Advantages And Disadvantages To Virginia Businesses In The Reconciliation Of Certain Major Accounting Areas As Between Federal And State Tax Laws

R. Braxton Hill Jr.
ADVANTAGES AND DISADVANTAGES TO VIRGINIA BUSINESSES IN THE RECONCILIATION OF CERTAIN MAJOR ACCOUNTING AREAS AS BETWEEN FEDERAL AND STATE LAWS

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Although many differences exist between the Federal and Virginia tax laws with respect to the treatment of specific items of income and deduction in the actual preparation of returns, a good many of the differences do not necessarily create problems of record-keeping however objectionable the dual reporting requirements may be. On the other hand, a large number of the differences in the laws do require dual record-keeping, especially in the area of business records. In addition, the rules and regulations issued by the Virginia Department of Taxation (the primary purpose of which is to explain and simplify the application of the Virginia law) are within themselves inconsistent and not applied similarly to various types of business entities.

Generally, the Virginia tax laws appear more simple in construction and context than do the Federal laws, and in numerous areas seem to accord fairer and more logical treatment to the taxpayer than do the Federal laws. However, this apparent simplicity is the primary cause of the inconsistencies in the rules and regulations issued by the Department. The State Tax Commissioner has obviously always attempted to interpret the Virginia tax laws fairly and impartially. To ease the record-keeping required of businessmen, the Commissioner permits conformity to Federal rules in those instances where his judgment dictates that there is no conflict in law. In many other instances, although it would appear that no conflict in law exists, or where the simplicity of the Virginia law is such that a regulation permitting conformity would be outside the scope of his authority, the Commissioner does not permit conformity.

The income tax laws of Virginia are generally embraced in Chapter 4, Title 58, of the Virginia Code. The interpretive regulations issued by the Commissioner are represented only by the instructions which accompany the various returns, as authorized as follows:

"The only rules and regulations that we issue are found in the printed instructions accompanying tax return forms issued to taxpayers. Our practice in the past has been to follow the federal
rules and regulations, except where they are not consistent with
the Virginia income tax law" (State Tax Comr. to P-H, 1-24-49;
1-1-52. P-H State and Local Taxes—Va.—Para. 10,208.10.)

On the other hand, the comparable income tax laws of the United States
are embraced in the Internal Revenue Code; the interpretive regulations
issued by the Commissioner of Internal Revenue being related directly to
each code section and arranged and published in logical sequence.

In the main, the Federal income tax laws and regulations, although
voluminous, attempt to touch on every type of transaction that a business
is likely to encounter, and to define the record-keeping and/or tax treat-
ment that should be accorded such transactions. The Virginia income tax
laws and regulations, as brief as they are, lack the depth and breadth
necessary for the determination of net taxable income of businesses on
a consistent and understandable basis; and even if they did, the lack of
conformity to the Federal laws would still result in the necessity for dual
record-keeping in many instances.

On the premises that the Virginia tax return instructions actually repre-
sent regulations, the following examples illustrate inconsistencies within
our own State rules.

I. ALLOWANCE FOR SALVAGE VALUE IN COMPUTING DE-
PRECIATION (All comparisons are as per the 1967 instructions
which accompany the returns):

A. Corporate Return........Salvage value required per Instruction 24.
B. Partnership Return.......Salvage value required per Instruction 18.
C. Fiduciary Return..........Salvage value required per Instruction J.
D. Farm Return...............Salvage value not mentioned in instruc-
tions.
E. Proprietorship Return..Salvage value not mentioned in proprietor-
ship instructions for Schedule G; required
only by indirect reference to another sec-
tion of the instructions.

