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TAX LEGISLATION ENACTED BY THE 1964 GENERAL ASSEMBLY OF VIRGINIA*

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The 1964 General Assembly enacted tax legislation affecting the tax on capital, granting general enabling legislation relating to local license taxes, and providing new rules in the corporation-stockholder relations area. These are the more important subjects covered by the 1964 legislation, and the discussion contained in this article will be limited to them. Other less important legislative changes will be summarized at the end of the article.

THE TAX ON CAPITAL

Capital is defined¹ as intangible personal property. For many years,² Virginia has levied a tax on the capital of manufacturing enterprises and others but particularly manufacturers. The definition of capital before the 1964 amendment included money on hand and on deposit, the excess of receivables over payables and inventories and then a general category including bonds, notes, choses in action and personal property tangible in fact used in the business.³

The tax on capital is an intangible property tax, but it is measured in part by tangible property. The 1964 legislation eliminated money from the base of the tax on capital beginning January 1, 1965.⁴ This is rather strange on first impression because money would seem to be the best example of the capital of any business, but the reason for the elimination was that the Virginia banks, and particularly the Virginia Bankers Association, were able to convince the General Assembly that many of the larger national corporations that normally kept a substantial amount of money on deposit in Virginia banks generally removed those deposits out of the Virginia banks and shipped them to New York in December in order to eliminate the money from the base of the tax on capital on the assessment date, which is January 1. Following such removal it would not be until the following February that the money could come back without running afoul of another Virginia

*This section of the Tax Conference Record has been included in the William and Mary Law Review, Vol. 6, beginning at page 203, as a convenience to readers of this Review.

1. VA. CODE ANN. (1950), § 58-410.

2. SEE ACTS, 1918, p. 171.

3. VA. CODE ANN. (1950), § 58-411.

4. ACTS, 1964, ch. 423.

statute⁵ which provides that if intangible property, within thirty days before January 1, is converted into non-taxable property such as Government bonds or is sent out of the State and then is brought back into the State within 30 days after January 1, this shall be prima facie evidence of an attempt to defraud the State of the tax and the tax will nevertheless apply unless the taxpayer can prove the absence of an attempt to defeat the tax.

Effective on January 1, 1965, tangible personal property other than inventory is eliminated from the base of the tax on capital and will be subject to local taxation. That provision does not apply to manufacturers and the mining industry.⁶ All tangible personal property of manufacturers and miners, including not only inventory but also other property such as office furniture and fixtures and automobiles, continues to be a part of the base of the tax on capital and therefore excludible from local taxation.⁷ As to other business enterprises, however, only inventories, in the category of property tangible in fact, will be included in the base of the tax on capital after 1964.

Effective January 1, 1966, agricultural products held for processing and which are of such a nature as to customarily require storage and processing for periods of more than one year, shall be includible in inventory and thereby subjected to the tax on capital for one year only.⁸ This provision was added in order to limit the tax on capital measured by tobacco products that are held for ageing. Since normally tobacco products are held in inventory for several years, the provision to tax those products only once is designed to make Virginia more competitive with neighboring States and encourage the growth of the tobacco industry here. It may be noted in passing that distillers have the same problem, but they were not given this relief from taxation of the same personal property more than once.

Finally, beginning in 1967,⁹ the rate of the tax on capital will be scaled down over a four-year period from the present rate of 65 cents per \$100 to 50 cents per \$100.

The only real justification for the tax on capital is that it eliminates the inventories of manufacturers from local taxation and makes such inventories subject to a uniform State rate of tax. This is because, as we have seen, capital is classified as intangible property not subject to local taxation.¹⁰ The tax, however, is not a popular one, and there is sub-

5. VA. CODE ANN. (1950), § 58-421.

6. ACTS, 1964, ch. 423.

7. VA. CODE ANN. (1950), § 58-405.

8. ACTS, 1964, ch. 423.

9. ACTS, 1964, ch. 430.

10. See CONSTITUTION OF VIRGINIA § 171, VA. CODE ANN. (1950), § 58-411.

stantial sentiment that if retained the rate should be reduced to a more or less nominal amount.¹¹

LICENSE TAXES

License or privilege taxes are levied on specified businesses, trades and professions on both the State and local levels. The 1964 legislation in this area consisted of an enabling act¹² clarifying and broadening the power of counties to raise revenue from this source.

