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DEVELOPMENTS BEARING ON THE FUTURE OF TAXATION IN VIRGINIA*

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For the first time since 1926, dramatic changes affecting the tax structure of the Commonwealth of Virginia and its localities are at hand. Internally, the spread of sales taxes among the cities in Virginia threatens to preempt the State of this lucrative source of revenue,¹ long referred to as the State's tax of last resort. Externally, after six years of extensive study and preparation the powerful forces of centralism are urging Congress to dictate federal standards for State taxation.

A. PRESENT TAX SOURCES IN VIRGINIA

Before income tax withholding, the 7-cent per gallon gasoline tax was the largest revenue producer among some 40 State taxes.² Even today, however, the State gasoline tax represents some 26.2% of the \$424,670,533 paid into the State Treasury for the fiscal year ended June 30, 1965, while individual and fiduciary income taxes represented 33.4% of total tax collections (exclusive of license fees), franchise and premium taxes, 10%, excise taxes on beer and selective sales taxes on tobacco and alcoholic beverages, 9.8%, and corporate income taxes 9.4%. Well down the list of revenue producers are Virginia's inheritance tax (1.4%) and gift tax (.08%).

On the local level, real estate levies in 1964 amounted to \$181,369,423, or about 60% of total local tax collections. Local levies on tangible personal property and machinery and tools added an additional \$49,000,000, and assessments on the property of public service corporations \$31,366,902, together amounting to another 30% of total local tax levies. The final 10% of local tax collections are made up primarily of gross receipts taxes on businesses and professions, taxes on merchants' capital and bank stock taxes.

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1. State sales taxes have been enacted in 39 states and the District of Columbia and are the chief source of revenue today in 30 states, aggregating 26% of total taxes collected by all 50 states.

2. Exclusive of licenses and permits, corporate franchise and charter fees, and miscellaneous privilege and service fees.

Virginia localities are denied the right to broaden their tax base through the imposition of payroll taxes,³ income taxes⁴ and taxes on intangible personal property.⁵ Virginia's counties are also apparently denied the right to impose any broad form of license tax which departs substantially from the present form of gross receipts taxation as to rates, exemptions, incidence or reporting periods (e.g., a sales tax).⁶

B. THE SPREAD OF LOCAL SALES TAXES

By all reports, the Commonwealth of Virginia heads into the 1966-68 biennium with a \$96 million surplus and an estimated increase of general revenues of approximately 20%. Such prosperity should hardly portend the adoption of a statewide sales tax.

The fact of the matter is, however, that the Governor desires an increase of general fund appropriations of about 40%, as well as a special fund appropriation increase of about 19% over the next biennium. These increases are scheduled primarily for improved highways, expanded support for higher education and mental health, and increased aid to localities (especially in the public school and welfare areas).

But more importantly, fifteen Virginia cities have already enacted local sales taxes, and at least three others are seriously considering the adoption of such taxes to become effective on or before July 1, 1966. Even without further legislative reapportionment, these cities will have tremendous political leverage when joined by the other cities and towns which are certain to act before the 1968 General Assembly and the urbanized counties which will undoubtedly be given sales tax powers by the 1966 General Assembly co-equal to their adjoining cities.⁷ In such event, control of the sales tax would be lost by the State and the citizens of the Commonwealth would be saddled with the three N's that now characterize local sales taxes in Virginia: nonenforcement, noncompliance and non-chalance.

Of the fifteen local sales tax ordinances enacted to date (not including the Henrico ordinance which was struck down by the Supreme Court of Appeals), only two⁸ are identical. The others all diverge in their approach to exemption of nonresident deliveries, charities, services or drugs, as well as their administrative interpretations concerning the imposition

3. Va. Code Ann. § 58-851.2 (Repl. Vol. 1959).

4. Va. Code Ann. § 58-80 (Repl. Vol. 1959).

5. Va. Const. § 171; Va. Code Ann. § 58-10 (Repl. Vol. 1959).

6. Board of Supervisors v. Corbett, 206 Va. 167, 141 S.E. 2d 504 (1965).

7. If one thing appears certain about the sales tax legislation in the 1966 General Assembly, it is this: if no statewide sales tax is adopted, counties will be authorized by general law to impose sales taxes to the same extent that cities and towns are now so empowered.