The law provides: Sec. 58-81." * * * Taxpayers
reporting income as prescribed by this chapter shall
be allowed the following deductions:

(i) Depreciation—A reasonable allowance for the
exhaustion, wear and tear (including a reasonable
allowance for obsolescence) —
(1) of property used in the trade or business

**II. WRITE OFF FOR BAD DEBTS—RESERVE METHOD** (All comparisons are as per the 1967 instructions and 1967 returns):

A. Corporate Return........ Reserve method permitted per Instruction 17. Special schedule is provided in the return.

B. Partnership Return....... Reserve method permitted per Instruction 17. Special schedule is provided in the return.

C. Fiduciary Return.......... Reserve method permitted per Instruction 7. No schedule is provided.

D. Farm Return.............. Reserve method permitted per Instructions Page 4. No schedule is provided.

E. Proprietorship Return.. Reserve method not mentioned. No schedule is provided.

The law provides: Sec. 58-81. "** Taxpayers reporting income as prescribed by this chapter shall be allowed the following deductions:

(g) Bad debts—Debts due the taxpayer and actually ascertained to be worthless and actually charged off within the taxable year."

**III. METHODS OF VALUING INVENTORIES** (All comparisons are as per the 1967 instructions and 1967 returns):

A. Corporate Return........ Instruction 2 requires valuation of "cost", or "cost or market whichever is lower". Question #11 on the return requires explanation of any other basis used, but gives no hint as to what other basis might be acceptable.

B. Partnership Return....... Instruction 2 similar to corporate instruction. Question #6 on the return similar to corporate question.

C. Fiduciary Return......... Instruction 7 requires valuation at "cost"
or "cost or market whichever is lower" only, with no alternative. No schedules or questions in the returns relate to inventories.

D. Farm Return. Instructions require valuation using "farm-price method" or "unit livestock price method" as appropriate. No other methods are authorized either in the instructions or in the return itself.

E. Proprietorship Return. Instructions require valuation at "cost" or "lower of cost or market". No other methods are authorized either in the instructions or in the return itself.

THE VIRGINIA STATUTE PROVIDES NO SPECIFIC AUTHORITY FOR THE USE OF INVENTORIES!!

It is apparent from the above three examples relating to depreciation, reserve for bad debts, and inventory valuation that the Virginia statutes and regulations are both found wanting insofar as consistency of application to various types of business entities. Such inconsistencies within themselves create serious problems in record-keeping.

Such problems are further compounded by inconsistencies between State and Federal rules, as indicated by the following examples.

I. DEPRECIATION—FEDERAL vs. STATE RULES:

<table>
<thead>
<tr>
<th>Federal</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>no</td>
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</tbody>
</table>

- Additional 20% first year depreciation allowed
  - Federal: X
  - State: X
- Basis of business property received by gift same as donor's basis
  - Federal: X
  - State: X
- Alternate valuation for basis permissible in re inherited business property
  - Federal: X
  - State: X
- First 10% of basis ignored in determining salvage value
  - Federal: X
  - State: X

II. BAD DEBTS:

<table>
<thead>
<tr>
<th>Federal</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>no</td>
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</table>

- Write off of partial business bad debt permitted
  - Federal: X
  - State: X
Write off of partial non-business bad debt permitted X X
Reserve method permitted by statute as well as by regulation X X

III. INVENTORIES:

<table>
<thead>
<tr>
<th></th>
<th>Federal</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use of inventories authorized by statute</td>
<td>X no</td>
<td>yes no</td>
</tr>
<tr>
<td>Use of “LIFO”, “FIFO”, etc. covered by regulations or statute</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Definition of “cost”, “market”, etc. defined by regulations or statute</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

In the above three major areas alone, the degree of inconsistent treatment accorded these items obviously creates serious accounting and record-keeping problems.

The State Tax Commissioner has repeatedly pointed out that his Department follows Federal Rules where, in his judgment, no conflict with the Virginia statute exists—even to the extent of indicating that such uniformity is desirable (underscoring supplied):

"The only rules and regulations that we issue are found in the printed instructions accompanying tax return forms issued to taxpayers. Our practice in the past has been to follow the federal rules and regulations, except where they are not consistent with the Virginia income tax law.” (State Tax Comr. to P-H, 1-24-49; 1-52. previously quoted hereinbefore).

Also:

"Up to now it has always been our view that there should be uniformity in federal and state rules, so that records for federal purposes would be sufficient for state purposes. Va. Code 58.81 (Para. 12,215.50; .55) provides "a reasonable allowance" for depletion and depreciation—this is broad enough to enable us to follow the new federal rules, which will be done. Code 58-81.1 (Para. 12,218-A on accelerated amortization rate on pollution control facilities, added by Acts 1954, c. 516, speaks for itself.” (State Tax Comr. C. H. Morrissett, to Prentice-Hall, Inc., 11-19-54. P.H. State and Local Taxes—Va.—Para. 10,375.10).