Before the 1964 amendment, cities and towns were given general authority to levy license taxes on any business privilege taxed by the State.¹³ Now, of course, cities have other sources of taxing power, namely their charters, and most cities, even before the 1964 amendment, were thought to have the power to levy license taxes on business privileges even though not taxed by the State, including sales and use taxes. The reason for that conclusion is the decision of the Supreme Court of Appeals of Virginia in the case of *Fallon Florist v. City of Roanoke*.¹⁴ In that case, Roanoke had passed an ordinance levying a sales tax on three types of transactions, sales by florists, sales of cigarettes and hotel room rentals. The Supreme Court of Appeals of Virginia pointed out that the charter of the city gave the Council the power to levy taxes deemed necessary for the governmental purposes of the city. The Court then said:

Clearly, this language was designed to confer upon the city the general power of taxation—that is, the power to levy and impose such taxes as the legislative body of the city may deem necessary for its governmental functions—except only as that power is limited by the Constitution and laws of this State and of the United States.¹⁵

The Court further decided that there were no such limitations on the power of the city to levy the selected sales taxes there involved.

Since most other cities have charter provisions similar to those of Roanoke, we may conclude that cities generally had the power to levy sales taxes and license taxes on privileges not taxed by the State even before the 1964 legislation. Counties, on the other hand, had no similar authority, in fact counties generally had no license tax authority at all. There were two statutes dealing with only a limited number of counties. Section

11. See Recommendation IX, *Opportunities for the Improvement of Virginia's Tax Structure* (Virginia State Chamber of Commerce, Richmond, Virginia, 1962).

12. Acrs, 1964, ch. 424.

13. VA. CODE ANN. (1950), § 58-266.1, before the 1964 amendment.

14. 190 Va. 564, 58 S.E. 2d 316 (1950). The result here was forecast by the case of *Norfolk v. Norfolk Landmark Co.*, 95 Va. 564, 567, 28 S.E. 959 (1898), where the Court explained similar language in the city's charter as follows: "This language has been construed by this court and held to confer the general power of taxation, except only as it may be limited by the laws of the State, or of the United States, and to include all powers and subjects of taxation."

15. *Supra* 577.

58-266.2 gave certain counties^{15a} the right to impose business license taxes, with specified exceptions, whether or not such privileges had been subjected to State taxation, and Section 58-266.3 gave certain other counties¹⁶ the right to impose business license taxes, again with specified exceptions, when anything for which a license is required by the State is to be done within the county. Other counties had no such taxing authority.

Now the 1964 legislation,¹⁷ which provides a general statute applicable to all counties as well as all cities and towns, enables those local governmental bodies to levy business license taxes whether or not the privilege is taxed by the State. The principal purpose of this legislation, certainly the purpose that the Legislature had in mind, was to give counties general license taxing authority and particularly the authority to tax retail and wholesale merchants.

One of the possible results of that broad grant of license tax authority, however, is that counties now might have the right to levy general sales taxes if the sales tax is imposed as a privilege tax on the retailer or vendor. That possibility undoubtedly was not in the mind of the General Assembly when it passed the legislation, but it is generally thought now, after the 1964 legislation, that counties have the power to levy sales taxes if imposed as a privilege tax.

Although it seems probable that counties now have the right after the 1964 legislation to impose sales taxes, counties very well might not be inclined to impose such taxes because they do not have the power to impose use taxes on purchases by residents outside the county for consumption, storage or distribution within the county. Counties, as distinguished from cities, do not have the power to impose use taxes because such a tax is not the type of property tax contemplated by general law (it is, in fact, an excise tax on the consumer), and the licensing authority that was granted by the 1964 legislation is the power to impose license taxes on a business or business privilege.

It should be noted here that a license form of sales tax would not prevent the purchaser or consumer from deducting the sales tax for Federal income tax purposes if the tax in fact is passed on and is

15a. These counties were Elizabeth City (Acts, 1948, ch. 150), Arlington and Pittsylvania (Acts, 1960, ch. 554) and Roanoke (Acts, 1960, ch. 554).

