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COORDINATION OF FEDERAL AND STATE TAX LAWS:

EFFECT ON VIRGINIA CORPORATIONS AND THEIR STOCKHOLDERS

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I. INTRODUCTION

Mr. Chairman and ladies and gentlemen:

It is always a pleasure for any lawyer to return to this cradle of the law in America. In addition it is a privilege to participate in this phase of the Virginia renaissance in tax matters that is being brought about in Williamsburg under the stimulating auspices of Dean Curtis and Professor Atkeson.

Mr. Rogers has already this afternoon forcefully presented the general reasons why virtually all tax practitioners in Virginia believe it desirable that our State income tax laws be conformed as much as possible with the federal. On behalf of the Taxation Committee of the Virginia State Bar Association I second and reaffirm them. Mr. Rogers was speaking specifically of the individual income tax but the general reasons he advanced apply equally to the corporate tax.

Since we are thus to consider the federal and the state income taxes on corporations and to study how they differ, let us see first what revenue-producing taxpayers we are dealing with in the case of corporations subject to the Virginia income tax and then let us look at the background of the two laws as they have evolved into their present form.

For the fiscal year ended June 30, 1966 there was corporate net income subject to the Virginia income tax of $963 million on 17,306 corporate income tax returns. The revenue to the state from the corporate income tax, including penalties and interest, slightly exceeded $48 million.¹ For comparison, the most recently available federal statistics indicated corporate net income, less deficits, of nearly $50 billion on returns from

¹ Report of the Department of Taxation to the Governor of Virginia for the Fiscal Year ending June 30, 1966, Table 1, page 9.
1,268,000 active corporations.\(^2\) Thus the number of Virginia corporate returns is less than 1.4 per cent of the federal, but their net income is approximately 1.9 per cent of the federal. Even allowing for the differences in state and federal definitions of corporate net income mentioned by Professor Cohen, these statistics suggest that Virginia's corporations are on the average more profitable than those of her sister states. To be remembered in looking at possible changes in the Virginia corporate income tax is that this law provides $48 million in revenue as opposed to $129 million (in 1964) from the individual income tax, but this revenue comes from only 17,000 corporate returns as opposed to some 1,300,000 individual returns filed. Thus the difference in the cost of processing and collecting the two taxes must be substantial.

Historically, we like to think that Virginia was here before the United States. I am not sure that we take equal pride in the fact that our state was well in the forefront of the federal government also in the use of an income tax. Virginia levied an income tax on salaries and certain other types of individual incomes as early as 1777.\(^3\) In 1843 the General Assembly levied a more comprehensive income tax, including a tax of 1 per cent on wages and salaries, with an exemption of $400, and a tax of 2-1/2 per cent on dividends received from joint stock companies and banks.\(^4\) While that 1843 tax on income from personal services did not apply to their individual merits or demerits, the major benefit of conformity is simplicity, an aid to the taxpayers in understanding the law and therefore

\(^2\) U. S. Treasury Department, Statistics of Income—1962, Corporation Income Tax Returns with Accounting Periods Ended July, 1962-June, 1963, page 5. The Virginia statistics do not indicate whether they exclude inactive corporations having no income or deductions, as has been done in the federal statistics. However, the federal experience indicates that overall the proportion of returns from inactive corporations is insignificant. Thus, the U. S. Treasury Department statistics, op. cit. supra, page 3, show 51,000 inactive corporation returns to the federal government for the fiscal year ended June 30, 1963.

\(^3\) The Act of October 20, 1777, Chap. II, imposed a tax of 10 shillings per 100 pounds on salaries and the “neat income” of certain offices of profit, and a tax of 2 shillings per pound on interest income and various annuities. IX William Waller Hening, The Statutes at Large 350, 353 (1821). For certain amendments (October 1778), see IX Hening at 548.

\(^4\) A few of the early Virginia statutes levying a property tax based the tax on the amount of annual rental income which the property actually generated, if rented, or was capable of generating if it were to be rented. E.g., see II Samuel Shepherd, The Statutes at Large of Virginia (New Series 1835), p. 15 (Act of December 23, 1796), p. 145 (Act of January 23, 1799), p. 200 (Act of January 23, 1800), p. 305 (Act of January 25, 1802).

\(^5\) Virginia Acts of Assembly, 1842-43, Chapter 1, Section 5. The tax on dividends was lowered to 1½% in 1845; Virginia Acts of Assembly, 1845, Chapter 1, Section 5.
corporations, the tax on dividend income did apparently apply to one corporation receiving dividends from another corporation. It is interesting to note that the 1843 income tax was enacted without express sanction from any portion of the Virginia Constitution of that time. The Constitutions of 1851 and 1869, however, expressly provided for income taxation, and the provision of the latter Constitution was carried over into § 170 of the Constitution of 1902. Pursuant to that Constitution, the General Assembly in 1903 enacted a comprehensive tax bill, taxing incomes in excess of $600 per year. The 1903 statute related, however, only to the income of individuals and contained no provisions for taxing corporate income. After several amendments of the Virginia income tax, in 1916 the income of corporations was specifically subjected to the same 1 per cent tax as applied to individuals. Finally, in 1926, the Virginia income tax statutes were extensively rewritten, and a number of the basic provisions relating to corporations in the present-day tax statutes were introduced. The 1926 statutes set the corporate income tax at 3 per cent of net income, and in 1948 the rate of tax on corporations was raised to the present level of 5 per cent.

