)(17) of the Code of Virginia prescribes that tangible personal property employed in a trade or business "shall be valued by a means of a **percentage or percentages of cost**." *(Emphasis added.)* A similar provision is made in paragraph (16) for computer equipment, adding "or by such other method as may be reasonably expected to determine the actual fair market value."

This section of the Code further provides, in paragraph (B), that *any* method of valuing the separate classifications of personal property listed in paragraph (A) must not only be consistent with the requirements of the section, but must also "**reasonably be expected to determine *actual fair market value*** as determined by the commissioner of the revenue…" *(Emphasis added.)*

What is "original cost" anyway? The legislative priority in the assessment of business tangible personal property is the use of a percentage of cost. But what is "original cost"? Anyone who has taken cost accounting understands the inherent danger in that question.

Fortunately, the state code provides a place to start and *a little* more clarity, in **§ 58.1-3518**, where if requested by the commissioner of the revenue, taxpayers are required to provide information with their annual returns including the "total of original cost" by year of acquisition. The section states that,

"cost should be **the original capitalized cost** *or* **the cost that would have been capitalized** if the expense deduction in lieu of depreciation was elected under Section 179 of Internal Revenue Code." *(Emphasis added.)*

In most cases, the cost is thus easy to determine: the amount depreciated or expensed as Section 179. These amounts can be found and verified on the taxpayer's federal depreciation schedule (Federal Form 4562 and supporting schedule).

<u>Three Problems:</u>

1. Some assets are not capitalized or expensed as Section 179.

2. Fully depreciated assets that have been "written off" but are still in service.

3. Recapitalized assets or assets that are capitalized at something other than market value.

In the first two cases, the original cost must be determined by another means than the depreciation schedule. In the third case, the commissioner must make a factual determination of factors and choose the best *alternate* method of assessment in order to "reasonably determine actual fair market value."

1. Non-Capitalized Assets

   Assets that were not capitalized or expensed as Section 179 assets must still be assessed by percentage of cost, if known. This can be done several ways:

   - By simple taxpayer compliance (asset list filed with return)

- Audit of invoices or expense records (including Schedule C expenses that may include smaller assets or expenses related to unreported larger assets)
    - e.g., internet access expenses that may reveal a computer.

- Assignment of cost or current assessed value from similar assets (usually for statutory assessments or assessments of items added by assessor in visual inspection). Several methods of cost/valuation are useful:
    - Similar businesses on file
    - "e-bay" or catalog pricing for the same or similar models

2. Fully-Depreciated Assets

These assets must still be assessed as long as they are still in use. The original cost can usually be found on prior returns, or on older asset lists.

In some cases, where prior returns do not list the asset or were not filed, it *may* be possible to find the asset's original cost by finding the taxpayer's journal entry (usually at the end of the year) that "wrote off" the asset. This would be an entry that "cleared" the asset from the records by debiting Accumulated Depreciation and crediting an asset account such as "Equipment," as follows:

Date	Description	Debit	Credit
12/31	Accumulated Depreciation	$5,000	
	Equipment		$5,000

With this simple transaction, the fully depreciated asset has been completely removed from the books, or "written off." In most cases, the debited amount here will be the original cost of the asset. All you need to finish the assessment is the year of purchase.

3. Recapitalized Assets or Assets Capitalized at Other than FMV

Recapitalized assets:

- Usually arise from change in business entity (incorporation of sole proprietor, etc.).
    - Recapitalized cost *may not* represent fair market value at the time of recapitalization.
    - Usually historical ("actual") cost is still available from same taxpayer, and may be shared.

Assets capitalized at other than FMV:

- Usually arise from sale of business as a whole or in large part.
    - Used assets lumped together (esp., real property mixed with personal property).
    - Goodwill may have been included in total asset valuation, resulting in "all assets."
    - Taxpayer may have completed depreciation schedule incorrectly or illegally.
    - The sale may have been a "fire sale," or less-than-arms-length transaction, resulting in *undervalued* capitalization of the assets on depreciation.
    - Usually historical ("actual") cost is *not* known, and may not be shared by assessor with new owner if it is on file (breach of confidentiality for prior owner).

In each of these cases, the use of "original *capitalized* cost" for "percentage of cost" *may or may not* "reasonably be expected to determine actual fair market value," as the Code above requires. In each case, the assessor or commissioner essentially has four choices:

1. Use the capitalized cost and year of acquisition as reported.
    - This is the preferred method, and most directly fits the statutory provisions, *if* it accurately represents the asset valuation at the time of acquisition by the new owner or new business entity.
2. Use historical cost and acquisition dates, if known and applicable.
    - Good in *recapitalizations by same taxpayer* or officer of same company.
    - New owner may have this, but assessor may <u>not</u> share this with new owner if he or she does <u>not</u> have it.
3. Assign more accurate market data for cost.
    - Deduct "goodwill" that may have been paid (but not amortized) in overvalued assets.
    - Increase cost assigned to "fire-sale" or other assets that may be undervalued in their capitalized cost.
4. Perform an inventory or visual inspection to arrive at a completely new "actual fair market value" for the current assessment.
    - Useful if assets were initially lumped together, especially if real estate or goodwill was included with personal property in the sale.
    - Use "e-bay" or catalog services to gather like-kind valuations for current assessment. *(Regression or consideration of interest or inflation could be used to go backward or forward in time as necessary.)*

4. <u>DISCUSSION OF LEASED EQUIPMENT</u>

Another type of "buyout" that can cause headaches in determining assessed values and "original capitalized cost" comes in the form of leases and lease-purchases. In fact, leasing companies and leased equipment present a complex array of situations that *reflect nearly every aspect of assessment for business equipment* in Virginia.

1. Filing Requirements for Leased Equipment.

   Pursuant to § 58.1-3518 of the Code of Virginia, **both the lessor/owner and lessee of leased business tangible personal property must file a return** listing that equipment to the locality where it has situs on tax day (January 1).
   - The *lessee* is required to give the name and address of the owner, while …
   - The *owner* must file and pay applicable tax on the equipment.