16. Arlington, Henrico and Warwick (Acts, 1948, ch. 105), Chesterfield (Acts, 1950, ch. 64), Elizabeth City and Fairfax (Acts, 1952, chs. 38 and 460), Chesterfield (Acts 1956, ch. 449), and Chesterfield (Acts, 1962, ch. 486).

17. Acts, 1964, ch. 424. Section 58-266.1 now reads: "The council of any city or town, and the governing body of any county, may levy and provide for the assessment and collection of city, town or county license taxes on businesses, trades, professions, occupations and callings and upon the persons, firms and corporations engaged therein within the city, town or county, whether any license tax be imposed thereon by the State or not * * *" subject to specified limitations.

separately stated.¹⁸ The fact that such taxes are normally passed on has led some observers to suggest that the incidence of the tax is in fact on the purchaser and therefore counties have no power to tax (as in the case of the use tax above), but this view does not give proper appreciation to the difference between the *economic* incidence (here, on the purchaser) and the *legal* incidence (here, on the businessman) of such a sales tax.

CORPORATIONS-SHAREHOLDERS

Almost everyone agrees that it is desirable for the Virginia income tax law to conform with the Federal income tax law, particularly with respect to business transactions, unless there are important policy reasons for having a different State rule. The Department of Taxation attempts to achieve this uniformity when it can properly do so, but when the Federal rule is provided by a specific and detailed statutory provision the Department of Taxation often—and quite properly—refuses to apply the Federal rule in Virginia without a similar statutory enactment. It is gratifying that the 1964 General Assembly acted on three subjects in the corporate-stockholder relations area with the result that there will be more uniformity of State and Federal income taxation than existed before.

Transfers of property to a controlled corporation solely in exchange for stock or securities long have been free from the recognition of gain or loss for Federal income tax purposes.¹⁹ A somewhat similar statutory provision²⁰ was adopted for Virginia in 1964, but with many latent differences:

(a) The Virginia legislation provides for the nonrecognition of gain or loss only if the transfer is to a newly organized corporation. This will allow the tax-free incorporation of a proprietorship or partnership, and that was the primary purpose of the legislation. Two possibilities might be considered for the tax-free acquisition of property by a previously existing corporation. The first is a contribution to capital without the issuance of additional stock. The second is the transfer of the property to a new corporation for its stock, followed by a merger of the new corporation into the previously existing corporation.

(b) The Virginia statute applies only to transfers by individuals.²¹

(c) Whereas the Federal rule applies to transfers for stock or “securities” the Virginia rule is limited to transfers solely for stock. Also,

18. INTERNAL REVENUE CODE OF 1954, SECTION 164(b)(5). This is true only for purchases not connected with a trade or business, but purchases of this latter type can generally be expensed or depreciated.

19. INTERNAL REVENUE CODE OF 1954, SECTION 351.

20. ACTS, 1964, ch. 369, adding § 58-86.1-3.

21. This difference is more apparent than real since the State Tax Commissioner previously has ruled that a transfer of property by a corporation to a newly formed wholly-owned subsidiary does not give rise to the recognition of gain or loss.

there is no limited tax treatment similar to that for "boot" exchanges under Federal law, but this is only consistent with the restriction of the Virginia rule to new incorporations where "boot" exchanges are seldom encountered or can be easily accomplished by a pre-incorporation sale between the transferors.

(d) The Virginia statute does not contain any limitation on the amount of indebtedness to which the transferred assets may be subject.²²

(e) There is no specific provision in the Virginia law that the basis of stock received in a § 58-86.1:3 transaction must be reduced by indebtedness assumed by the corporation.²³

(f) The Virginia statute specifically provides that it does not apply to transfers to mutual funds.²⁴

From the foregoing outline of differences between the Federal and the Virginia rules relating to the tax consequences of transfers to controlled corporations it might appear at first that significant tax differences will result. With the possible exception of the use of securities, as distinguished from stock, in the exchange, that conclusion seems improbable. The existence of the Federal rule should eliminate at least most of the possible problems relating to the assumption of indebtedness, and the downward adjustment of basis by the amount of the assumed liabilities might well be within the administrative authority of the Department of Taxation.