Notwithstanding the above, it is obvious to taxpayers and tax-practitioners that uniformity and consistency have not been adhered to by
the State, even though in many cases a uniform and consistent treatment of a specific item could have been achieved without conflict with the State statute.

Some varied examples are as follows:

I. Sewerage companies—"Sewerage public service corporations operating strictly as sewerage companies and not in connection with supplying water pay the regular State income tax. Connection fees paid to such companies by developers are includible in gross income; they are not includible as contributions in aid of construction for purposes of the Virginia corporation income tax." (Letter of State Tax Commissioner to Commerce Clearing House, Inc., July 7, 1965. CCH Va. Reporter Para. 10,220.85).

Note: Virginia's statute is silent on this matter. Federal rule treats connection fees as reduction in cost basis of property and not as gross income. Based on the above ruling, consistent treatment with Federal rule is obviously not permitted.

II. Corporation's organizational expenses deferred for state income tax purposes.—

Q. Will the Department of Taxation permit organizational expenditures of corporation to be treated as deferred expenses and deducted over period of 60 months or more for Va. income tax purposes by 248 of the Internal Revenue Code.

A. "Corporation electing under 248 of the IRC to treat organizational expenditures of corporation as deferred expenses may file income tax return in same manner." (Tax Comr. to P-H, 7-1-65. P. H. State and Local Taxes—Va.—Para. 13,009.)

Note: Virginia's statute is silent on this matter. But consistent treatment with the Federal rule is permitted in this instance.

III. Business Auto Expense—"In lieu of itemizing and deducting actual expenses, you may figure the cost of operating your own automobile for business purposes at a rate of 7¢ per mile (and no more) for such use regardless of the number of miles". ( Instructions—Form 760.)

Note: Both Federal and State statutes are silent on this item. Federal regulations permit 10¢ deduction per mile up to 15,000 miles, and 7¢ per mile in excess of 15,000 miles. Consistent treatment not permitted by State, notwithstanding lack of statutory provision in both instances.
In addition to the above examples, a few others are mentioned at random in order to demonstrate the wide range of returns affected:

A. Fertilizer and lime costs for long-term conditioning of soil:
   Federal Return.........Deductible (Internal Revenue Code, Sec. 180).
   Virginia Return.........Must capitalize (per farm return instructions; not covered in Virginia statute).

B. 52-53 Week Fiscal Years:
   Federal Return.........Permissible (Internal Revenue Code, Sec. 441).
   Virginia Return.........Not permissible (Statute requires year to end on last day of a month).

C. Research and Development Expenses:
   Federal Return.........Deductible (Internal Revenue Code, Sec. 174.)
   Virginia Return.........No provision as to treatment in either statute or instructions.

D. Exploration and Development Expenses:
   Federal Return.........Deductible (Internal Revenue Code, Sec. 615 and 617).
   Virginia Return.........No provision as to treatment in either statute or instructions.

* * * * *

In light of all the foregoing, it is apparent that many differences now exist between the Federal and Virginia income tax rules, and that a very substantial number of the differences make for the necessity of dual record-keeping as well as onerous reconciliation of book income to Federal taxable income to Virginia taxable income.

Many of the existing differences do not appear justified, and are nuisance in nature. The vast majority of Virginia's income tax statutes were, as originally enacted, based upon the Federal statutes at that time. The differences that now exist create confusion and uncertainty in the minds of businessmen and their advisors in tax matters.

As indicated hereinbefore, the Virginia State Tax Commissioner has always demonstrated the highest integrity in attempting to keep faith
with the Virginia statutes—but with the ever widening breach between the Federal and State statutes the task of maintaining completely equitable tax treatment toward our taxpaying citizens and businesses has become an insurmountable task.

The disadvantages of conforming will have to be declaimed by someone other than this speaker . . . I can’t think of any.