   <u>Two notable exceptions</u> involve federal, state, or local <u>government agencies</u>:
   - Property **leased to any such government agency** is taxed to the *owner*. (§ 58.1-3501).
   - **Property of the government** that is leased to or used by a private party for business is *taxed to the lessee (user)* as if the lessee were the owner. (§ 58.1-3502) . <u>Please note</u>, however, that § 58.1-3502 has been ruled discriminatory (against taxpayers using government equipment that is not owned by the Virginia Port Authority, which it exempts) and thus unconstitutional by U.S. vs. City of Manassas, et. al., 830 F.2d 530 (4th Cir., 1987). It, however, has never been amended or taken out of the Code – so its use may be a judgment call for your Commissioner or Director of Finance.

   Leased equipment should be cross-referenced from the lessee's return to that of the lessor (usually a commercial leasing company, but not always), to ensure that the equipment is taxed to the owner, as well as to prevent double taxation if both entities claim ownership or capitalization of the asset.

2. Assessment of Assets Filed by Lessors/Leasing Companies.

   Leased equipment is often owned by leasing companies that file consolidated returns of their equipment. Many of the returns of these leasing companies are filed from out of state, and may present numerous problems for assessors here in Virginia. One single return may cover issues as broad as intangible assets used by a manufacturer, to assets identified with incorrect situs.

   Following is a checklist of basic items that should be considered when assessing leased property for a leasing company.

Things to ask yourself of the ***whole return:***

- Are any known city or town mailing addresses in your jurisdiction missing?

  - You may need to request copies of returns filed to neighboring jurisdictions, especially where independent cities adjoin counties.

    ⇒ Virginia is almost unique in its use of independent cities, and most leasing company clerks are unaware of this until they are told. Many popular property tax management software products use ZIP codes to assign jurisdiction for asset reporting; and all assets from one ZIP code or city name may get reported to that locality in error.

    ⇒ The www.USPS.com website (The U.S. Postal Service) is useful in identifying address jurisdiction. The "Find ZIP Code" feature identifies proper jurisdiction (as well as ZIP Code) by street address. Its database is maintained by local postmasters; and as a free service, it is good to recommend to leasing companies who have filed in error to another jurisdiction.

- Is the **name/account correct**?

  - Make sure that you adjust or note name changes, mergers, etc., with a ***good audit trail***, as customers generally only know the lessor by a trade name, or by the name of the original company that set up the lease.

    ⇒ Watch for **mergers, acquisitions, and new accounts *constantly*!!!** Like mortgage bankers, leasing companies make money in part by selling their portfolios, or buying out other companies. Assets assessed to "General Capital" last year, may be owned by "General Credit" this year, although both are subsidiaries of "G E C Parent" company, and the client may still report the lease as owned by Company Capital.

Things to ask yourself of ***each lease***: *(as applicable to your locality).*

- Is the equipment computer equipment or software?

  - Va. Code § 58.1-3503(A) (16) provides specific provision for valuing computer equipment separately from other tangible personal property. You may need to identify the equipment and make a factual determination to assess it separately if your locality provides for separate assessment of computer equipment.

- Va. Code § 58.1-1101(A) (8) defines computer application software as intangible. You may need to determine if software listed on the return is operational (tangible and taxable) or application (intangible, not taxable).

- Is the ***lessee*** a **manufacturer**?

  - **If yes**, **the same rules of assessment for the manufacturer apply to the leasing company**, because the M & T rules turn on *use* by a manufacturer (not on ownership). Leases made to a manufacturer make the equipment thus "used by a manufacturer."
    - The property is assessed as either **machinery and tools ("M&T")** (taxable) or **intangible** (exempt). [See Va. Code § 58.1-1101(A) (8).]

    ⇒ Refer to City of Martinsville v. Tultex Corp., 238 Va. (1989) for a discussion of leased property used in manufacturing. The decision stated that the test is whether property was in fact "used or employed in a manufacturing…" business, and *not* necessarily how *the owner* used the property.

- Is the **leasing company** itself the **manufacturer** of the equipment?

  - **If yes**, the manufacturer (e.g., **Xerox Corp.**) may be required by the commissioner to report the leases **at manufacturer's suggested retail price** (not "cost"!!), and they are treated as BTPP unless *used* by a manufacturer (lessee), just as above.

    ⇒ ***Be careful**: This scenario is rare! It is* more *likely that the* manufacturer *(such as **IBM**) will set up a* subsidiary *or* spin-off *(such as **IBM Credit Corp.**). In that case, **the "credit corp." is** **not** **the manufacturer** and thus reports equipment **at cost**, just like other leasing companies.*

♦ Is the lessee a **church** (or its duly designated ecclesiastical officer), denomination, or religious association?

⇒ If so, the property MAY be **exempt**, as per Code § 58.1 –3617, which exempts property **owned by the church** and extends (starting 2001) this exemption to business equipment that is **leased** to a church **in the name of a duly designated ecclesiastical officer or church trustee**. [Please note: Because the code defines such equipment (leased to the church in the name of the officer or trustee) as "property of a church, religious association, or religious denomination," and deems it "owned by [the] church, association, or denomination," but does **not** specifically address property **leased in the name of the church**; you may need to consult your attorney or commissioner for a ruling on equipment that is leased to the church in its own name.]

⇒

- Is it a **true lease** or **conditional sale**? This is an important question, it may not be clear. Often a factual determination must be made using the actual lease document*.* *In general* the following qualities distinguish the two:

⇒ A **true lease** (a.k.a., "**operating lease**") is billed to the ***lessor***.

- *Usually an **FMV** buyout option, if any.*
- *Equipment to be returned at end if no buyout option offered or taken.*
- *Lessee cannot capitalize.*
- *Lessee* may *have option to cancel with proper notice (not necessarily).*

⇒ A **conditional sale** (a.k.a., "**capital lease**") is billed to the ***lessee***.

- *Usually **$ 1*** (or "nominal") *"bargain purchase" buyout option*
- *Usually **non-cancelable**.*
- *Usually may be capitalized by lessee.*
- *May be a "**statutory finance lease.**" (UCC, Vol. 2A, Va. Code § 8.2A-103,* et seq.*)*
  - May have a purchase option "not to exceed (NTE) 10%" of cost.