By contrast, the federal government began taxation of incomes in 1862, and continued off and on with income taxes until the landmark decision of the United States Supreme Court in *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429 (1895), specifically holding the federal income tax constitutional.

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5. There was an express exception for corporations not within the jurisdiction of Virginia. *Virginia Acts of Assembly*, 1842-43, Chapter 2, Section 12.

6. The Virginia Constitution of 1851, Article IV, Section 25 authorized a tax on incomes and salaries. The Virginia Constitution of 1869, Article 10, Section 4, permitted the General Assembly to levy a tax on incomes in excess of $600 per annum.


9. *Virginia Acts of Assembly*, 1916, Chapter 472. The 1916 statute, introducing a corporate income tax, expressly provided that it should not apply to public service corporations subject to a state franchise tax, or to insurance companies subject to a state gross premiums tax, or to state or national banks. Such provisions have been carried forward constantly in the Virginia income tax laws. The corporate tax provisions were enlarged by *Virginia Acts of Assembly*, 1918, Chapter 219, which added a definition of the term "corporation."


12. The Act of July 1, 1862 imposed a federal income tax on incomes in excess of $600, which continued in effect until 1872. The constitutionality of the tax was upheld in *Springer v. United States*, 102 U.S. 586 (1880).
tax unconstitutional. Later however, the Supreme Court upheld a corporate excise tax of 1 per cent of corporate net incomes in excess of $5,000, imposed by the Tariff Act of 1909.\textsuperscript{13} This federal tax, although it was a tax on the privilege of being a corporation, was measured by net income, and is regarded by many commentators as the forerunner of the general federal tax now permitted by the Sixteenth Amendment.\textsuperscript{14}

While the federal government has imposed a continuing tax on corporate net incomes since 1913, and Virginia has done so since 1916, there has not been much uniformity in the approach of the state and federal statutes. To the extent there is any uniformity in the statutes today, it derives largely from Virginia enactments of the 1960's relating to corporate liquidations, organizations, anti-trust divestments, etc.

It is interesting to note that most of the state income tax statutes conforming to the federal pattern, in providing for a tax on individuals, incorporate the federal provisions at the point of defining gross income or adjusted gross income, and again at the point of defining permissible itemized deductions. Typically, the federal definition of adjusted gross income will be taken, subjected to certain adjustments, and then the state will prescribe its own scale of personal exemptions and will prescribe a set of itemized deductions (for those taxpayers who wish to itemize), based on the federal deductions but with modifications. All of this process leads eventually to a definition of state taxable income of the individual. By contrast, the typical conforming statute imposing an income tax on corporations will introduce the federal concepts much more quickly, by defining state taxable income of the corporation directly in terms of federal taxable income, and then applying in one step whatever modifications are needed. A good example is the brand new West Virginia Corporation Income Tax Statute, which defines the "West Virginia taxable income" of a corporation to be "the taxable income of the corporation as defined by the laws of the United States for federal income tax purposes" with certain adjustments.\textsuperscript{15}

If Virginia should undertake to conform its income tax laws more closely to the federal, then, as you know from earlier discussions, one of the great problem areas is whether, and to what extent, Virginia should depart from its existing rules concerning dividends and concerning capital gains. While the basic decision of how to treat capital gains and dividends

\textsuperscript{13} Flint v. Stone Tracy Company, 220 U.S. 107 (1911).

\textsuperscript{14} For a brief discussion of the history of the federal income tax, see Erwin N. Griswold, Cases and Materials on Federal Taxation, pages 3-5 (1960).

\textsuperscript{15} West Virginia Code Annotated, Section 11-24-3(b)(11) (Supp. 1966). The West Virginia statute relating to corporation income tax became effective July 1, 1967.
will probably be made in the context of the income tax on individuals, that decision, once made, will have considerable tax repercussions on corporations. Much of the complexity in the federal tax law today results from the special status accorded to capital gains. If Virginia follows the federal approach to taxing capital gains, then it would matter very much whether transactions such as the sale or exchange of stock in a corporation give rise to capital gain or ordinary income. Thus, for example, if Virginia should conform on the treatment of capital gains generally, it might feel a need for some rules concerning collapsible corporations, comparable to IRC § 341. Under the present Virginia tax law, it makes no difference whether the gain on sale of corporate stock is treated as ordinary income or capital gain, and hence at present there is obviously no need for collapsible corporation rules in Virginia.

If Virginia should retain any portion of its present rule permitting corporate dividends to be received free of income tax to the extent the income of the corporation was subject to Virginia tax in the previous year, then a real question would be presented whether to adopt, for example, the federal rules treating certain stock redemptions as dividends. In the case of Neal v. Commonwealth, decided by the Richmond Law and Equity Court in 1929, a corporation “reduced the amount of its outstanding stock by purchasing some of it” from the stockholders. Due to the Virginia rule permitting a deduction for dividends, the stockholder contended that this redemption should be treated as a dividend under the broad statutory definition of “dividend”. The Law and Equity Court rejected that contention, characterizing the transaction as a sale resulting in taxable capital gain.

