

THE VIRGINIA SUPREME COURT REVISITS BUSINESS PERSONAL PROPERTY TAXES: VIRGINIA’S CONFUSING CLASSIFICATION STATUTE AND ITS “PUT BACK” PROVISIONS

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Virginia Supreme Court confirms that certain Business Personal Property of a cable provider is not taxable—orders \$1 million refund. Virginia’s Classification Statute and its “Put Back” language applicable more broadly to manufacturing businesses examined below.

The Supreme Court of Virginia recently ruled in favor of the taxpayer in *Verizon Online LLC v. Horbal, Commissioner of Revenue for Chesterfield County*, 2017 WL 829932 (Mar. 2, 2017). A first read of this decision might suggest that the ruling is of interest only to cable companies. A narrow view of the case confirms that Virginia localities may not tax the set top boxes provided by cable providers to their customers. The case, however, has far broader implications, and reaffirms that companies in “manufacturing businesses” could be due substantial refunds on improperly assessed Business Personal Property taxes.

The box to the right tracks how Virginia courts and local taxing authorities should analyze what is taxable Business Personal Property under Virginia’s “Classification Statute,” Va. Code. § 58.1-1101. The first question is whether this statute classifies the property as “intangible.” If so, then the property is not taxable. But we still must examine whether the “put back” provisions in the statute return to the property to

Virginia Localities’ Taxation of Business Personal Property

What is “Intangible Personal Property”?
Va. Code Sec. 58.1-1101, the Classification Statute, gives the answer

The Statute Classifies Certain Personal Property as “Intangible” under Subparts 1 through 9. Examples:

Subpart 2 — Intangible = Personal property used in Manufacturing businesses

Subpart 2a — Intangible = Personal property used in Cable Television businesses

But the Statute includes “Put Back” provisions that return some property for taxation:

Subpart 2 “Put Back” — “Machinery and tools, motor vehicles and delivery equipment”

Subpart 2a “Put Back” — “Machines and tools, etc.

taxable status. This seemingly innocuous language in fact controls the tax status of billions of dollars of business property.

As an example of the impact of the Classification Statute, a Silicon Valley company obtained a refund of more than \$3 million of local Business Personal Property taxes from a Northern Virginia jurisdiction. The company contended that it was a manufacturing business, even though its Northern Virginia operations focused on its performance of government contracts and its marketing and sales of its products to the federal government and to private contractors. Under the company's successful argument that it was a manufacturing business, its local Business Personal Property should be classified as "intangible" and therefore not subject to taxation by the locality. Moreover, the property was not "machinery and tools" subject to the "put back" provisions of the statute.

A sometimes overlooked or forgotten part of the analysis concerns leased property. While Business Personal Property taxes are assessed to the leasing companies, under Virginia law it is the use of the property that dictates whether it is excluded from local taxation. This means that a company using leased Business Personal Property in a manufacturing business should not be taxed—the leasing company should first benefit, but under most lease agreements the exclusion benefits are passed through to the lessees.

In this White Paper, we first look broadly at the Virginia local tax landscape, including the applicable provisions of the Virginia Constitution and the several taxes imposed by Virginia localities. The paper's focus then narrows to the localities' taxation of Business Personal Property under the Classification Statute and the legislature's use of the term "intangible," with attention on the Statute's subparts 2 and 2a. The next step is consideration of the "put back" provisions in the subparts.

The *Verizon Online* case is then reviewed and analyzed. This case is best understood as the latest case in a line of Virginia Supreme Court decisions that have interpreted the Classification Statute. As mentioned above, the case obviously benefits the cable companies—Verizon Online, Comcast, Cox, and Time Warner—but when we step back and look more

broadly at the case consequences, the case has significance for many manufacturing businesses because the "put back" language is very similar (but not identical) in the two subparts. This means that Business Personal Property that is being taxed likely should be excluded from local taxation in Virginia.

The last section of this paper provides an overview of the process for pursuing a refund from a Virginia locality. While each locality may have its own idiosyncratic provisions, there is a common path for seeking refunds. Under Virginia law, a taxpayer may claim refunds for the current and the three most recent tax years, and if successful will be entitled to the refund plus interest. This means that a claim initiated in 2017 could cover tax years 2014, 2015, and 2016, with 2017 added after payment of current year taxes.