- *Two documents give specific guidance for accountants and assessors to determine the nature of a conditional sale:*
  - The Uniform Commercial Code, Vol. 2A (Va. Code § 8.201 & 203, *et seq*.) identifies terms for leases, including the "statutory finance lease." [A copy of relevant sections has been included as an appendix here, but is also available online as part of the Code of Virginia.]

  - FASB 13 covers the basics for lease accounting. It sets the standards for the Financial Accounting and Reporting for Leases in the following sections:
    1. Definition of Terms
    2. Classification of Leases
    3. Criteria for Classifying Leases
    4. Accounting and Reporting by Lessees
    5. Accounting and Reporting by Lessors

6. Leases involving Real Estate
7. Leases between Related Parties
8. Accounting and Reporting for Subleases
9. Accounting and Reporting for Leveraged Leases

⇒ *The* Statement of Financial Standards 13, *(FASB 13, ¶6 & 7) lists four tests to determine if a lease is an operating lease or a capital lease: It is a* ***capital lease*** *if it meets* **one** *of the following criteria:*

⇒

1. *Lease term is at least 75% of the property's economic life.*

2. *PV of minimum lease payments exceeds 90% of the property's fair market value at inception of the lease.*

3. *The lease contains a "bargain purchase option."*

4. *The lease transfers ownership of the property to the lessee by the end of the term.*

- Ultimately, the terms of the lease may be contradictory; and the commissioner may have to make a **factual determination of ownership**. A "lease" that transfers substantially all of the benefits and risks of ownership of the property at hand will usually be seen as a sale, taxable to the "lessee"; while the lease that retains substantially all of the benefits and risks of ownership with the lessor will usually be considered a true lease, taxable to the lessor. In either case*, be careful* to prevent double taxation.

5. DISCUSSION OF LEASEHOLD IMPROVEMENTS

Leasehold improvements are alterations made to office and general commercial space as part of a lease agreement. Leasehold improvements range from trade fixtures to adding electric grids to provide power to industrial powered machinery.

Although the General Assembly has clearly excluded "chattel" from the statutory definition of real estate, thereby leaving such items to classified as personal property, the Code of Virginia does not offer much assistance in distinguishing "chattel" from "fixtures." Local taxation of leasehold improvements in all cases warrants the review of the lease, a physical inspection of the property by both a representative from the

Commissioner of Revenue and local Assessor. In other words, factual and legal inquiries will determine the correct classification of these improvements. The classification decision rests with the local assessing officer who must base the determination on Common Law definitions, the agreement of the parties, and the Common Law Doctrine of Fixtures.

We open our discussions with the following edited presentation:

VIRGINIA ASSOCIATION OF LOCAL TAX AUDITORS
MAY 2002 MEETING STAUNTON, VA

CLASSIFICATION
OF
LEASEHOLD IMPROVEMENTS

Presented by
Jan Proctor
Deputy City Attorney
City of Chesapeake

1. **Classification by Common Law definition:**

A. *Chattel* - An article of personal property, as distinguished from real property. A thing personal and moveable.

B. *Fixture* - An article in the nature of personal property which has been so annexed to the realty that it is regarded as part of the real property. That which is fixed or attached to something permanently as an appendage, and not moveable.

A thing is deemed to be fixed to real property when it is attached to it by roots, imbedded in it, permanently resting upon it, or permanently attached to what is thus permanent, as by means of cement, plaster, nails, bolts, or screws.

Goods are fixtures when they become so related to particular real estate that an interest in them arises under real estate law: e.g., a furnace affixed to a house or other building; counters permanently affixed to the floor or a store; a sprinkler system installed in a building.

Black's Law Dictionary, 6th Edition, 1995

2. **Classification by Agreement:**

In classifying items installed by a tenant in a leased premises, the local tax authority should engage in a thorough review of the lease. Virginia law is well settled that the landlord and tenant may fix the character of an improvement, even though the agreed upon classification may be contrary to the common law doctrine of fixtures. Thus, in Adams Outdoor Advertising v. Long, 253 Va. 206, 483 S.E.2d 224 (1997), the Court reviewed the terms of the lease and found the parties had classified a billboard permanently affixed to the land as personal property. In an earlier case, the Federal District Court applied Virginia law and found that a broadcast tower was personalty pursuant to a sales agreement between the parties. CSB, Inc. v. Cradle of Democracy Broadcasting Co., 547 F. Supp. 106 (E.D. Va. 1982).

In other instances, the agreement may provide for the same classificationas would be expected under the common law doctrine of fixtures. For example, in Bolin v. Laderberg, 207 Va. 795, 153 S.E.2d 251 (1967), the Court reviewed lease provisions and found that the parties had agreed that the air conditioning system, heating unit, and electric sign were all realty. In Prince William County v. Thomason Park, 197 Va. 861, 91 S.E. 441 (1956), the tenant constructed a building without reserving any right of removal or ownership. The Court held that without such provision in the lease, the building must be considered attached to and part of the real estate.

As with all contracts, leases may be difficult to interpret. Often, the language used is ambiguous, contradictory and fails to clearly define essential terms such as "trade fixtures," "improvements," and "personal property." The Supreme Court of Virginia struggled with this issue in Bolling v. Hawthorne Coal and Coke Company, 197 Va. 554, 90 S.E.2d 159 (1955). Characterizing the provisions of the lease as "cloudy" and "confused," the Court finally concluded that "[t]he obvious inconsistencies, conflicts, and ambiguities… create doubt as to the real meaning and interests of the parties, and require that extrinsic evidence should be received in explanation." Bolling, 197 Va. At 570, 90 S.E.2d at 170. In other words, the court had to look beyond the four corners of the document to determine the intent of the parties.