8. Petersburg and Colonial Heights.

of the pesky \$4 maximum tax, allowance of credit for taxes paid on bad debts, use of exemption numbers and certificates, etc., etc., etc.

It is bad enough for the ordinances and published regulations to diverge but even worse is the attitude of most tax administrators who, as elected officials, are praying that the 1966 General Assembly will make their sales tax interpretative responsibilities short-lived (but fighting to retain local collection authority), and the city councilmen who feel that they are being of service to their community by imposing a sales tax in order to bargain with the General Assembly in the distribution of State sales tax funds when, in fact, it may be many years before the effect on the income and morality of merchants, consumers, accountants and lawyers caused by the sloppy tax ordinances and inefficient administration can be corrected.

C. SALES TAX DISTRIBUTION PROBLEMS

Almost everyone will concede that a uniform statewide sales tax is preferable to a patchwork of local taxes, but almost no one can agree on the proper distribution of sales tax revenues as between the State and its localities.

Prior to the convening of the 1966 General Assembly, it was generally felt that the State would have to return to the localities at least 2% of a statewide sales tax in order to give the sales tax cities at least as much from a statewide tax as they claim to be able to collect from their own local taxes, such limiting factors as the \$4 maximum to the contrary notwithstanding.⁹ With this in mind, there were four generally accepted formulas being widely discussed:

1. **The ABC Formula.** The simplest method of distribution is utilized in the distribution of funds collected through State controlled sales of alcoholic beverages. Such funds are distributed on a population basis. The Virginia Association of Counties consistently maintains that this is also the proper method for distributing any general sales tax funds.

2. **The Stanley Tax Study Commission Formula.** In its report to the Governor in 1963, the Stanley Tax Study Commission did not recommend the adoption of a statewide sales tax by the 1964 General Assem-

9. If the cities ever drop the \$4 maximum, the State could never hope to return as much revenue to the cities short of a 2% local tax distributed solely on the basis of source of retail sales. The objective of all distribution formula discussions, however, is to give to the nonmarketing, rural areas a share of sales tax proceeds in recognition of the fact that the tax is passed on to the consumer. The non-resident may very well owe a small part of his sales taxes to the market locality (e.g., for police and fire protection, streets, etc.) but "his tax money" should not be taken in aid of the market locality's welfare, public school and other expenses only indirectly related to the nonresident.

bly, but did support (without substantial dissent) the distribution of any State sales tax funds one-half on the basis of source and one-half on the basis of average daily attendance. It is well to keep in mind that ADA figures are designed to reflect school population, not total population, so that localities with large school populations will obviously receive more funds than those that attract elderly or retired persons, for example. Also ADA figures may vary considerably from average daily *membership figures*,¹⁰ and school age population may be altogether a different figure (i.e., include private school enrollment as well as children of school age who have never enrolled and become part of the membership figure).

3. **Local Option Formulas.** Those who favor any form of local option sales tax, whether or not based on theories of maintaining local autonomy and responsibility for tax imposition, are really arguing for the distribution of sales tax proceeds on the basis solely of source. The cities, as the primary markets of the State, obviously prefer this type of distribution. The local option concept is of course diluted by compromise proposals that part of the State's sales tax proceeds should be returned to the localities on a partial ADA basis or as additional support for the payment of minimum teachers' salaries established by the State Board of Education.¹¹

4. **Local Effort and Incentive Formulas.** Few seriously dispute the principle that a person (or locality) should be compensated on the basis of his efforts. But how can local effort be determined?¹² To judge local effort, at least two factors are needed: fiscal capacity (ability to pay)¹³

10. For example, the 1963-64 total average daily attendance for Norfolk was 51,166, while average daily membership was 54,544 (106.6%); in Richmond total ADA was 40,151, total ADM 43,222 (107.7%).

11. The long-delayed report of the VALC, finally published on January 4, 1966, recommended a 3% statewide general sales tax, with 1% of the proceeds to be distributed one-half according to source and one-half according to ADA, and another 1% used to absorb 100% of the minimum salary schedule of State-approved teaching positions in localities which are providing from their own local tax funds not less than 25% of the total cost of maintenance and operation of the public schools, including debt service and capital outlay.

