2025 Workgroup to Review the BPOL Out-of-State Deduction

June 3, 2025

Welcome

Meeting Agenda

- Introduction and purpose of the workgroup
- Background of the deduction
  - Scope of the deduction
  - P.D. 18-170 and 22-117
- Additional information on the deduction relevant to the Workgroup
  - Constitutional, federal, and case law concerns
  - Preliminary analysis on the impact to local governments of expanding the scope of the deduction
  - Potential administrative issues for taxpayers
  - Other provisions of law that may impact the deduction
    - Taxes in other states that may impact the deduction
- Statements from each workgroup member (please try to limit your statement to 3 minutes)
- Discussion of legislatively mandated topics
- Conclusion and follow-up items

Introduction

What brings us together

- Chapter 192 of the 2025 Acts of Assembly (House Bill 1743) requires the Department to convene a workgroup to review the local license tax deduction in Virginia for receipts attributable to out-of-state business, including a review of:
  - Current policy and methodology of the deduction set forth in § 58.1-3732 (B)(2);
  - Any constitutional or case law concerns regarding the existing laws governing such deduction;
  - Any potential impact on local government revenue as a result of determining such deduction based upon receipts subject to a net income tax or gross receipts tax in another state or foreign jurisdiction and alternatives to phase in any such potential impact;
  - The potential administrative complexities or benefits for taxpayers and the support structure necessary to verify across local jurisdictions the applicable deduction and to enforce compliance; and
  - Any impact to such deduction from other existing provisions of law.

Introduction

- The workgroup shall consist of individuals with experience in local license tax compliance and enforcement, including representatives of:
  - The Virginia Municipal League,
  - The Virginia Association of Counties,
  - The Commissioners of the Revenue Association of Virginia,
  - The Virginia Society of Certified Public Accountants,
  - The Council on State Taxation,
  - The Virginia Chamber of Commerce, and
  - Any other key business tax representatives as determined by the Department.
- The Department must submit a report of the findings/recommendations, if any, of the workgroup to the Joint Subcommittee on Tax Policy and to the Chairs of SFAC and HAC by October 1, 2025.

Background

- The deduction in *Virginia Code* § 58.1-3732(B)(2) was enacted in 1996 following a 1995 report by a joint subcommittee's study of BPOL administration.
- Most of the recommendations resulted from a consensus between representatives of the business community and localities. See House Document No. 59 (1995).
- However, consensus was not achieved regarding *Virginia Code* § 58.1-3732(B)(2).
- Instead, alternatives were presented to the joint subcommittee, which voted to adopt the present language.

Background

- On the topic of the proposed deduction the subcommittee report noted:

At its January 9, 1995 meeting, the Joint Subcommittee also adopted a deduction that effectively exempts all receipts that are subject to income tax in other states. This is contrary to the concept of a privilege tax, which generally looks to the place where the privilege was exercised rather than the destination of the goods. Localities are extremely concerned about such a provision, especially larger localities who contend it could cause significant revenue losses. The business community would prefer to exempt all gross receipts which have any connection with activity in other states. The provision, however, only exempts receipts when the activity in the other state has resulted in an actual income tax liability to the other state or foreign country. The apportionment of receipts attributable to activities within Virginia will not be affected. Nor does the provision allow for a deduction for a business which has its only office in Virginia and its contacts with other states is not sufficient to allow any other state to impose an income tax.

Current Policy and Methodology

Deduction for Receipts Attributable to Out-of-State Business

- *Virginia Code* § 58.1-3732 (B)(2) provides that any receipts attributable to business conducted in another state or foreign country in which the taxpayer (or its shareholders, partners or members in lieu of the taxpayer) is liable for an income or other tax based upon income are deductible from gross receipts or gross purchases for license tax purposes.
- The Department is authorized by *Virginia Code* § 58.1-3703.1 to issue determinations on taxpayer appeals of BPOL assessments.
- The Department's rulings on the scope of the deduction have clarified that the deduction is available for taxes paid to other states that are based on income regardless of whether such taxes are called an "income tax" but the out-of-state taxes being deducted must be assessed on *net income* to be deductible.

Virginia Tax

Current Policy and Methodology

Scope of the Deduction

- Taxpayers must first identify whether employees at a Virginia location participated in interstate transactions to ascertain if the taxpayer may be subject to income taxation in another state.
- To that end, the methodology for determining the amount of taxes paid that are properly deductible generally requires that:
  - Receipts be sitused to a definite place of business in Virginia, and
  - From those receipts assigned to a definite place of business within a Virginia locality, a business may deduct receipts to the extent that the taxpayer can identify receipts attributable to business conducted in another state in which it filed an income tax return and income tax was paid.