If the federal approach to capital gains were adopted by Virginia, then individual taxpayers would no doubt welcome a Virginia equivalent to IRC § 1244, treating loss on the sale of certain “small business stock” as ordinary loss, whereas any gain would be treated as capital gain. Now there is of course no such special rule.

Virginians would also welcome a state equivalent to Subchapter S per-

16. Virginia Code Section 58-81(1) sets forth the present Virginia rule on taxation of dividends. It is sometimes said that the theory of the Virginia statute is to avoid taxing earnings twice (as is done in the federal pattern), once to the corporation and again when distributed as dividends to the stockholder. In fact, however, the statute very imperfectly serves this purpose, since the tax treatment of the dividend, which may arise from earnings accumulated by the corporation many years before, depends only on the proportion of the corporation’s income which was subject to Virginia tax in the previous year. Illustrations are contained in Note, Virginia Taxation—Deductibility of Earnings Received as Liquidation Distribution, 40 Va. L. Rev. 519, at 533-34 (1954).

17. See discussion in 40 Va. L. Rev. at 528.
mitting certain corporations to be taxed essentially like partnerships. Virginians might also welcome a state equivalent to IRC § 1361, which presently permits certain unincorporated business enterprises to elect to be taxed as corporations. Here is an illustration, however, that uniformity in the state and federal tax laws would require continuing change in the Virginia law: § 1361, though now in the federal law, ceases to be effective in 1969.

But all of these matters relate to the basic income tax on corporations and individuals. While conformity is under discussion, it might well be remembered that in the corporate area, the federal law has imposed on corporations not only the basic income tax, but, unlike Virginia, also an accumulated earnings tax (since 1921) and a personal holding company tax (since 1934).

In the case of holding companies, however, the federal pattern would not be entirely workable, because Virginia residents might establish corporations in other states, and utilize them as personal holding companies which would not be subject to the taxing jurisdiction of Virginia. For this reason, if Virginia were to adopt provisions concerning holding companies, it would most likely need provisions comparable to the federal statutes concerning foreign personal holding companies (IRC §§ 551-558), where the additional tax is levied on the shareholders rather than the corporation.

But all of this just shows to what extremes absolute conformity could lead. For the balance of this discussion, we will stick to the basic income tax, and it is now in order to consider the effect of conformity in that area on corporations and stockholders.

II. COMPARISON OF VIRGINIA AND FEDERAL STATUTES

In corporate transactions, the income tax effect on the corporation is so often intertwined with the tax effect on the stockholder that we really will be talking about stockholders just as much as corporations. Another point to keep in mind is that a change in any tax rule may be deemed sometimes beneficial, sometimes harmful, depending on the circumstances of the taxpayer. Hence, in some instances when we discuss the changes that might be wrought by conformity, it is not always possible to say that the change would be uniformly an advantage or uniformly a disadvantage. Let us now proceed to compare some of the specific Virginia and federal tax statutes in various categories, starting with the formation of a corporation and going on through its existence to its end by reorganization or liquidation. In this I apologize in advance for re-

erring so often to various provisions of the IRC merely by the number
of the section. Every year at the N Y U Tax Institute half the audience
is left blank by at least half the speakers never saying what a particular
section contains and referring to it only by number. And yet sometimes
this is unavoidable in the time permitted—and I see a great many ex-
perienced practitioners here who will probably be way ahead of us.

1. Investments in a Corporation. Both the Internal Revenue Code
(§ 351) and the Virginia Code (§ 58-86.1:3) provide that no gain or
loss shall be recognized if property is transferred to a corporation by one
or more persons solely in exchange for stock of the corporation, provided
that the transferors are in control of the transferee corporation imme-
diately after the exchange. Control is defined under both statutes to mean
ownership of stock possessing at least 80 per cent of the total combined
voting power of all classes of voting stock and at least 80 per cent of the
total number of shares of all other classes of stock. However, there are
some curious differences in the statutes. (a) The Virginia statute, unlike
the federal, speaks only of transfers to a “newly organized corporation”.
The federal regulations make it clear that the federal statute is not re-
stricted to newly organized corporations. (b) The Virginia statute requires
that the property be transferred “solely in exchange for stock”, whereas
the federal permits a transfer in exchange for “stock or securities”. (c)
Under the Virginia statute, the transferors must be “individuals”. By
statutory definition [Va. Code § 58-77(4)], the term “individuals” in the
Virginia law specifically excludes corporations and partnerships. The
federal § 351 speaks of transfers by “persons”, which, under the federal
statutory definition [IRC § 7701(a) (1)] includes not only individuals
but also corporations and partnerships. Thus, if one corporation transfers
property to a newly-formed, solely-owned subsidiary, the transaction is
within the scope of the federal rule excluding recognition of gain or loss,
but is not within the scope of the Virginia statute. (d) The federal statute
has a savings provision in the event the transferor receives boot in addition
to stock or securities, limiting the recognition of gain without totally
eliminating the benefit of § 351. Virginia has no such qualification, and
when the Virginia statute is read literally, it would not apply unless the
transfer of property is solely in exchange for stock. (e) Section 351 con-
tains a special rule relating to the fact that the transferors must be in
control of the transferee corporation immediately after the exchange. The
special rule is that if one of the transferors is a corporation which dis-
tributes some of the stock it receives to its own shareholders, this distrib-
ution is not taken into account for purposes of determining whether the
investing transferors are in control immediately after the exchange. The
Virginia statute has no comparable provision, but as noted above, the
Virginia statute does not by its terms allow corporate transferors anyway. Since the federal rule has greater scope than the Virginia rule and resolves some doubts left unresolved by the Virginia statute, conformity would surely be an advantage to Virginia corporations in this area.