12. Fundamental in any distribution formula is the principle that the factors used should bear a reasonable relation to the end to be served. This is not always observed, however. Population, for example, is the method now used for local distribution of ABC receipts by the State; yet such a standard bears no relation to either those who drink (21 and over, less abstainers), those on welfare (higher in the cities), the need for police protection (higher in the cities), or anything else.

13. Fiscal capacity (or more freely translated "how much can the taxpayers bear?") is generally gauged by a survey of tangible wealth represented by property values or per capita personal income. As might be expected, the choice of one or the other approach will produce different results. Virginia localities have no right to tax income, and so personal income might be said to be no part of a locality's fiscal capacity, but it cannot be denied that all taxes, both on property and income, are paid out of income and not principal.

and evidence of effort.¹⁴ The primary exponent of the local effort and incentive formula is Alan S. Donnahoe, a Richmond newspaper executive, who proposed that a locality's fiscal capacity be judged by the true value of its real estate and all public service corporation property, and that local effort be evidenced by the amount spent by a locality for the operation of its public schools (not including debt service or capital budget, or federally impacted funds). The Virginia Association of Counties strenuously resists this formula, urging that if anything fiscal capacity should be judged by per capita personal income. Regardless of the outcome, the use of such complex formulas is always a statistician's delight, as can be seen by a comparison of the rank of localities under various factors:

Donnahoe Plan

	1. <i>Local effort factor (rank)</i>	2. <i>True tax rate-1964 (rank)</i>	3. <i>Total (rank)</i>	4. <i>Per Capita Income-1960 (rank)</i>	<i>Population 1964 (rank)</i>	<i>ADA-1963-64 (rank)</i>
Arlington	.84(26)	\$1.31(13)	\$ 4,900(4)	\$3,455(1)	181,205(4)	25,256(6)
Fairfax	1.16(3)	1.32(12)	10,738(1)	2,717(4)	346,667(1)	76,476(1)
Henrico	.90(19)	.90(30)	3,154(6)	2,559(5)	137,006(5)	26,847(5)
Norfolk	.83(29)	1.26(14)	7,602(3)	1,989(26)	315,032(2)	51,166(2)
Richmond	1.07(6)	1.61(1)	8,018(2)	2,323(7)	219,205(3)	40,151(3)
Roanoke	.89(21)	1.39(4)	2,962(7)	2,088(17)	101,118(11)	18,384(10)

With all these different formulas being discussed, Governor Godwin on January 17, 1966 indicated his support of a 2% State sales tax proposal with 1% (less the tax on motor vehicles and services) being returned to the localities one-fourth on the basis of source and three-fourths on the basis of school-age population (not ADA or ADM). No part of the remaining 1% would be allocated to the localities, since only \$15.7 million would remain for the State after it had absorbed the losses from repeal of the State merchants license taxes and reduction of the State tax on business capital from 60 cents to 30 cents per \$100 (together

14. After determining a locality's ability to raise money, what areas of expenditure should be compared? Use of total budgets would of course inject high service costs for urban communities that spend large sums for police and fire protection, welfare and public health, mass transportation and sewerage, and also be subject to distortion for localities which have a high proportion of retired or elderly persons, or school children, or poverty persons. Some will contend that total taxes collected, when compared to fiscal capacity, are the only true reflection of local effort but this "truth" is often enhanced by its simplicity. A form of effort factor was also written into the 1964 formula for State aid to public schools under which a locality's share of the teachers' salary and minimum education funds was based on an assumed equivalent true tax rate of \$.60 per \$100, even though some 47 counties in 1962 had an average effective true tax rate of less than \$.60 per \$100.

totaling \$33.5 million), and the highway fund deficit (another \$26.9 million).

Needless to say the cities are distraught. Few ever contemplated a mere 1% return to the localities with the total exclusion of receipts from vehicle sales (\$12 million for each 1%) and services (another \$6 million per year). Time will tell where the political power lies in the State and whether the cities can muster enough support to overcome what promises to be a crushing defeat on the sales tax issue.

It has also become apparent that the Governor is committed to carve out of the general statewide sales tax and earmark for highway purposes alone receipts from the imposition of any tax on the sale of motor vehicles. This approach, together with exclusion of services from the sales tax base, could very well upset the delicate balance of any sales tax distribution formula even if 2% is returned to the localities.

In any event, each local tax official will be asking the 1966 General Assembly the parochial question: "What's in it for me?", and this will more often than not determine the "fairness" and "equity" of the distribution formula in the questioner's mind.