In other cases, the Court has simply disregarded the contractual significance of the lease. In a 1991 condemnation decision , the Supreme Court held that billboards are to considered as part of the realty when land and leasehold interests are being condemned, regardless of a different understanding between the lessor and lessee. See Lamar Corporation v. City of Richmond, 241 Va. 346, 402 S.E.2d 31 (1991). The billboard was thus considered realty even though the lease provided that the lessee was to retain ownership of the structure and had the right to remove same. Additionally, even if the lease controls ownership and allows th tenant to remove property, the tenant's failure to do so within a reasonable period of time following termination of the tenancy could be considered abandonment and lead to a merging of a "permanently affixed" structure to realty. See Adams Outdoor Advertising' supra. In the same vein, a tenant permitted to remove "trade fixtures" who fails to do so within the time allowed under the lease may lose the contractual right. The trade fixtures may then be classified as realty. See Mullins v. Strugill, 192 Va. 653, 66 S.E.2d 483 (1951).

Thus, while leases should always be thoroughly reviewed, the assessing authority must be wary of results that appear contrary to those anticipated under the common law doctrine of fixtures. In such cases, reliance on the lease provisions should serve primarily as evidence of the intent of the parties under the three prong test described in the next section.

3. Classification under Common Law Doctrine of Fixtures

Where an agreement between the parties does not control, the common law doctrine of fixtures applies. In Virginia, the doctrine requires the application of a three-prong test to determine whether improvements are personality (chattel) or realty (fixtures) as follows:

(1) Manner of annexation to the realty;

(2) Adaptation of the items to the use of the realty; and

(3) Intention of the parties making the annexation.

Of these factors, the intention of the parties making the annexation is given primary consideration. See Danville Holding Corporation v. Clement, 178 Va. 223; 16 S.E.2d 345 (1941); Highway Commissioner v. Edwards Co., 220 Va. 90, 255 S.E.2d 500 (1979). The intent of the parties may be expressed or implied and may be discerned from many factors, including the following:

- Nature and Use of the item – if essential the use or helps facilitate the highest and best use of the land, the asset is more likely to be realty.

- Mode of Annexation – if permanent or will cause damage in removal, the asset is more likely to be realty.

- Value Enhancement – if the added value is substantial or permanent, the asset more likely to be realty.

- Lease Provisions:

Ownership designations.

Installation – expense and responsibility.

Maintenance – expense and responsibility.

Insurance – duty to insure and disbursement of proceeds.

Taxes – duty to pay and right to challenge.

Right of removal – conditions/time limitations.

- Depreciation Schedules – if depreciated 10 years or less, more likely to be personality.

- Mortgage – if covered by a deed of trust, the asset is more likely to be realty.

Any doubt as to intent is resolved in the favor to the landowner such that fixtures are considered part of the real estate. See Danville Holding Company, supra; Transcontinental Gas Pipe Corp. v. Prince William Co.; 210 Va. 550, 172 S.E.2d 757 (1970). Moreover, property that may normally be considered fixtures under the lease or under the annexation and adaptation tests should not necessarily be classified differently based solely on stated intentions of the parties. See 1987 -= 1988 Op. Atty. Gen. Va. 576. Often, such statements may be self-serving.

In attempting to classify leasehold improvements as real estate or personal property, it may help to realize that even the courts find this to be a challenging task. In Danville Holding Corporation, the Supreme Court stated:

> [i]t is difficult, if not impossible, to frame any precise rule to determine whether an article used in connection with realty is to be considered a fixture or not a fixture. Each case must be decided according to its particular facts and circumstances.

Danville Holding Corporation, 16 S.E.2d at 341.

Deputy City Attorney
City of Chesapeake

This ends our discussions of the above edited presentation.

Real World Considerations In The Classification Of Leaseholds :

1. DEGREES OF PERMANENCY

Themed Restaurants such as Rainforest Café are chock full of seemingly permanent improvements, but are they really? Rainforest Cafés, include aquariums, and specialized technical moving animals, but **everything** is designed to be removable, not only with no damage to the building, but to the assets as well. Generally, assets that are specific to the tenant's "look", especially in a mall (discussed in the next section) are taxable as BPP.

2. THE SHOPPING MALL

Malls are built as true "shells", three walls and a front gate. In addition, they have the basic plumbing and lighting as well as control panels, but that's about it. Lease agreements between tenant and landlord should be standard documentation in a COR's office for each tenant. Don't assume every tenant has the same lease agreements. Did the tenant get a rent concession? If so, how much and how was it supposed to be used? Was the tenant allowed to spend it on inventory or improvements? Who owns the property bought with the rent concession seed money? Check the lease and the depreciation schedule.

Property such as elevated flooring or lowered ceilings, built-in bars and cabinetry that would normally be considered realty in an independently owned establishment that has had several proprietors who attempt their hand at running a restaurant and close down are taxable to the tenant in a mall, mainly because they have no use to the new tenant that moves in. Everything is built to be able to be removed for the next tenant.

3. REAL ESTATE ASSESSOR v. COMMISSIONER OF THE REVENUE

What if the property is deemed to be tangible personal property by the IRS, but the Real Estate Assessor claims the rights to tax? Case in Point - Today's marinas are built with "floating piers" as opposed to permanent ones. What is a floating pier? A floating pier is one that moves up and down with the tide. It is less likely to be harmed in a storm. In other words, it has a small degree of permanency. Floating piers are 5 year property according to IRS depreciation rules. To the Real Estate Assessor the marina is an income producing property, which means the docks are the primary generating source of income. If the COR taxes the docks as tangible personal property, then the risk of double taxation has presented itself. Conclusion: The Assessor's office and COR must be in constant communication each informing the other of special issues.

4. RECENT DEVELOPMENTS

Studies conducted by Congress and the Treasury Dept have concluded that the current tax depreciation life for non-residential (39 years) improvements exceeds their economic life. A realistic cost recovery period of 10 years is under consideration, but 15 years is more probable. Localities would have to study the depreciation schedule more closely than before, because it is easy to dismiss 39 year property as real estate. Since machinery and equipment also has a 10 to 15 year life, it will be imperative to obtain the detailed fixed asset report.