2. Corporate distributions.

(a) Dividends Generally. Virginia defines the term "dividend" broadly to mean "any distribution made by a corporation out of its earnings or profits . . . , whether such distribution be made in cash or in other property." [Va. Code § 58-78(9)]. The federal definition in IRC § 316 is similar, although it breaks down "earnings and profits" into two categories: those accumulated after 1913 and those arising in the current taxable year. The federal rules, of course, with the exceptions in IRC § 302 and § 303, treat distributions in redemption of stock as dividends. Because of the Virginia rule making corporate dividends deductible from the stockholder's income to the extent the corporation's own income was subject to Virginia tax in the prior year [Va. Code § 58-81(1)], Virginia stockholders receiving a corporate distribution in redemption of stock have sometimes argued that the Virginia definition of "dividends" (which speaks of any distribution out of earnings or profits) is broad enough to apply to that situation. Thus, for example, suppose a Virginia stockholder of a corporation, all of whose income is subject to Virginia corporate income tax, holds a share of stock with a cost basis of $100. If he receives $120 from the corporation in redemption of his share of stock, and if $80 of the $120 distribution represents the prorata amount of earnings and profits attributable to such share, the Virginia stockholder would like to say that he had received a dividend of $80, all of which would be free of Virginia income tax. The remaining $40 of the distribution would then be applied against the cost basis of $100, resulting in a capital loss of $60. Prior to a 1948 amendment of the Virginia law relating to corporate liquidation, Virginia stockholders made the same type of argument in the case of liquidations as well as in the case of redemptions. In three lower court decisions (in Richmond, Norfolk, and Roanoke), Virginia trial courts have upheld the contrary position of the State Tax Commissioner to say that, notwithstanding the breadth of the statutory definition of dividends, a distribution in redemption of a share of stock is not a dividend.19 In one of these cases, the Norfolk Circuit Court said the word "dividend" as used in the Virginia taxing statutes.

was used in "its primary meaning of current dividends annually declared from the earned profits in the regular course of the corporation's annual business operations." Absent the special Virginia rule making certain corporate dividends deductible, there would be no impetus to seek dividend status for distributions in redemption of stock. In fact, if the federal rules were adopted in Virginia, Virginia stockholders would certainly want the limited protections from dividend treatment afforded by IRC § 302 in the case of redemption distributions which are "not essentially equivalent" to dividends, "substantially disproportionate", or "terminations of interest". Also desirable would be the provisions of IRC § 303, avoiding dividend treatment of certain stock redemptions for the payment of death taxes.

(b) Stock Dividends and Stock Rights. The Virginia definition of dividend [Va. Code § 58-77(9)] specifically provides that the distribution of a stock dividend is not to be treated as a dividend. This is similar to the federal rule in IRC § 305, although the federal statute has two exceptions: (i) a stock dividend issued in discharge of preference dividends for the current taxable year of the corporation is taxable income; (ii) if the stockholder has an election to receive a dividend either in stock or in property, then the dividend is taxable income even though he elects to receive stock. The federal rule excluding stock dividends from income taxation also applies to stock rights. Virginia law is entirely silent as to the treatment of stock rights. CCH says Virginia "presumably" will accept whatever federal treatment the stockholder elects to use, and this is probably the case. Because of the possibility of the so-called preferred stock bail-out where preferred stock has been issued as a dividend on common stock, in the event the Virginia corporate tax rules should be rewritten in the federal pattern, the Department of Taxation would no doubt favor inclusion of a § 306 in the Virginia law.

3. Reorganizations. Section 368 of the Internal Revenue Code defines the several types of corporate reorganizations which are "tax free" under the federal law, and IRC §§ 361 and 354 state the effect on corporations and stockholders of engaging in such reorganizations. Va. Code § 58-86

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21. 1 CCH, Va. State Tax Reporter, para. 11-301, states that although the treatment of stock rights is not covered in the Virginia law or in the tax return instructions or in any administrative ruling, Virginia will "presumably" accept the federal treatment of distribution, exercise or sale of stock rights. It should be remembered that under the federal rule (IRS Section 307), the stockholder sometimes has an election whether to allocate any of the basis of his stock to the stock rights.
states that in connection with the reorganization, merger or consolidation of a corporation, if a taxpayer receives, in place of stock or securities owned by him, new stock or securities of the reorganized, merged or consolidated corporation, then no gain or loss is deemed to occur from the exchange until the new stock or securities are sold. The basis of the old stock or securities is transferred to the new. The Virginia statute specifically gives this treatment to “A” reorganizations (i.e., mergers or consolidations), but does not define reorganizations generally. It is known that the Virginia Tax Commissioner has issued rulings that certain transactions constituting tax-free reorganizations under the federal statute were also tax free under Virginia law; but in the absence of a detailed statutory definition of reorganizations, there can obviously be no assurance that the Virginia taxing authorities will in every instance follow the federal rules. The great benefit of adopting the federal rule for Virginia in the area of corporate reorganizations would be greater certainty as to the state income tax consequences of a reorganization. At the present time, it seems fair to say that few reorganizations of major companies occur in Virginia until they have received the specific ruling of the State Tax Commissioner that they are non-taxable.


