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INSIGHT: Virginia State and Local Tax Issues for Virginia-Based Data Centers

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States have been racing to attract data center facilities through the means of increasingly favorable tax incentives. According to a study by Jones Lang LaSalle on US Data Center Outlook in 2018, Northern Virginia has emerged as a titan in the trend, enticing 317 megawatts (MW) out of a total 759.7MW for 2018 construction projects providing cloud data projects across North American, Europe, Middle East, and Africa and Asia-Pacific markets. This dominance is due to Virginia's continued favoring of companies looking to establish large scale facilities in the state, and recent updates to tax exemptions have made the environment even more attractive.

Technology giants such as Amazon, Facebook, and Microsoft have spent a combined $80 billion dollars in the last year on physical assets and have shown an increasingly large appetite for large construction projects as noted by Bloomberg.com in a Sept. 24 article on how much companies' spend to achieve a competitive edge. The surge in big data management, blockchain technology, and cloud computing is only accelerating this spending. For states, it means that competition for large scale development and employment opportunities brought by the big spenders is fierce, and needs to be wooed. For Virginia, having won a portion of Amazon's HQ2 bid, the taxation issues and incentives associated with data centers are now more relevant than ever.

Virginia has worked to provide several positive incentives, but companies considering utilizing favorable tax treatment need to carefully strategize on placement for construction site location as there are general requirements to qualify for exemptions in addition to local tax treatment differing across counties. Virginia and local tax planning must include a consideration of sales tax, property tax, and professional and occupational license tax (BPOL) etc. For the tax professional and the business manager alike, these considerations are the details that have a direct effect on the practical business decisions leading to the thumbs up signal when giving the authorization to build in Virginia.

1. Sales and Use Tax

The most recent addition to Virginia's tax incentives comes in the form of a data center retail sales and use tax (DCRSUT) exemption. This exemption stems from the Virginia Senate Finance Committee unanimously endorsing S.B. 268 in February 2018 amending Virginia Code Section 58.1-3503. The bill allows local governments to create an entirely separate category of tangible personal property exemptions specific to ''computer equipment and peripherals used in a data center.'' Va. Code Sec. 58.1-4303.43. Data centers looking to qualify for the DCRSUT exemption must first enter into a memorandum of understanding (MOU) with the Virginia Economic Development Partnership (VEDP), which then gets forwarded on to the Tax Department in charge of issuing the DCRSUT exemption certificate. The MOU must include information such as the amount of investment, local employment, and other requirements that must be met to qualify. A failure to meet

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these qualifications will result in an immediate termination of the exemption and a requirement to repay of any tax exemptions previously granted.

Qualifying persons include an enterprise or a co-location data center whereby affiliated parties enter into a MOU independently or jointly to meet the requirements for the DCRSUT exemption. The aggregation of tenants allows a flexibility in application. Multiple facilities in one locality will be considered collectively as one data center if the appropriate information is filed in the exhibits of the MOU in conjunction with a participation agreement. It is also important to note that the effective date of the DCRSUT exemption will be from the date of the data center's MOU, allowing a retroactive application of the sales exemption up to that date. Specific to this process, an exempt facility may also assign its certification form to buyers, tenants, etc. to qualify for the exemption. An improper aggregation of tenants or co-location centers will be not meet the appropriate requirements for a qualified MOU and will be subject to an immediate termination of the DCRSUT and reimbursement requirement for any exemptions. At such time, the data center must notify its tenants of the revocation of the DCRSUT.

The DCRSUT exemption, while showing favorable steps for data centers, raises a concern over valuation of property for tax purposes. For taxation analysis purposes, the pertinent language is ''computer equipment and peripherals used in a data center, which shall be valued by a means of a percentage of percentages of the original cost, or by such other method as may reasonably be expected to determine fair market value.'' Va. Code Sections 58.1-3506 and 3503. This language does not inspire confidence in a concrete and consistent method of valuation and any financial analysis should factor in potential risk factors for swings in valuation methods.

2. Property Tax

Virginia, as many states, levies both real and tangible personal property taxes. Also, unique to Virginia, there is a unique machine and tools tax often associated with manufacturing. For the purpose of the discussion of property taxation here, the focus will be kept on real and tangible personal property. Counties in Virginia, such as Henrico County, have reduced the tax rate on computers and related equipment to much more favorable rates than in the past to encourage data center development for qualifying projects. As an example, in Henrico County, the reduction has gone from $3.50 per $100 of assessed value to $0.40 per $100. A table of corresponding local tax rates is below:

County	Value	Rate	Year 1	Year 2	Year 3	TOTAL
Prince William County	$100,000,000	$1.25	$625,000	$437,500	$250,000	$1,312,500
Fairfax County	$100,000,000	$4.57	$2,285,000	$1,599,500	$914,000	$4,798,500
Loudoun County	$100,000,000	$4.20	$2,100,000	$1,680,000	$1,260,000	$5,040,000
Fauquier County	$100,000,000	$2.30	$1,380,000	$920,000	$460,000	$2,760,000
Culpeper County	$100,000,000	$3.50	$2,275,000	$1,750,000	$1,400,000	$5,425,000
Henrico County	$100,000,000	$0.40	$272,000	$180,000	$108,000	$560,000
Virginia Beach	$100,000,000	$0.40	$160,000	$160,000	$160,000	480,000

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According to information published in an economic development site www.yesvirgniabeach.com, in conjunction with lowered tax rates for qualifying equipment, counties have also established acceptable depreciation schedules:

County	Method of Depreciation			Tax Rate per $100 of Assessed Value
	Year 1	Year 2	Year 3	
Prince William County	50%	35%	20%	$1.25
Fairfax County	50%	35%	20%	$4.57
Loudoun County	50%	40%	30%	$4.20
Fauquier County	60%	40%	20%	$2.30
Culpeper County	65%	50%	40%	$3.50
Henrico County	68%	45%	27%	$0.40
Virginia Beach	40%	40%	40%	$0.40

These rates and schedules must be used in conjunction with an overall tax assessment to arrive at the most beneficial location overall. Developers researching potential data center locations should consider a county by county thorough analysis by a tax professional as a mandatory requirement before committing to one location over another.