6. DISCUSSION OF MACHINERY AND TOOLS

We open our discussion with the following edited presentation:

Taxation of Businesses
Written and Compiled for the Commissioner of the Revenue Association of Virginia by the Certification Committee

A. Introduction

The *Code of Virginia* § 58.1-3507 provides that "Machinery and tools, except machinery and equipment used by farm wineries as defined in § 4.1-100, used in a manufacturing, mining, water well drilling, processing or reprocessing, radio or television, broadcasting, dairy, dry cleaning or laundry business shall be listed and are hereby segregated as a class of tangible personal property separate from all other classes of property and shall be subject to local taxation only."

B. Manufacturing Determination

The most difficult step in the assessment of the machinery and tools tax is determining when a business operation is considered to be in the business of manufacturing, The state code does not provide a definition of what a manufacturer is or what constitutes manufacturing nor does it define any of the other businesses qualifying as machinery and tools as stated in § 58.1-3507. Guidance can be found by examining case law.

Various court cases have held that a comprehensive definition of the term manufacturing recognizes three essential elements:
1. Original material (often referred to as a raw material);
2. A process whereby the original material is changed;
3. A resulting product, which, by reason of being subjected to processing, is different from the original material.

In Prentice v. City of Richmond, 197 Va. 724 (1956), the courts defined manufacturing as a process which involves the transformation of a product into a new and different article. Unless processing transforms material into a product of substantially different character, it cannot be considered manufacturing even though value or usefulness of the product are increased. Manufacture implies a change, but not every change is manufacturing.

Court decisions have been made that attempt to explain the difference between whether an original (raw) material has been changed or not. The Prentice decision concluded that a chicken processed at the plant that was merely cleaned and dismembered, remained a chicken. Therefore, the process did not constitute manufacturing. However, in Commonwealth v. Meyer, 180 Va. 466 (1942), a hog processed at the plant was transformed into hams, shoulders, and lard which were substantially different products from the original hog and, as a result, the business was classified as a manufacturer.

In addition, in the case of Solite Corp. v. county of King George, 220 Va. 661 (1980), in which Solite Corp. crushed stone and mixed gravel, the court concluded that the mere blending together of ingredients, in the absence of a transformation into a product of substantially different character is processing, but it is not manufacturing.

As stated in the Department of Taxation's *BPOL Guidelines*, mere manipulation or rearrangement of the original materials is not sufficient; there must be a substantial, well-signified transformation in form, usability, quality, and adaptability rendering the original material more valuable for use than it was before. Merely processing, blending, grading, etc. material is not manufacturing.

The court case of County of Chesterfield v. Brown Boveri 238 Va. (1989), presents the issue of ancillary activities. The term ancillary is defined as subordinate, helping, or auxiliary. The court differentiated between a business engaged in two separate trades, one that is exempt and one that is not, and a business where non-manufacturing activities are ancillary to the primary business of manufacturing.

A business will not lose its favorable tax status as a manufacturer merely because it conducts some non-manufacturing activities. When a business is engaged in both manufacturing and non-manufacturing activities, it will be classified as a manufacturer for tax purposes if the manufacturing portion of its business is substantial. The business must be considered as a whole in determining whether it qualifies as a manufacturer. To be considered substantial, the manufacturing component of a business must not be de minimus, merely trivial, or only incidental to its principal business.

The factors that a court may consider in determining whether the manufacturing component of a multipurpose business makes a substantial contribution to the entire business include the manufacturing component's financial receipts, its proportion of the total corporate income, the percentage it comprises of the total capital investment, the number of employees working in the manufacturing component as compared with the total number of employees, or the ratio of manufacturing activities to the entire business. Brown Boveri.

When trying to decide if a particular process is manufacturing, officials must keep in mind the following statement: Because the public policy of Virginia is to encourage manufacturing in the Commonwealth, this definition should be applied liberally. Prentice and Brown Boveri.

C. **Separate Lines of Business**

The *Code of Virginia* § 58.1-5 provides that " . . . when any person, firm or corporation is engaged in more than one business which is made by law subject to taxation, such person, firm or corporation shall pay the tax provided by law on each branch of his, their or its business . . . " Coca-Cola Bottling Company of Roanoke, Inc. v. County of Botetourt (2000). If non-manufacturing activities operate as separate lines of business from manufacturing activities, local business personal property tax can be imposed.

The court held that the property in issue was not used in the taxpayer's manufacturing business, but was used as part of the taxpayer's separate sales business. Whether a taxpayer's activities are considered as two separate businesses for tax purposes is not determined by the formal structure of the taxpayer's functions or the taxpayer's relation to its franchiser. Rather, that issue is determined by the manner in which the taxpayer actually conducts its business. Caffee v. City of Portsmouth, 203 Va. 928 (1962).

Hence, in deciding whether this sales equipment was "used in a manufacturing business", the court applies the plain meaning of those words as used in the statute. Unlike the computers and office equipment in the American Woodmark and Tultex cases, which were used, in whole or in part, in planning, directing, or administering the manufacturing function, the evidence in this case indicates that the sales equipment in question was not used in manufacturing but merely in selling the finished product. Thus, they concluded that the evidence supports that this equipment could be considered sales equipment used in a separate sales business.

D. **Property Leased by a Manufacturing Business**

In the court case of the City of Martinsville V. Tultex Corp., 238 Va. (1989), a California corporation owned computers that were leased to Tultex, a manufacturing business, which used them exclusively for administrative, accounting and information accumulation and retrieval purposes. The issue at hand was whether Tultex, the lessee, or the California Corporation, the lessor, was liable for taxation. The Virginia Supreme Court held that computers used by a manufacturing business were subject only to state taxation under the predecessor to § 58.1-1101(A)(2). The decision stated that the test is whether property was in fact "used or employed in a manufacturing . . ." business and not necessarily how the owner used the property. The computers were assessed as intangible property taxable only by the state even though the owner/lessor used the computers as leased property.

E. **Determination of What is and is not a Machine and Tool**

The determination of when property of a manufacturer is considered machinery and tools and when it is considered intangible personal property can be difficult. One has to determine when the manufacturing process begins and ends in order to carve out the property subject to the machinery and tools tax. This analysis can also be complicated when reviewing the property of a processor or reprocessor.

State Tax commissioner Morrisett put forth in 1950 that an item of property is machinery and tools if it is either used directly in manufacturing operations or used in connection with machinery that is actually and directly used in manufacturing.