(a) Liquidations Generally. Since 1924, the federal tax law has contained the provisions now found in IRC § 331 stating that distributions in complete liquidation of a corporation are treated as payments in exchange for the stock, thus giving rise to a capital gain or loss. Va. Code § 58-86, relating to exchanges of property in various corporate situations, was silent on the subject of liquidations prior to 1948. This statute, which also covers reorganizations, mergers and consolidations, was briefly discussed a moment ago in regard to redemptions. The 1948 amendment states that when certain property is received in exchange for stock in the course of a complete liquidation of a corporation, no gain or loss is deemed to occur. The “certain property” which may be thus received tax-free in a corporate liquidation is property “acquired by the liquidated corporation out of the funds resulting from the sale of stock, advancements made by stockholders or other assets not accumulated out of profits or earnings.” To the extent then that the liquidating distribution represents earnings...
and profits, the receipt of such property is not a tax-free transaction. Based on the position taken by the Department of Taxation in a 1950 case, it appears to be the view of the Department that, to the extent property distributed in a complete liquidation represents accumulated earnings and profits, the fair market value of that property at the time of the liquidating distributions shall be determined and applied to reduce the basis of the stock. The remaining basis of the stock, if any, would then be carried over to the distributed properties which derived from the original sale of stock by the corporation or other sources exclusive of earnings and profits. The Virginia statute is not entirely clear, however, and it has been argued that the distribution of earnings and profits in a corporate liquidation should be treated under the current Virginia statutes as a dividend.

It might be noted in passing that Va. Code § 58-86 relates only to complete liquidations. The Virginia statutes do not contain provisions concerning partial liquidations comparable to the provisions found in IRC §§ 331 and 346.

(b) Complete Liquidations of Subsidiaries. In 1964, Virginia added to its tax statutes a section (58-86.1:2) similar to IRC § 332, so that a parent corporation might liquidate a subsidiary without recognition of gain or loss, regardless of accumulations of earnings and profits, if any, in the subsidiary. The Virginia statute, like the federal, contemplates the adoption of a plan of liquidation of the subsidiary, and the parent corporation, from the time of the adoption of the plan until the time when the distribution of assets is completed, must be the owner of at least 80 per cent of all the voting stock of the subsidiary and at least 80 per cent of all other stock except non-voting preferred. The Virginia statute does not have the federal provision specifically permitting the liquidating distributions over a 3-year period.

The federal statute has a special rule pertaining to indebtedness of the subsidiary corporation to the parent, so that the subsidiary will not recognize any gain or loss in the course of a 332 liquidation when it transfers property to its parent in satisfaction of indebtedness to the parent. There is no comparable provision in the Virginia law.

The Virginia law lacks one very useful provision of the federal Code in regard to liquidations of subsidiaries. Because of IRC § 334(b) (2), one corporation may buy up 80 per cent or more of the shares of another corporation during a 12-month period, adopt a § 332 plan of liquidation within two years after acquiring such shares, and then, at the time of


liquidation, its cost basis for the stock of the subsidiary will be transferred to the property received in liquidation. In practice, this means that one corporation will sometimes pay a bit of a premium for the shares of another corporation, since the acquired corporation can be liquidated and a stepped-up basis assigned to its assets at the time of liquidation. The Virginia statute requires that the parent company's basis, after liquidation, be the same as the subsidiary's basis for its assets.

(c) One Month Liquidations. In 1966, Virginia adopted a section (58-86.1:5) like IRC § 333, permitting a “qualified” shareholder, at his election, to avoid recognition of gain in a corporate liquidation where the stockholder receives no money and no stock or securities acquired by the corporation after 1953, and where the corporation has no accumulated earnings and profits. To the extent that (i) the corporation does have accumulated earnings and profits allocable to his shares, or to the extent (ii) the stockholder receives money, or stock or securities acquired by the corporation after 1953, (whichever is greater), the stockholder must recognize gain. After adoption of a plan of liquidation, the transfer of all property of the corporation for purposes of liquidation must occur within some one calendar month. If a single corporate stockholder possesses 50 per cent or more of the voting stock of the liquidated corporation, such corporate stockholder cannot obtain the benefit of § 333. Moreover, in order for the benefits to be available to any qualified individual stockholder, the holders of at least 80 per cent of the voting stock owned by individuals must elect the benefits of § 333. Similarly, a qualified corporate stockholder may come under § 333 only if qualified corporate stockholders possessing at least 80 per cent of the voting stock owned by qualified corporate stockholders so elect.

The main purpose of this provision is to allow corporations holding appreciated property, but having no earnings and profits, or cash, to be liquidated without recognition of gain by the stockholders.25 This provision was introduced into the federal tax law in 1938, to permit liquidation of personal holding companies which had been subjected to the very burdensome personal holding company tax by the Revenue Act of 1934.