D. THE PROPOSED FEDERAL LEGISLATION

Surprisingly little noise was made in constitutional law circles when, on September 3, 1959, Congress passed Public Law 86-272 in an attempt to provide a transitional jurisdictional rule for the taxation of transactions "exclusively in interstate commerce" in light of the Supreme Court's decision in *Northwestern States Portland Cement v. Minnesota*, 358 U.S. 450 (1959), decided on February 24 of that year. This law, however, marked the first congressional attempt to regulate state taxation of interstate commerce.

Tucked away in Public Law 86-272 was a reference to the establishment of a special Joint Study Committee of the House Judiciary Committee and the Senate Finance Committee directed to "make full and complete studies of all matters pertaining to the taxation by the States of income derived within the States from the conduct of business activities which are exclusively in furtherance of interstate commerce or which are a part of interstate commerce, for the purpose of recommending to the Congress proposed legislation providing uniform standards to be observed by the States in imposing income taxes on income so derived." After the decision in the *Scripto* case the following year,¹⁵ holding that an out-of-state business could be required to collect and pay over a use tax on sales made within the taxing state even though it maintained no facilities in the state and its sales were made entirely through inde-

15. *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

pendent contractors, the whole area of use tax collection responsibilities was also added to the task of the special Joint Study Committee.

On June 15, 1964, the Special Committee published its first report covering broadly the subject of state income taxes.¹⁶ On June 30, 1965, the Committee reported its findings and conclusions on sales and use taxes, capital stock taxes and gross receipts taxes.¹⁷ On September 2, 1965, the Special Committee made its recommendations to the House Judiciary Committee,¹⁸ and the full Committee on the Judiciary, acting through Chairman Willis (D., La.), introduced H.R. 11798 on October 22, 1965 to implement the recommendations of the Special Committee.

The conclusions reached after the six-year study are at once striking in their scholarship and devastating in their scope. The report and H.R. 11798 should be required reading for all who have any interest in the subject of a state's power to tax!

The Special Committee found, as might be expected in any federal system, widespread lack of uniformity among the taxing states,¹⁹ yet the present level of compliance costs is low—but only because most taxpayers (particularly the small businessmen) do not even try to comply. This of course results in widely varying effects on those similarly situated.

As an enticement to the states to surrender their taxing powers, the Special Committee concluded that the states currently are losing huge amounts of revenue by virtue of their inability or failure to enforce their tax programs: *ergo*, only the federal government can bring order out of chaos and protect the national market under the aegis of the promotion and regulation of interstate commerce.

This article is not the place for an extensive review and study of H.R. 11798 and the Special Committee reports.²⁰ It should be noted, however, that the state's power to tax not only interstate commerce but also intrastate commerce, which cannot itself be favored (i.e., discrimination against interstate commerce) and yet will not be given less favorable treatment (i.e., political reality), will be regulated by the federal govern-

16. H. Rep. 1480, 88th Cong., 2d Sess. (1964), Volumes 1 and 2.

17. H. Rep. 565, 89th Cong., 1st Sess. (1965).

18. H. Rep. 952, 89th Cong., 1st Sess. (1965).

19. It is interesting to compare the Special Committee's findings on the non-uniformity and diversity of state taxation (the justification for federal intervention) with the present status of local city sales taxes in Virginia and the cries for uniform statewide legislation. Other conclusions of the Special Committee are also striking in their similarity to the difficulties posed in seeking an accommodation between the State and its localities in Virginia.

20. See generally Horsley, *Taxation, 1964-1965 Annual Survey of Va. Law*, 51 Va. L. Rev., (Nov. 1965); see also Horsley, *Taxation, 1963-1964 Annual Survey of Va. Law*, 50 Va. L. Rev. 1496, 1506 (1964).

ment as well. The days of taxation without representation may again be upon us.

H.R. 11798 proposes an effective date two years after enactment. On such date, a corporation's business location will fix a state's jurisdiction to tax—such location being determined by the ownership or lease of real property or, if such standard is not applicable, where the taxpayer has one or more employees in the state or its base of operations there without a location in any other state. As might be expected, there would be centralized administration and uniform rules and returns as directed by the Internal Revenue Service.