3. Issues in Evolution of The Law: Characterizing Tangible v. Intangible Property for Tax Valuation

Modern technological advances in data management and servicing have exposed significant issues in the categorization and valuation of tangible business property for tax purposes. As with most states, Virginia's current tax laws were written in a pre-modern manufacturing economy. Virginia and its and localities have exhibited growing pains in the attempts to comingle the valuation of intangible assets contained on a tangible piece of property (data on a server). The issue of property characterization is pivotal for a data center to assess potential tax liability. Thus far, legislators have seemingly carved out three categories of property: (1) tangible, (2) intangible, and (3) data centers, being a hybrid of the two.

A recent example of the issues arising from the characterization of tangible versus intangible property arose in the Virginia Tax Commissioner Ruling 18-167 on Sept. 26, 2018. Virginia's Tax Commissioner—as have many other state tax administrators—deliberately sidestepped the issue of valuing intangible property as its own entity. The commissioner instead aggregated the value of a data center into the category of tangible property—analyzing it as exempt from a tangible business property tax based upon whether it was part of a separate line of business or integral to the business claiming an exemption.

The absence of language discussing intangible property in depth was likely not by accident, but carefully crafted to avoid the substantial complications that would arise when determining when and how valuations would occur. Other issues for intangible property might arise in the form of discrimination cases resulting from the carve outs for ''data centers'', under Section 58.1-3503, that use the same equipment a non-exempt business might possess. This constitutional issue of discrimination, while only briefly touched upon here, will be something for savvy tax practitioners to investigate further going forward.

Knowing whether the servers in a data center are valued as ''a percentage of its original cost'' or ''by such other method as may reasonably be expected'' is vitally important as it can lead to wild swings in valuations if it is determined that the value of the intangible property residing on the server becomes integral to the value of the physical property. For the purposes of assessing potential property tax liability on a data center, this is a vital distinction. Currently, there is no indication in the statute or rulings that the valuation would be bifurcated into tangible and intangible tax categories. Data and information may or may not be held in a fixed location, and, if it is, it might be in that location for a set or varied period. If it was the case that a tangible, physical server's value should incorporate the value of the intangible property that can move in and out of a server in real time, then it is easy to see how the value of a server could fluctuate wildly from one snapshot in time to the next. The valuation process becomes complicated quickly and could be ripe for manipulation of businesses that ''data dump'' prior to any assessment period.

4. Business Professional and Occupation License Tax

The BPOL taxes in Virginia are another factor to consider within the framework of decisions affecting data center development. This tax is calculated as a function of gross receipts subject to rate caps set forth in Va. Code Section 58.1-3706. Any business with gross receipts exceeding $100,000 or $50,000, as applicable, may be subject to a tax that is capped at a level pertaining to a particular category of business or services. Whether a data center qualifies as a professional or business service will have implications on cost, with professional services caps set to $0.58 per $100 of gross receipts and ''business services and all other services not listed'' at $0.36 per $100 of gross receipts as outlined in Section 58.1-3706.

There is also no language indicating how these classifications are determined, or whether or not gross receipts are assessed based on one locked characterization of a business, or pro-rated via various characterizations for data centers performing mixed functions. County finance departments have expressed varying answers on the matter but have also expressed a willingness to work with developers to allow for flexible characterizations. Parties concerned about BPOL should establish clear guidelines with counties as to how their projects fit into one or more categories for taxation purposes.

Various localities have taken inconsistent positions on the BPOL assessment, and this inconsistency extends to rebates, reimbursements and exemptions (referred to in Virginia Beach as ''technology zone incentives''). Qualifying data centers may be eligible for rebates and reimbursement of various taxes and fees, including a rebate of the license tax. As an example, Henrico County has a full exemption for data warehousing but not for data servicing. These rebates and reimbursements should be analyzed on a case by case basis.

5. Going Forward

While the current tax environment in Virginia is favorable toward the development of data center facilities, it may also be useful to attempt to forecast how sustainable these credits are from economic or political perspectives. Economic or political analysis will be left for those specializing in that kind of forecasting, but it nonetheless should be included in the list of questions to ask when considering long term projects. This is mentioned because Virginia held the lions share of IT and data project development *before* many of the tax exemptions were set into motion, and as such, there have been political voices making the argument that the state is giving too much away for free when the area had a favorable advantage from the start.

How this plays out over time is anyone's guess, but it should be taken into consideration when assessing a risk profile for a long-term project worth potentially hundreds of millions of dollars—or more. One more consideration about Virginia moving forward, the decision by Amazon to place one portion of its HQ2 in Arlington County may increase the level of interest when it comes to placing a data center in Virginia and the interest of the General Assembly and the Governor in developing opportunities for future growth.

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