The Virginia statute is almost word for word the same as the federal § 333, except that the special rule at the end of the statute relating to personal holding companies is somewhat truncated in the Virginia version. Since it is the purpose of this statute to defer recognition of gain, except to the extent there are earnings and profits or cash and post-1953 stock and securities, the Virginia statute added subsection (f) to say that dis-

tributions in liquidations under this statute should not be regarded as dividends under the general Virginia definition of dividends.26

(d) Gain or Loss on Sales of Assets by Corporations in Connection with Liquidations. As all of you know, section 337 of the federal code was introduced to reverse the Supreme Court's rule in Commissioner v. Court Holding Company, 324 U.S. 331 (1945). In 1960, Virginia adopted a similar section (58-86.1:1). The general rule of the federal and Virginia provisions is that a corporation, having adopted a plan of complete liquidation, may sell or exchange assets without recognition of gain or loss so long as the distribution of all assets of the corporation, less those retained to meet claims, is completed within twelve months from the date of adoption of the plan of liquidation. This general rule does not apply to the sale or exchange by the corporation, within the twelve-month period, of stock in trade unless substantially all of the stock in trade is sold or exchanged to one person in one transaction. There is also a limitation on application of the general rule insofar as installment obligations are concerned. While the Virginia rule and the federal rule appear to be very similar, there is one subtle difference. The federal § 337 does not apply to those liquidations which fall under the provisions of § 333. Remember, however, that § 333 is an elective provision, and will not apply unless elected by the requisite 80 per cent of qualified shareholders. The Virginia rule, by its terms, is not applicable to sales or exchanges following the adoption of a plan of complete liquidation “if the transfer of all the property under the liquidation occurs within some one calendar month.” It is possible that the liquidating distributions might be completed within one calendar month after adoption of the plan of liquidation even though the shareholders had not elected the benefits of § 333. If such were the case, then the federal § 337 would apply, but the Virginia counterpart rule would not apply. Generally speaking, neither the federal § 337 nor its Virginia counterpart would apply when there is a liquidation by a parent corporation of an 80 percent or more owned subsidiary. This, however, is subject to an exception where the liquidation of the subsidiary falls under IRC § 334(b) (2) because at least 80 per cent of the stock of the subsidiary was acquired in a twelve-month period and the plan of liquidation was adopted not more than two years after such acquisition. [Remember that Virginia has no equivalent to IRC § 334(b)]

26. In inserting subsection (f) into Virginia Code Section 58-86.1:5, the legislature failed to alter properly the cross-references at the end of subsection (a) taken from the federal statute. Virginia also added subsection (i) stating that the basis of property received in an elective one-month liquidation would be the basis of the stock cancelled, plus the amount of gain recognized, minus the amount of any money received by the stockholder.
In this circumstance, if the corporation being liquidated should sell or exchange properties within twelve months after the adoption of the plan of liquidation, the federal non-recognition of gain or loss provisions in § 337 would be applicable, but the Virginia counterpart statute would not apply. One might also note that the federal § 337 is not applicable to sales or exchanges of assets made by collapsible corporations. Virginia has no equivalent limitation, since the Virginia law at present is not concerned with collapsible corporations.

One final difference in the state and federal rules is that the federal statute contains special provisions for certain minority stockholders, which are not found in the Virginia law. Suppose a corporation is owned 80 percent or more by another corporation, but that ownership has not been acquired over any one 12-month period, and the subsidiary corporation sells some assets and then liquidates. The sale of assets cannot qualify for § 337 treatment because of § 337(c)(2)(A), but the liquidation is tax-free to the parent corporation under § 332 and does not come under § 334(b)(2). Here the parent corporation takes as its basis for the distributed assets the basis of those assets in the hands of the liquidating corporation. There is in this situation a very complex federal rule to benefit the minority stockholders, if any, by in effect giving them credit for the tax the liquidated corporation had to pay because it was not eligible for 337. Virginia has no such special rule for minority stockholders.27

From the above examples concerning liquidation, it is apparent that while the Virginia rules closely parallel the federal rules, it is quite possible for a transaction to have the benefit of a federal rule on liquidation and not have the benefit of the similar Virginia rule. The very close similarity of the Virginia statutes could easily mislead the unwary. Since Virginia has so closely approached the federal rules concerning liquidations, it would certainly appear desirable to conform the Virginia statutes in this area a bit further to eliminate some of these traps.

5. Loss Carryovers.

(a) Operating Losses. Virginia Code § 58-81.2 allows to a "manufacturing business" a three-year net operating loss carryover. The federal provision, IRC § 172, which allows both a five-year carryover and a three-year carryback of net operating losses, is obviously much broader. In addition, the federal net operating loss carryover and carryback are not restricted to manufacturing businesses.

(b) Capital Losses. Section 1212 of the federal Code allows corpora-

tions a five-year capital loss carryover. There is no equivalent in the Virginia Code.


The Virginia rule (Va. Code § 58-81(n) and § 58-81 (a)(1)(B)) and the federal rule (IRC § 170(b)(2)) limiting charitable deductions for a corporation are quite similar. Basically, the limitation in each instance is 5% of the corporation’s taxable income (computed without regard to the charitable deduction). There are certain additional refinements in the federal limitation. Where excess charitable contributions are made in any taxable year, however, the federal statute allows a five-year carryover to corporations, but the Virginia statute has no carryover provisions. In this area, conformity would be an advantage to corporations paying Virginia income tax.