The *Code of Virginia* does not provided a definition of the terms machinery and tools. A 1988 Attorney General opinion does, however, specifically define "machinery" as a complex combination of mechanical parts and "tool" is commonly defined as an instrument of manual operation, that is, an instrument to be used and managed by the hand instead of being moved and controlled by machinery. 1987-1988 Op.Va. Att'y Gen. 591,592 (1988). A 1986 Attorney General opinion concluded that the phrase "machinery and tools used in a manufacturing business" are the machinery and tools which are necessary in the particular manufacturing business and which are used in connection with the operation of machinery which is actually and directly used in the manufacturing process. 1985-86 Op.Va. Att'y Gen. 316,317 (1986)

Many Attorney General opinions hold that once a taxpayer is classified as a manufacturer, it is not relevant what the actual tangible personal property is used for. For example, in one opinion, a pleasure boat owned by a manufacturer was considered to be capital taxable only by the Commonwealth. The boat had no relevance to the actual manufacturing and operations of the taxpayer. See Attorney General Ann. Rep. 411 (1977-78)

In the case of the City of Winchester v. American Woodmark Corporation, 250 Va. (1995), the corporate headquarters of the manufacturer was located in Winchester and was utilized by accounting, sales and manufacturing officers' personnel. All of the manufacturing facilities were located outside the Commonwealth. Although the personnel operating out of the headquarters controlled the computer system, it was not directly used in product design nor research and development. The court ruled that American Woodmark's furniture, fixtures, office and computer equipment are not "machinery and tools" within the meaning of § 58.1-1101(A)(2) because these items are not used in connection with the operation of machinery which is actually and directly used in the manufacturing process. The Code does not require that capital used in a manufacturing facility be physically located within the geographical boundaries of Winchester.

In the case of the County of Chesterfield v. Brown Boveri, (1989), an area of dispute was whether the design and engineering stages of a manufacturing job constituted manufacturing. It was disclosed that [the taxpayer's] design and engineering work was ancillary either to original manufacturing work or to a rebuilding job. Thus, because [the taxpayer's] design and engineering are integral parts of its manufacturing activity, such work is properly classified as manufacturing.

Manufacturers are not the only business operations subject to the machinery and tools tax. As provided for in § 58.1-3707, in addition to manufacturing businesses, the following business operations are also subject to the machinery and tools tax: mining, water well drilling, processing or reprocessing, radio or television broadcasting, dairy, dry cleaning or laundry businesses.

As provided for in § 58.1-1101(2), property that is not considered part of a process is declared intangible and thus exempt from local taxation when used in the following businesses: manufacturing, mining, water well drilling, radio or television broadcasting, dairy, dry cleaning or laundry. However, machinery and tools, motor vehicles and delivery equipment of such businesses shall be taxed locally.

Processing and reprocessing businesses are not entitled to the exemption from local taxation as provided in § 58.1-1101(2). Therefore, all property used by a processor or reprocessor is subject to taxation either as machinery and tools or tangible personal property. The determination of when the processing begins and ends has to be determined. All tangible property used by these businesses that is not used in the process/reprocess is classified as tangible personal property and taxed as such. The omission of the words processing and reprocessing from § 58.1-1101(2) is an example of the Dillion Rule. If it is not specifically stated in the *Code of Virginia*, one cannot assume that the property is subject to intangible classification.

As provided for in § 58.1-1101 personal property, tangible in fact, used in cable television businesses, machines and tools, motor vehicles, delivery equipment, trunk and feeder cables, studio equipment, antennae and office furniture and equipment of such businesses shall not be defined as intangible personal property for purposes of this chapter and shall be taxed locally.

Computer application software, considered intangible, and certified pollution control equipment, exempted by local ordinance, is excluded form the machinery and tools tax.

Quality control or quality assurance property is taxed as machinery and tools provided that it is not for administrative or other non-production line/area use.

Equipment used in research and development for both manufacturing and non-manufacturing activities is taxed as machinery and tools. However, if the equipment is exclusively used in research and development, then it is exempt from taxation.

The previous information was compiled for the Taxation of Businesses certification course prior to the Supreme Court decision in the case of The Daily Press, Inc. v. City of Newport News. The complete decision is available at the following address:

http://www.courts.state.va.us/opinions/opnscvtx/1021107.txt

The court case of The Daily Press, Inc. v. City of Newport News 265 Va. (2003), presents the issue of where the process of manufacturing begins. The court ruled that the taxpayer manufactures newspapers, not news. The only place where manufacturing occurs is in the pressroom where a printing press transforms a news print roll into a newspaper. Only machines and tools that physically alter raw material to a finished product are assessed as machinery and tools.

The court ruled in The Daily Press that it is not appropriate to apply a liberal definition of the term manufacturing as used in the case of Brown Boveri. The question in Brown Boveri was whether the taxpayer should be classified as a manufacturer within the purview of the Code. American Woodmark rather than Brown Boveri controls the disposition of The Daily Press. A strict application of determining what machines and tools are used in the process was applied.

In addition, a very interesting article in the William and Mary Law Review is noted in § 58.1-1100. Intangible personal property; segregated for state taxation. Stacey L. Wilson wrote the article after the local court decision in the case of Coca-Cola Bottling Company of Roanoke, Inc. v. County of Botetourt but before the Supreme Court reversed the local court's ruling.

As quoted from the conclusion:

"The American Woodmark case has important implications of the tax base of local government. If businesses are successful in their attempts to expand Virginia's manufacturing tax exemption, the financial impact on localities will be significant. Although the goal behind the tax incentive is to create a favorable environment for Virginia manufacturers, the current exemption benefits businesses already established in Virginia without any requirement that they create new jobs, expand, or otherwise promote economic development. In addition, it apparently gives manufacturers with a retail component a competitive advantage over those businesses that engage solely in retail. Further interpretations of the statute may extend the exemption to include equipment leased by manufacturing businesses and may have unintended consequences if Virginia consumers are forced to bear more of the state's tax burden. Even though expanding the manufacturing tax exemption undoubtedly benefits Virginia businesses, local government should take precautions to ensure that the state's long-term base is both balanced and equitable."