Public Document 18-170

- In P.D. 18-170, the Department evaluated deductions for taxes paid to AZ, CA, DC, FL, GA, NY, TX, UT, and WV. Relying on P.D. 97-490 and 23 VAC 10-500-80 (A)(2), the Department clarified that a business is eligible for the deduction for gross receipts for states in which the business was liable for a tax based upon income, regardless of whether the tax is called an income tax.
  - P.D. 97-490 clarifies that a taxpayer must be *required* by the laws of another state or foreign country to file an income tax return or other return or for a tax based upon income in order to be eligible to claim a deduction.
  - 23 VAC 10-500-80 (A)(2) requires a taxpayer to file an income or income-like tax return in a state or foreign country even if there is no actual tax liability in a given year, in order to claim the deduction in that state or foreign country.

Current Policy and Methodology

Public Document 22-117

- In P.D. 22-117, the Department considered whether deductions for taxes paid in Ohio, Texas, and Washington were correctly disallowed due to those states not having an income tax filing requirement. The Department determined that allowing the deduction for any taxes not imposed on or measured by net income would have the effect of broadening the deduction beyond the clear statutory language.
  - OH's Commercial Activity Tax (CAT), TX's Margin Tax, and WA's Business and Occupation Tax (B&O Tax) are gross receipt-based taxes levied in lieu of a corporate income tax. The Department determined that deductions for these taxes were correctly disallowed.
  - The Department's analysis focused both on whether the taxes at issue were imposed on net income and whether the taxes were subject to P.L. 86-272.

Constitutional Concerns

The Complete Auto Transit Framework

- The U.S. Supreme Court, in *Complete Auto Transit, Inc. v. Brady (1977),* articulated a four-prong test for determining whether a state tax on interstate commerce passes Constitutional muster under the Commerce and Due Process Clauses:
  - Substantial nexus,
  - Fair apportionment,
  - Non-discrimination against interstate commerce, and
  - Fair relation between the tax and the services provided by the state.
- If a Constitutional question is raised regarding a deduction or credit for taxes paid to another state, it is most likely to be raised on the "fair apportionment" prong.

Fair Apportionment

- Fair apportionment requires that the state may not exact from interstate commerce more than the state's fair share of a single integrated enterprise carried on both within and without the state.
- The Court's jurisprudence since *Complete Auto* has relied upon a test of internal and external consistency to determine whether a state's tax is fairly apportioned:
  - Internal consistency requires that a tax be structured so that if every state were to impose an identical tax, no multiple taxation would result.
  - External consistency requires that a state tax only that portion of revenues from interstate activity that reasonably reflects the in-state component of the activity being taxed.

Constitutional Concerns

Federal Law and Nexus

- Public Law 86-272 prohibits a state from imposing a net income tax where the only contacts with a state are a narrowly defined set of activities constituting solicitation of orders for sales of tangible personal property.
- The scope of P.L. 86-272 is limited to only those activities that constitute solicitation, are ancillary to solicitation, or are de minimis in nature.
- The Department's rulings concerning the BPOL out-of-state deduction reflect consideration of the impact of P.L. 86-272 with regard to the methodology for computing the out-of-state deduction when payroll apportionment is used to situs gross receipts.

Constitutional Concerns

Federal Law and Nexus

- P.L. 86-272 is relevant to the consideration of the BPOL out-of-state deduction when determining whether the activities related to an interstate transaction that are undertaken by employees in Virginia are sufficient to qualify for the deduction of gross receipts upon which taxes were paid to a particular state.
  - Since the possible activities that could create taxable nexus with another state far exceed activities protected under P.L. 86-272, a taxpayer engaging in those activities has exceeded P.L. 86-272's protections and may be taxed in the other state or jurisdiction.
  - Accordingly, minimal contacts with an interstate transaction by personnel based at a definite place of business in a Virginia locality would be sufficient to qualify the business for an out-of-state deduction.

Additional Information

The Potential Impact to Local Governments of Expanding the Deduction

- BPOL revenues represent a significant source of funding for the localities that impose it and expanding the deduction would most likely result in a reduction of those revenues.
  - Localities may not be equipped to replace the lost revenues since they are barred from imposing a tax on net income.
- Corporate apportionment methodologies amongst various states are not always consistent.
  - Localities strive for consistency and predictability in their tax bases and expanding the deduction to include different and evolving types of taxes would not only lessen the tax base but would make year-over-year assumptions difficult for localities.
- Alternatively, a broader deduction that offers greater predictability and a lower tax burden may encourage more businesses to establish business operations in Virginia.