7. Exempt Organizations.

Virginia Code § 58-128 exempts from the Virginia income tax “religious, educational, benevolent and other corporations not organized or conducted for pecuniary profit.” The federal definition of exempt organizations in IRC § 501 is, of course, vastly more detailed. In addition, the federal statute conditions exempt status on the avoidance of certain “prohibited transactions” [IRC § 503 (c)]. The federal § 503 also conditions charitable deductions for a donor to situations where the donee is exempt from income taxes under § 501. The Virginia provision concerning charitable deductions in Virginia Code § 58-81 does not thus condition the charitable deduction for the donor.

Under the federal scheme, an organization claiming to be exempt from income tax must file an application with the district director to establish its exempt status. Prior to the establishing of exempt status in this manner, the organization must file the regular corporate income tax return (if it is a corporation) and pay the tax indicated. Then, upon establishing exempt status, it may file for a refund of any taxes thus paid. Obviously, the federal approach to exempt organizations is considerably more sophisticated than the Virginia approach.

If Virginia should follow the federal procedure, and deny exempt status to organizations which had not submitted an appropriate application, or which had engaged in “prohibited transactions,” then an interesting question under the Virginia Constitution might conceivably arise. Section 183 of the Virginia Constitution makes the property of various charitable and other organizations “exempt from taxation.”

29. Treas. Regs. § 1.6033—1(c).
case of Commonwealth v. P. Lorillard Company, Inc., 129 Va. 74 (1921), construing a Virginia tax statute, held that a tax on income is a tax on property. That is to say, the term “property” was deemed to comprehend “income.” If that same interpretation were given to the term “property” in § 183 of the Virginia Constitution, then it might be impossible to apply to the organizations described in § 183 some of the restrictions and prohibitions appearing in the federal income tax law. In addition, such an interpretation of the word “property” in the Virginia Constitution could interfere with a tax on the unrelated business income of exempt organizations, such as is imposed by the Internal Revenue Code in § 511.

8. Banks.

Virginia Code § 58-128 excludes state and national banks from the Virginia corporate income tax. Virginia Code § 58-473, however, imposes on stockholders of banks an annual intangibles tax of 1 per cent of the value of the bank shares. “Value” is based on the capital, surplus and undivided profits of the bank. (Va. Code § 58-471). The mechanics of this tax are such that the bank itself pays the tax for its shareholders.

The question of uniformity of state and federal taxation is especially difficult with respect to national banks, because there is a federal statute (12 U.S. Code § 548) which restricts the taxes that may be levied by a state with respect to such banks. Generally speaking, the state is permitted either to tax the shares of a national bank (as Virginia does), or to tax the shareholders on the dividend income which they receive from the bank, or to levy an income tax on the bank itself or a franchise tax based on net income of the bank. Only one of these approaches may be followed by the state, except, that if a state imposes an income tax on corporations generally and also an income tax on individuals generally, then it may levy a corporate income tax on the national bank and also include bank dividends in the taxable income of the stockholders. There are restrictions on the rates which may be imposed. The federal statute, however, does not permit both a net income tax on a national bank and an intangibles tax on the bank shares. Thus, if Virginia should choose to tax the income of national banks, as the federal government does, Virginia would have to give up its intangibles tax on national bank shares. The federal statute would not prevent Virginia from levying both a corporate income tax and an intangibles tax with respect to state banks. However, it seems unlikely that Virginia would subject its own state banks to more onerous taxation overall than would be permitted for national banks operating in Virginia. Whether the intangibles tax or a corporate income tax on banks would yield the greater revenue obviously would depend on operating results and share capital of the particular bank in question.
9. Professional Associations.

Because of the relative tax benefits provided under the federal law to corporations with respect to profit-sharing and pension plans, deductibility of premiums on group term life insurance, etc., professional partnerships have long envied the tax advantages of being classed as an "association" under the definitions of IRC § 7701. The Treasury, in the so-called Kintner Regulations, in 1960 outlined the corporate characteristics which a professional partnership would need to qualify as an "association" taxable as a corporation.

To assist professional partnerships in meeting the requirements of the federal regulations, various states, including Virginia, have adopted professional association statutes. The Virginia statute (Va. Code § 54-873 et. seq.) dating from 1962 specifically makes associations qualifying under the provisions of Chapter 25 of Title 54 taxable as corporations, and those provisions are certain and easily met by professionals who wish Virginia corporate treatment. Section 54-878 provides for the filing of articles of association with the State Department of Taxation, and to date articles have been filed on seventeen, mostly architects and engineers, a few doctors' clinics and two or three law firms.

The Treasury, however, has considerably tightened up the federal requirements for corporate status in 1965, making it virtually impossible for professional associations to qualify. One United States District Court case, Empey v. United States, 20 A.F.T.R. 2d 5403 (D.C. Colorado 1967), has held certain of the Kintner Regulations invalid insofar as they affected a Colorado professional association of lawyers. Court attacks on the Regulations are also underway in several other jurisdictions. In addition, there is now pending before the House Ways and Means Committee a bill (H.R. 7627) which would amend IRC § 7701 to make it quite clear that professional associations can qualify for corporate tax status. For the moment, however, the standing of these associations under federal tax law is quite uncertain.