"Good Intentions, But Unintended Consequences: Expanding Virginia's Manufacturing Tax Exemption Under *City of Winchester v. American Woodmark Corp*.," see 41 Wm. & Mary L. Rev. 1138 (2000).

7. DISCUSSION OF AUDIT PROGRAMS FOR PROPERTY

Why Audit? Business personal property is a self reporting ad-valoreum system. The Audit function is designed to create uniformity, discovery, and compliance.

A. Uniformity and Consistency:
   I. Accurate filing of returns.

B. Discovery:
   I. Are they filing all of their property?
   II. Are they expensing instead of depreciating?
   III. Are they using the 179 method?
   IV. Is there leased equipment, and does it belong to them?
   V. Are they filing original cost or fair market value?

C. Compliance:
   I. Are they filing at all?

2. Who to Audit?

   A. Non Filers: Auditing these people can recocile address issues due to moving, or being out of business. It is also a great motivational tool to get non filers to become compliant in the future. These people generally do not file because they are not organized or are trying to avoid taxation.

   B. New Businesses: This is a great opportunity to have a one on one discussion with the taxpayer about compliance and their requirements to file a return each year and what can happen if they do not file. Many times new business owners do not fully understand the filing requirements for business personal property or what they are required to file. This can eliminate filing problems in the future.

C. Property Values Inconsistent with Business License Class: The Commissioners Office has a wealth of information available to it. This is a great discovery tool for determining how accurately property returns are being filed. Generally property values can be consistent among like businesses. Hotels for example that have the same amenities will normally have similar property values. A great way to determine consistency along the class is to divide the total property value by the number of rooms and then compare the figures. This method also works with square footage and is a great tool in determining consistency with the restaurant industry and many others. UCC filings are another great tool for determining consistency with contractors. Many banks use UCC filings to secure priority claim as collateral for heavy machinery and FF & E.

D. Non Profits: With the responsibility of exempt designation now falling on the localities, it is important to audit the entities every two years to determine compliance and qualification. Many times these organizations do not identify themselves to the locality because they assume they are exempt from taxes. The Virginia Department of Agriculture and Consumer Affairs (VDAC) is a great discovery tool for locating non profits.

E. Manufacturers: It is a good idea to audit these businesses on a bi-annual basis. Since manufacturing is not defined in local or state tax codes it is a good idea to monitor this business to make sure they are filing their return correctly and accurately. In many cases, furniture, fixtures and computer equipment can be exempt for taxation locally. Qualifications for these businesses can change from year to year as a result of new Supreme Court rulings, rulings of the Attorney General, or rulings of the Tax Commissioner.

3. Send Audit Notification: Once you have determined who to audit, you must provide written notification of your intent to audit their books and records. Below is an example of this type of notification:

A. **RE: AUDIT VERIFICATION OF BUSINESS PERSONAL PROPERTY**

Dear:

In accordance with the City of Virginia Beach Municipal Code and the State Code of Virginia , records are subject to inspection by the Commissioner of the Revenue at all times, for verification of Business Personal Property. An appointment has been scheduled for an audit of your records for the calendar years

and on at , at your location. To expedite your audit, please make the following information available:

4. What To Ask For: What to ask for can vary depending upon the business type. The information requested needs to be aligned to the industry you are auditing. Generally federal depreciation schedules will be available from corporations, partnerships, LLC, and professionals. Individuals often do not have federal depreciation schedules, and may require looking at actual receipts or using your experience to determine if the values reported are reasonable and consistent with the business class.

   A. Complete copies of income tax returns for the appropriate calendar years.

   B. Annual Statements of income and expenses.

   C. A detailed inventory of business personal property.

5. How To Audit: Property audits should be performed in the field. They can be done as a desk audit, but the accuracy of the audit will be affected. There are a number of items to address prior to performing the Audit.

   A. Review prior year returns so that you are as familiar with their property as possible, prior to going to the site.

   B. Research industry for common types.

   C. Determine, if possible, the size of the company so that you will know what resources to have available.

   D. Compare total property value with other similar business, and note any unusual finding that may need to be looked into, while performing the audit.

   E. Review and research any known issues that are in question, so that they can be addressed during the audit. This can be done on line or through state and local code books.

Once you have addressed these steps, you will be ready to perform an onsite business personal property audit. Below are some areas of concern to be aware of while performing an on site audit:

A. Observe the outside surrounding when you arrive at the business. The economic condition of the business could affect the value of the property.
   I. Is the property run down or in good condition?

II. Is the property value reported reasonable for the business in its current condition?

B. What are the attitudes of the people you meet at the audit site. Emotions can be a sign that there could be unreported property at the site. They could also mean that the people are nervous about sharing information concerning their business because they are in a very specialized market.

C. As you tour the facility, observe the age and condition of the property.

I. Is the age of the property as reported by the business consistent with the appearance of the property? This can be a sign that the business is replacing the old property with new and expensing it, and leaving the old fully depreciated equipment on the books.
II. Does the value represent the condition of the property.

D. Does the business report its property in generic categories, or do they itemize the property?

I. Generic categories can be a sign of missing property or disposed property still reported. You may need the business to provide a break down of what's in the category. The businesses are normally not too cooperative with this information. If you have exhausted all avenues, you may have to make a judgment call based on the over all value of the property.

E. Do they appear to be missing property?

I. Can you match the depreciation schedule to the physical property? You need to be able to match what property is in the business during your visit with the detailed inventory supplied by the business. If the business is expensing property, by using the 179 write off, this will be visible as you check off the property.

F. Does the business report only old equipment?

I. Most businesses will make some type of replacements for FF&E every couple of years. If the business does not show replacements, that is a good indication that there may be property missing from the return.

6. Do not disclose the results of the audit while on site.

A. Take the time to review the information gathered during the site visit. Compile the information into a spread sheet of some kind, so that you have a clear picture of the property before you. When you are comfortable with the results send the information to the business in writing. Make sure you have documentation to support corrections in assessments you may have to make.