For income taxes, taxable income would be defined as set forth in the Internal Revenue Code of 1954, plus or minus any adjustments which the state might prefer to make, excepting only provisions affecting a taxpayer's taxable year, depreciation base or rate and certain elements of foreign source income. Once defined, income would be apportioned among the several states based on a taxpayer's payroll and property (i.e., there would be no sales factor nor allocation of nonbusiness income as presently exists under Virginia law).

For sales and use tax purposes, federal law would demand a destination tax imposed only by the locality of end use. All states would be required to have provisions excluding separate freight charges from the tax base, exempting household goods for persons moving from one state to another, excluding the first \$100 in sales per reporting period, and giving credit for sales and use taxes paid in other jurisdictions without regard to reciprocity. Further, if any state desires to assert collection jurisdiction over persons not having a business location within the state (e.g., mail order houses), it must join in a "cooperatively administered sales tax system", which is just a fancy name for a federal sales tax bill describing in detail every aspect of the sales tax program, including exemptions, reporting methods and collection procedures.

In matters of such sweeping effect, it is of course always dangerous to rely on impressions of shock, disbelief or rage. Although it would appear that the state tax administrators are uniformly and violently opposed to enactment of any such legislation (as should be the great body of businessmen engaged in interstate commerce who the report asserts do not come anywhere close to paying their tax liabilities), it must be remembered that the Committee report represents six long years of extensive hearings, detailed investigative circulars and skilled draftsmanship. Such a prodigious effort is not easily overcome, but overcome it must be if the states are to maintain their taxing autonomy—hopefully to move voluntarily closer to uniformity and adopt more realistic en-

forcement practices, recognizing that sound taxpayer morality is the real secret behind tax collection efficiency.

In interstate commerce as elsewhere, taxpayer morality must be nurtured by fair laws and fair administrative practices, including the enforcement of such laws and practices equally for those similarly situated; otherwise, hundreds of thousands of dollars are placed in jeopardy when the infectious cancer of what Virginians call the "personal-property-tax game" spreads throughout a taxing system. Admittedly, the self-assessment aspects of tax collection in this country are unique in the history of the world, and it is disheartening to read the Committee's conclusions that the only remedy for widespread noncompliance with state and local tax laws is further centralization of tax responsibility and policy in the federal government.

E. OTHER TAX REFORM PROPOSALS

Should the General Assembly adopt a statewide sales tax in 1966, there are numerous tax reform proposals that have been waiting patiently in the wings for many years. Although the iniquitous gross receipts taxes on wholesale and retail merchants seem sure to be repealed and the tax rates on business capital substantially reduced, proposals for the repeal of the Virginia inheritance and gift taxes and adoption of a Virginia estate tax, for a rate reduction in the lowest bracket of State income tax as a partial offset to the impact of the sales tax on the lower income taxpayer, and other aspects of income tax reform tending toward closer conformity with present federal standards seem destined for much more difficult treatment. The Virginia State Bar Associations, with the Virginia Bankers Association and the Virginia Society of Certified Public Accountants, have worked hard in past years to effect certain of these basic reforms, and undoubtedly the time is ripe to renew their efforts since no other substantial source of new revenue is in sight for the future.

The Virginia State Bar Association has offered a bold program for a 2-year study of the need and desirability of conforming Virginia income tax law with that of federal law. Many tax practitioners are disenchanted with the informality of income tax administration in the State and concerned about future interpretation once the 40-year continuity of administration is broken, and the federal system is the only available taxing system which offers an extensive body of law and administrative practices which are familiar to and touch all of the State's citizens. As pointed out above, if H.R. 11798 is passed by the Congress this session in substantially its present form, such a study would be mandatory in order to conform Virginia income tax law and practice to that required by the federal legislation possibly effective on July 1, 1968.

F. CONCLUSION

The year 1966 is clearly a landmark in the history of taxation in Virginia. Tax practitioners throughout the State have an obligation to inform themselves of the issues and principles at stake; otherwise, the popular tendency to avoid becoming involved in the "complex" and "technical" aspects of tax policy and practice may result in the loss of basic freedoms merely by default. There is much to be done, and it will take an informed and dedicated professional community to do it—to see that Virginia's tax systems are responsible, fair and well respected from the standpoint of the legislator, the tax collector, the tax practitioner and the beleaguered taxpayer.