1. VIRGINIA'S BUSINESS TAXATION MAZE.

The Commonwealth of Virginia often describes the state as tax friendly for businesses. When the entirety of state and local taxes are considered, Virginia may not be as tax-friendly as it would like you to think.

Like most states, Virginia imposes a state income tax on corporations and LLCs. Virginia's tax is 6%. There is also a sales tax burden, with the sales tax now 6% in some parts of the state (Virginia's sales tax has both state and local components, so the total rate may vary by locality). For many businesses, however, the greater Virginia tax burdens are imposed at the local level. The Business Personal Property tax can, in the aggregate over several years, be a 20-30% tax on personal property, and the BPOL (Business, Professional, and Occupational License) tax functions as a gross receipts tax. Business Personal Property taxes are administered by the localities; the BPOL tax, while governed by state statutes and regulations, is also locally administered.

The independence of the Virginia localities often comes as a surprise to out-of-state companies conducting business across the Commonwealth. A company may find that it must file 50 or more Business Personal Property tax returns to satisfy the different localities. To further complicate the matter, there is no required significant coordination among the localities, and each of the returns may mandate unique formats and require different information.

Virginia Constitution – Taxing Authority

- Virginia localities may tax “Real estate ... and tangible property.” *Article X, Section 4.*
 - Intangible personal property exempt from taxation. *Article X, Section 6(a)(5).*
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The localities’ taxing authority follows from the Virginia Constitution, which in Article X, Section 4, provides to the localities the right to tax “Real estate . . . and tangible property.” This unique constitutional grant of taxing authority shapes Virginia’s governments by providing localities a degree of independence from the state government. Virginia localities, however, are limited in what property they may tax. The Virginia Constitution, Article X, Section 4, provides that locally taxed property “shall be assessed for local taxation in such manner and at such times as the General Assembly may prescribe by general law.” The segregation of Business Personal Property for local taxation only is repeated in Va. Code § 58.1-1100.

In Va. Code § 58.1-1101, the legislature gives directions on what is taxable tangible personal property by classifying certain property as “intangible” and confirming that taxation of so-called intangible property is exempt from taxation. The Virginia Constitution also expressly states, in Article X, Section 6(a)(5), that intangible property is exempt from taxation.

2. VA. CODE § 58.1-1101— THE “CLASSIFICATION STATUTE.”

Under the Virginia Code, Business Personal Property is defined as either tangible or intangible property. Put aside any common sense understanding of “intangible.” Intangible personal property is whatever the state legislature says irrespective of any dictionary definition.

Subpart A of the Classification Statute includes 10 subparts (the subparts are identified as 1 through 9, with subpart 2 followed by a separate subpart 2a) that identify what is “defined as intangible personal property.” For example, subpart 2a addresses “personal property, tangible in fact used in a cable television

business . . .” This subpart is the focus of the *Verizon Online* case. Some of the subparts are easily understood—for example, subpart 3 is simply “Money,” and subpart 5 applies to “Shares of stock.”

The wildcard subparts are Va. Code § 58.1-1101 (A)(2) and (2a), which identify property used in manufacturing businesses and in cable television businesses. The entirety of subpart 2 is this:

- A. The subjects of taxation classified by this section are hereby defined as intangible personal property:
- ...
2. Capital which is personal property, tangible in fact, **used in manufacturing (including, but not limited to, furniture, fixtures, office equipment and computer equipment used in corporate headquarters)**, mining, water well drilling, radio or television broadcasting, dairy, dry cleaning or laundry businesses. **Machinery and tools**, motor vehicles and delivery equipment of such businesses **shall not be defined as intangible personal property** for purposes of this chapter and shall be taxed locally as tangible personal property per the applicable provisions of law relative to such property;

The portions of subpart 2 that we are most interested in for purposes of this White Paper are highlighted in bold text. Read this subpart in two steps—first, all personal property that falls under the first sentence is classified as “intangible personal property,” but then, second, certain limited property is returned to the tax rolls. So that there is no ambiguity as to what this means, in subpart C the statute provides:

- C. **The subjects of intangible personal property** set forth in subdivisions 1 through 9 of subsection A **shall be exempt from taxation** as provided in Article X, Section 6(a)(5) of the Constitution of Virginia.