Appendix: 1. UCC 2A

The Uniform Commercial Code, as relates to ***leased business equipment*** *and* ***lease-purchase agreements*** *of various types in Virginia.*

Code of Virginia § 8.1A-201. General definitions.

(a) Unless the context otherwise requires, words or phrases defined in this section, or in the additional definitions contained in other titles of the Uniform Commercial Code that apply to particular titles or parts thereof, have the meanings stated. …

(35) **"Security interest"** means **an interest in personal property or fixtures that secures payment or performance of an obligation.** "Security interest" includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Title 8.9A. "Security interest" does not include the special property interest of a buyer of goods on identification of those goods to a contract for sale under § 8.2-401, but a buyer may also acquire a "security interest" by complying with Title 8.9A. Except as otherwise provided in § 8.2-505, the right of a seller or lessor of goods under Title 8.2 or Title 8.2A to retain or acquire possession of the goods is not a "security interest," but a seller or lessor may also acquire a "security interest" by complying with Title 8.9A. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer under § 8.2-401 is limited in effect to a reservation of a "security interest." **Whether a transaction in the form of a lease creates a "security interest" is determined pursuant to § 8.1A-203.** …

(Code 1950, §§ 6-408, 6-544, 6-550; 1964, c. 219, § 8.1-201; 1973, c. 509; 1984, c. 613; 1991, c. 536; 1992, c. 693; 2000, c. 1007; 2003, c. 353.)

§ 8.1A-203. Lease distinguished from security interest.

(a) **Whether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case.**

(b) A transaction in the form of a lease **creates a security interest if** the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease and is **not subject to termination by the lessee**, *and:*

(1) the **original term of the lease is equal to or greater than the remaining economic life** of the goods;
(2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
(3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or
(4) the lessee has an **option to become the owner of the goods for *no additional consideration*** or **for *nominal* additional consideration** upon compliance with the lease agreement.

(c) A transaction in the form of a lease **does <u>not</u> create a security interest** merely because:

(1) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into;
(2) the lessee assumes risk of loss of the goods;
(3) the lessee agrees to pay, with respect to the goods, taxes, insurance, filing, recording, or registration fees, or service or maintenance costs;
(4) the lessee has an option to renew the lease or to become the owner of the goods;

(5) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or
(6) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

(d) Additional consideration is **nominal** if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised. Additional consideration is not nominal if:

(1) when the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed; or
(2) when the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed.

(e) The "remaining economic life of the goods" and "reasonably predictable" fair market rent, fair market value, or cost of performing under the lease agreement must be determined with reference to the facts and circumstances at the time the transaction is entered into.

(1964, c. 219, § 8.1-201 (37); 1973, c. 509; 1984, c. 613; 1991, c. 536; 1992, c. 693; 2000, c. 1007; 2003, c. 353.)

§ 8.2A-103 DEFINITIONS AND INDEX OF DEFINITIONS

(1) In this title unless the context otherwise requires: …

(g) "**Finance lease**" means a lease with respect to which:

(i) The lessor does not select, manufacture, or supply the goods;
(ii) The lessor acquires the goods or the right to possession and use of the goods in connection with the lease; and
(iii) One of the following occurs:
  (A) The lessee receives a copy of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;
  (B) The lessee's approval of the contract by which the lessor acquired the goods or the right to possession and use of the goods is a condition to effectiveness of the lease contract;
  (C) The lessee, before signing the lease contract, receives an accurate and complete statement designating the promises and warranties, and any disclaimers of warranties, limitations or modifications of remedies, or liquidated damages, including those of a third party, such as the manufacturer of the goods, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods; or

(D) If the lease is not a consumer lease, the lessor, before the lessee signs the lease contract, informs the lessee in writing (a) of the identity of the person supplying the goods to the lessor, unless the lessee has selected that person and directed the lessor to acquire the goods or the right to possession and use of the goods from that person, (b) that the lessee is entitled under this title to the promises and warranties, including those of any third party, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods, and (c) that the lessee may communicate with the person supplying the goods to the lessor and receive an accurate and complete statement of those promises and warranties, including any disclaimers and limitations of them or of remedies.

(i) "**Installment lease contract**" means a lease contract that authorizes or requires the delivery of goods in separate lots to be separately accepted, even though the lease contract contains a clause "each delivery is a separate lease" or its equivalent.

(j) "**Lease**" means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease. Unless the context clearly indicates otherwise, the term includes a sublease.

(k) "**Lease agreement**" means the bargain, with respect to the lease, of the lessor and the lessee in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this title. Unless the context clearly indicates otherwise, the term includes a sublease agreement.

(l) "**Lease contract**" means the total legal obligation that results from the lease agreement as affected by this title and any other applicable rules of law. Unless the context clearly indicates otherwise, the term includes a sublease contract.

(m) "**Leasehold interest**" means the interest of the lessor or the lessee under a lease contract.

(n) "**Lessee**" means a person who acquires the right to possession and use of goods under a lease. Unless the context clearly indicates otherwise, the term includes a sub lessee.

(o) "**Lessee in ordinary course of business**" means a person who in good faith and without knowledge that the lease to him or her is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods leases in ordinary course from a person in the business of selling or leasing goods of that kind but does not include a pawnbroker. "Leasing" may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a preexisting lease contract but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

(p) "**Lessor**" means a person who transfers the right to possession and use of goods under a lease. Unless the context clearly indicates otherwise, the term includes a sublessor.

(q) "**Lessor's residual interest**" means the lessor's interest in the goods after expiration, termination, or cancellation of the lease contract.

(r) "**Lien**" means a charge against or interest in goods to secure payment of a debt or performance of an obligation, but the term does not include a security interest.

(1991, c. 536; 2000, c. 1007; 2003, c. 353.)

Appendix: 2. <u>“Section 9 Tangible Personal Property Tax, 2003” of the Weldon Cooper Center for Public Service publication “ Tax Rates 2003” reprinted with permission of the authors</u>

Appendix: 3. <u>"Section 10 Machinery and Tools Tax, 2003" of the Weldon Cooper Center for Public Service publication " Tax Rates 2003" reprinted with permission of the authors</u>