Thus, this is one area in which Virginia clearly would not wish to conform to the current federal rule (as stated by the Treasury). Until the federal regulations are overturned conclusively by legislation or court decisions, the Virginia rule affording corporate income tax status to professional associations is certainly preferable to the federal.


Since 1926, Virginia has had a statute permitting the Department of Taxation to redetermine the net income of a corporation where it buys from or sells to or otherwise deals with affiliated parties in a manner purposely calculated to create a loss or to reflect net income improperly.
Where two affiliated corporations are involved in such transactions, the Department of Taxation may require from them a consolidated income tax return. (Va. Code § 58-140). It is of interest to note that § 482 of the Internal Revenue Code, in even broader language, similarly permits reallocation of income, deductions, and credits among two or more taxpayers if the Commissioner of Internal Revenue determines that such is necessary to prevent evasion of federal income taxes or to reflect clearly the income of the several taxpayers.


Virginia and the United States have roughly the same definitions of affiliated groups for the allowance of consolidated income tax returns. Virginia as usual has no regulations under its statute, and thus it is anyone's guess as to whether in each particular the state will follow the extremely complicated federal regulations in this area. The advantage of uniformity here would be certainty.

12. Fiscal Year.

Virginia has a statute which specifically permits a corporation to use for Virginia tax purposes the same fiscal year on which it reports to the federal government.a

III. SOME INTERSTATE TAX CONSIDERATIONS.

At the time when Virginia subjected corporations to income tax in 1916, it passed a separate statute exempting from the tax any Virginia corporation which did no part of their business within the state. (Acts, 1916, c. 495). In the case of Virginia corporations which did a portion of their business within the state and a portion without, Virginia briefly attempted to levy a corporate income tax on total income from all sources. The United States Supreme Court held this to be an unconstitutional denial of equal protection of the laws to Virginia corporations operating both within and without the state. F. S. Royster Guano Co. v. Virginia, 253 U.S. 412 (1920). Apparently anticipating the constitutional objection, the Virginia legislature in 1918 amended the tax statutes to say that corporations doing a part of their business within the state and part without should be taxed only upon the income derived from business transacted within Virginia and from property located in Virginia. (Acts, 1918, c. 219).

In a 1921 Virginia case, Commonwealth v. P. Lorillard Co. Inc., 129

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Va. 74, an out-of-state corporation had been assessed by the Virginia authorities with a tax on a portion of its income which the taxing authorities attributed to Virginia operations. But the Virginia statute in question failed to provide a formula for allocating a portion of the corporation's net income to Virginia, and the Virginia Supreme Court said that the taxing authorities could not apply a formula of their own making. The adoption of an appropriate formula was a legislative function. But needless to say, at its next meeting, the General Assembly enacted a formula.

One of the things which apparently motivated the General Assembly to set up the Tax Study Commission in 1966 was the pendency before Congress of a proposed "Interstate Taxation Act" (H.R. 11798, Oct. 22, 1965), which would apply restrictions to state income taxation of corporations operating in more than one state. The federal bill, which was referred to the Committee on the Judiciary, would not only require states in assessing income tax on such corporations to begin with the federal concept of corporate net taxable income, but would require in a sense a moving base, since the state statute would have to provide for picking up amendments in the Internal Revenue Code after the adoption of the state statute.

The federal bill would also prohibit certain types of adjustments such as adjustments in depreciation or adjustments affecting basis.

It would also impose a two-factor formula for allocation (property factor and payroll factor), which would be different from Virginia's current three-factor formula (Virginia also has a sales factor).

Further bills of this type have been introduced into Congress this year and are now pending. (H.R. 2158, and S. 968).

The passage of any federal legislation requiring the states to apply certain federal rules to their taxation of the income of interstate corporations would certainly be an additional motivation for applying those same rules to Virginia's corporations doing all their business within the state.

IV. CONCLUSIONS; BENEFITS OF UNIFORMITY

If any generalization may be drawn from the foregoing discussion as to the benefits or disadvantages of conforming the Virginia tax law to the federal where corporations and stockholders are concerned, perhaps one might say that overall the federal rules allow greater flexibility—i.e., more alternates and elections. In addition, greater conformity would have the

benefit of eliminating some of the tax traps which lie in the approximate but not complete similarity of some of the present Virginia and federal laws.

In theory the Virginia rules are simpler but fail, particularly in the absence of regulations, to answer many questions and they also fail to include many specific rules such as the Subchapter S election that federal experience has found to be called for under present day business and legal circumstances. Over and above these details however and, regardless of their individual merits or demerits, the major benefit of conformity is simplicity, an aid to the taxpayers in understanding the law and therefore in reporting income correctly. Voluntary proper reporting is the foundation stone of all our income tax laws and this is even more important in a system such as Virginia's where no substantial funds are expended in examining the returns in the field. Both the Virginia State Bar and the Virginia State Bar Association as well as, I believe, the official organization of the accountants in Virginia have gone on record as favoring conformity, and we hope that forthcoming legislation will do away with as many as possible of the differences between the two laws. But the greatest advantage of all in such conformity, an advantage I am sure everyone here will by this time appreciate, is that it will save future tax conferences from having to endure speeches on conformity such as this.