The cited section from the Virginia Constitution exempts from both state and local taxation “[i]ntangible personal property, or any class or classes thereof, as may be exempted in whole or in part by general law.”

The use of “exempt” in both the Virginia Constitution and the Classification Statute might first suggest that these provisions are typical tax exemptions to be narrowly applied. The Paper’s authors prefer to identify the provisions as “exclusions,” because the Virginia Supreme Court has consistently held that the provisions are to be construed against the government and in favor of the taxpayer.

To emphasize the significance of the statutory classification of property as “intangible personal property,” appreciate that the covered property may not be taxed by the locality. In the example cited in the introduction to this paper, the Silicon Valley company had \$50 million of personal property that otherwise would have been subject to local taxation at a rate greater than 4.5% annually. The tax dollars at issue quickly added up such that the total Business Personal Property taxes and eventual refund exceeded \$3 million.

3. THE “PUT BACK” PROVISIONS IN SUBPARTS 2 AND 2A OF THE CLASSIFICATION STATUTE.

Turn the attention now to the second sentence in subpart 2 of the Classification Statute. Here the legislature grants to the localities the right to tax “Machinery and tools, motor vehicles and delivery equipment . . .” In subpart 2a applicable to the cable companies the language is “Machines and tools” rather than “Machinery and tools.” On one hand, the legislature has defined property “used in manufacturing . . . businesses” as “intangible” and therefore not taxable by Virginia localities. But in the next sentence it seems that the legislature is shifting back to the localities a portion of this property, with the consequence that the localities may impose taxes. The practical concern is that the terms “machinery” and “machines” are so generic that their use potentially negates the preceding exclusions.

As explained below, the impact of the “put back” language has been limited by the case law. The Virginia Supreme Court views the “put back” language to be a grant of taxing authority to the localities. Twenty-two years ago, in *City of Winchester v. American Woodmark Corp.*, 250 Va. 451 (1995), the Virginia Supreme Court told us that the Classification Statute, and specifically the “put back” provisions, are general

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tax statutes which the courts construe against the government and in favor of the taxpayer. The Virginia Supreme Court confirmed in *Verizon Online* that “statutes imposing taxes are to be construed most strongly against the government, and in favor of the citizens, and are not to be extended by implication beyond the clear import of the language used. Whenever there is just doubt that doubt should absolve the taxpayer from his burden.” Strong language indeed.

4. VERIZON ONLINE: THE CABLE SET TOP BOXES CASE.

The Virginia Supreme Court’s decision in *Verizon Online* is important in the analysis for determining what Business Personal Property a Virginia locality may tax, and how local tax collectors and courts should apply the Classification Statute. Most significantly, the *Verizon Online* decision confirms the workings of the critical “put back” provisions in subparts 2 and 2a of the Classification Statute.

The case addresses specifically set top boxes provided by the cable company to its customers. Verizon Online argued that under Va. Code § 58.1-1101(A) (2a) the set top boxes were personal property “used in cable television businesses.” As such, the property was classified as intangible and therefore not taxable by Chesterfield County. The County replied that the “put back” language in subpart 2a, which included “machines and tools,” returned the property to the County’s tax rolls. The County’s argument was that the set top boxes qualified as “machines”, which it defined expansively.

The Virginia Supreme Court had no difficulty with the case. The Circuit Court below granted

Verizon Online’s motion for summary judgment, ruling that the set top boxes are “intangible personal property.” This meant that they were not subject to local taxation. The crux of the case was whether the set top boxes were within the meaning of the term “machines” in the “put back” portion of subpart 2a. Here the Supreme Court could rely on a ruling of the Virginia Tax Commissioner, which had sided with Verizon Online. The Commissioner’s rulings are presumptively valid, and therefore it was the County’s burden to show that the ruling was erroneous. The County could not make this showing.