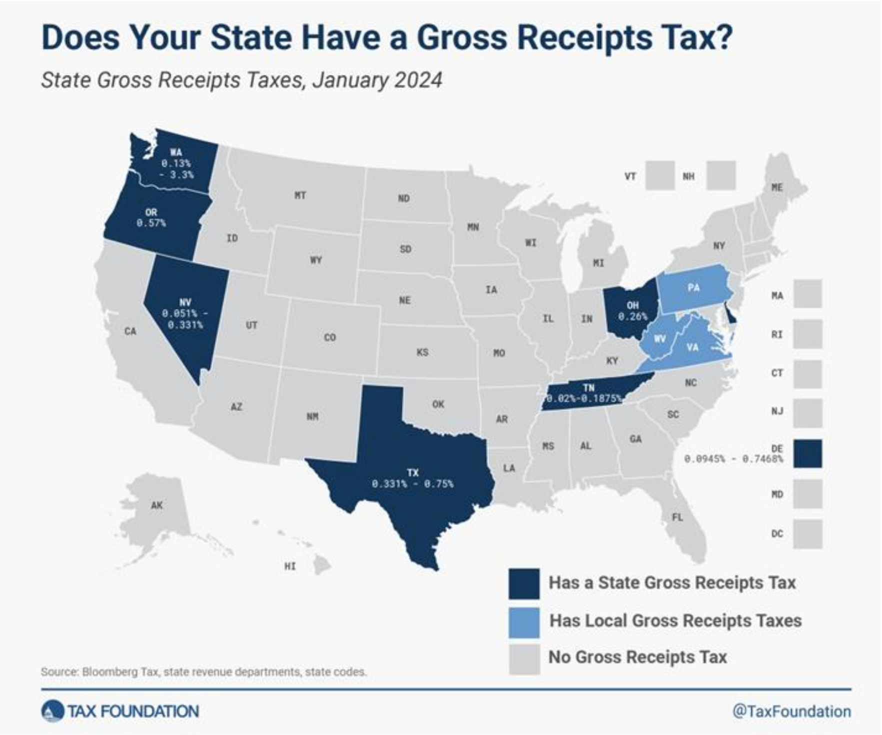
Additional Information

The Potential Administrative Impact to Taxpayers

- Broadening the deduction could ease the administrative burden on taxpayers.
  - Broadening the statutory language to include taxes on gross receipts or net income could potentially increase predictability and consistency for taxpayers as the amended deduction would presumptively apply to all similar taxes paid to other states.
  - While the Department's rulings on this issue have consistently recommended that localities apply the same methodology for determining the eligible gross receipts, amending the statutory language to broaden the deduction would lessen the number of aggrieved taxpayers and reduce the number of appeals submitted to the Department.
- It is unclear what support system is necessary to verify across local jurisdictions the applicable deduction and to enforce compliance. Localities are best situated to comment on this.

Other Provisions of Law That May Impact the Deduction

- Several other states have adopted gross receipts taxes in lieu of income taxes:
  - Ohio
  - Oregon
  - Texas
  - Nevada
  - Washington
  - Tennessee
  - Delaware



Additional Information

Other Provisions of Law That May Impact the Deduction

- Ohio’s CAT is an annual privilege tax on businesses with annual taxable gross receipts greater than $3 million, measured by gross receipts from business activities in Ohio.
- Washington’s B&O Tax is a gross receipts tax measured on the value of products, gross proceeds of sale, or gross income of the business. No deductions are permitted for business expenses or costs of production or labor.
- Oregon’s Corporate Activity Tax is a privilege tax levied on commercial activity in Oregon which exceeds $1 million annually. A 35% deduction for certain business expenses is permitted.
- Texas’s Franchise Tax is a privilege tax assessed on the revenue reported for federal income tax minus several statutory exclusions. The “no tax due” threshold is $2.47 million.

Other Provisions of Law That May Impact the Deduction

- Nevada’s Commerce Tax is imposed on businesses exceeding $4 million in gross revenue.
- Tennessee imposes a Business Tax and, in very narrow instances, a Gross Receipts Tax. The tax is levied at the state and city level.
- Delaware’s Gross Receipts Tax is levied on the total gross revenues of a business. There are no deductions for the cost of goods or property sold, material or labor costs, interest expense, discounts paid, delivery costs, state or federal taxes, or any other expenses allowed.