In sum, in *Verizon Online* the taxpayer had the benefit of broad classification language that initially moved the set top boxes beyond the reach of Chesterfield County. When the County argued an expansive definition of “machines” that would have negated the initial exclusion in subpart 2a, the Virginia Supreme Court applied an analysis that limited the reach of the term.

The same limiting test applied in *Verizon Online* for subpart 2a should carry over to the interpretation of subpart 2 for manufacturing businesses. The term “machinery” in subpart 2 arguably should be construed even more narrowly than “machines.”

5. MANUFACTURERS PAYING BUSINESS PERSONAL PROPERTY TAXES ON “PERSONAL PROPERTY, TANGIBLE IN FACT, USED IN . . . MANUFACTURING BUSINESSES.”

Verizon Online and a line of earlier cases confirm the proper application of the Virginia Classification Statute and the treatment of the “put back” provisions in that statute. In *American Woodmark* and then in *Daily Press, Inc. v. City of Newport News*, 265 Va. 304 (2003), the Virginia Supreme Court previously articulated and then confirmed the appropriate analysis. Fourteen years after *Daily Press*, the Supreme Court reminds us that the analysis to be used with the Classification Statute is unchanged.

The Cable Television Business portions of the statute in subpart 2a are obviously limited to only a few players. By far the more common and significant part of the Classification Statute is subpart 2, which applies to Manufacturing Businesses. In Northern

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Virginia, the *Verizon Online* case impacts the local taxation of companies that are predominantly manufacturing businesses (even if the manufacturing is done internationally, and arguably even if much of the manufacturing is subcontracted to others), and which have offices or operations in this region. Quite frequently, the local operations of these companies focus on the performance of government contracts and product sales, including sales to the federal government and to private contractors. There is no local manufacturing requirement—the test is not whether there is local manufacturing, but whether the property is used in a “manufacturing business.”

6. A TAXPAYER MAY PURSUE ADMINISTRATIVE REMEDIES, OR MAY PROCEED DIRECTLY TO THE STATE COURTS.

Companies pay the Business Personal Property taxes directly to the localities or, in the case of leased property, indirectly to the localities through a leasing company. For taxes paid directly to the localities, a business taxpayer may pursue refunds using local administrative procedures, or it may pursue refunds in the state courts as provided by the Virginia Code. There is no required exhaustion of administrative remedies—a taxpayer may go directly to the circuit court. Claims may be pursued for the current tax year and the for the prior three tax years.

For leased property, it is still the use of the property that controls that classification apart from any leasing arrangement. That is, if it is leased property used in a manufacturing business, then the locality cannot properly tax the property; but the refund claim would have to be made in the name of the leasing

company. Typically, lease agreements require that the lessees reimburse taxes paid by the leasing companies, and it is the leasing companies that file the local tax return. The leasing companies are just intermediaries, however, and the analysis is otherwise unchanged. Past experience is that most leasing companies will cooperate with their customers in the pursuit of Business Personal Property tax refunds.

7. SUMMARY: THE VIRGINIA SUPREME COURT'S REMINDER ON THE CLASSIFICATION STATUTE AND THE "PUT-BACK" LANGUAGE.

At least once each decade, the Virginia Supreme Court reminds Virginia localities that there are constitutional and statutory limits to their taxation of Business Personal Property. The *Verizon Online* decision, while facially limited to a single category of cable equipment, is the reminder that the Classification Statute is alive and well in Virginia, and

that certain classes of Business Personal Property remain excluded from local taxation. The localities' consistent encroachment on the exclusions will be restricted, with the "put back" language in the statute construed narrowly. The Court's further reminder is that "statutes imposing taxes are to be construed most strongly against the government, and in favor of the citizens, and are not to be extended by implication beyond the clear import of the language used. Whenever there is just doubt that doubt should absolve the taxpayer from his burden."

Companies paying Business Personal Property taxes to Virginia localities should look closely at whether the property they are reporting is taxable by the localities. If the workings of the Classifications Statute, as revisited in the *Verizon Online* ruling, raise questions, then a business taxpayer should consult with knowledgeable counsel, and should consider correcting its reporting and pursuing refunds for past overpayments. ■

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