The second subject in the corporate-stockholder relationship area is the nonrecognition of gain or loss upon the liquidation of a controlled corporation.²⁵ Before the 1964 legislature²⁶ the Virginia rules really amounted to a tax trap, for a parent corporation could acquire all the assets and liabilities of a subsidiary corporation without the recognition of gain if the advisors of the parent knew how to go about it. The old technique was to merge the subsidiary into the parent, and if the transaction constituted a statutory merger it was clear that gain was not recognized to either the parent or to the subsidiary. On the other hand, if the subsidiary were liquidated into the parent without taking the relatively insignificant step to qualify the transaction as a merger, Virginia imposed the income tax on any gain realized by the parent.

22. Compare INTERNAL REVENUE CODE OF 1954, SECTION 357(c), relating to the transfer of property subject to a liability in excess of basis.

23. Compare INTERNAL REVENUE CODE OF 1954, SECTION 358(d).

24. This is an illustration of the influence of the ruling policy of the INTERNAL REVENUE SERVICE. See T.I.R. No. 303 (February 9, 1961), as amended by T.I.R. No. 11 (March 3, 1961). The reason for the VIRGINIA rule appears to be the fear that if a taxfree exchange results in the achievement of a diversification of investments, the owner will retain the mutual fund shares until he dies, thus obtaining for his beneficiaries a stepped-up basis and a consequent loss of income tax revenues to the State.

25. INTERNAL REVENUE CODE OF 1954, SECTION 332.

26. ACTS, 1964, ch. 280, adding § 58-86.1:2.

The 1964 legislation conforms the Virginia law to the Federal law and no longer requires that the liquidation of a controlled subsidiary must be accomplished by way of a merger to prevent the recognition of gain to the parent. There is, however, one omission from the Virginia statute that is found in a related Federal statute. The Federal statute²⁷ provides that, if a subsidiary corporation is liquidated within two years after the parent acquired the stock,²⁸ the basis of the properties in the hands of the parent after the liquidation will be the cost of the stock rather than the old basis in the hands of the subsidiary.

Again, the forgoing difference in the statutory provisions probably is of minor practical importance because the Department of Taxation and the Virginia courts have Federal tax law precedent to achieve substantially the same result should they desire to do so. In the *Kimball-Diamond Milling Company*²⁹ case, the court held that if stock is purchased with the intention of liquidating the corporation in order to acquire direct ownership of the underlying assets, the basis of the assets received in the liquidation is the cost of the stock. The rule of the present Federal statute has the advantage of a fixed time limit—2 years—for application of the principle, but this does not change the principle if the appropriate intention can be shown.

Another 1964 legislative enactment in the corporate-stockholder relationship area was a statute³⁰ providing that no gain or loss is recognized if common stock of a corporation is exchanged solely for common stock of the same corporation or if preferred stock of a corporation is exchanged solely for preferred stock of the same corporation.

We should note that the statute applies only to an exchange of common for common or preferred for preferred of the same corporation. It would apply, for example, in the case of an exchange of voting common for nonvoting common or to an exchange of one series of preferred for another. This statute does not apply to an exchange of preferred stock for common stock, or vice-versa, even of the same corporation, but such an exchange nevertheless well might qualify for tax-free treatment as an exchange pursuant to a plan of reorganization, i.e., a recapitalization.³¹

Finally, legislation³² was adopted in 1964 that is similar to the Federal statute³³ relating to distributions of stock pursuant to an anti-trust order

27. INTERNAL REVENUE CODE OF 1954, SECTION 334(b)(2).

28. The stock must have been acquired in a taxable transaction, i.e., by purchase.

29. *Commissioner v. Kimball-Diamond Milling Co.*, 187 F. 2d 718 (5th Cir. 1951), affirming 14 T.C. 74 (1950).

30. ACTS, 1964, ch. 529, adding § 58-86.1:4. This is identical with INTERNAL REVENUE CODE OF 1954, SECTION 1036.

31. See VA. CODE ANN. (1950), § 58-86.

32. ACTS, 1964, ch. 53, adding § 58-85.3.

33. INTERNAL REVENUE CODE OF 1954, SECTION 1111.

of a court. The new Virginia rule, effective with respect to distributions after December 31, 1963, is that a distribution of divested stock shall not be deemed to be a dividend, but the fair market value of the divested stock shall be applied against and reduce the basis of the stock with respect to which the distribution was made. Any excess of value over basis will be treated as gain.

Thus, beginning in 1964, distributions of General Motors stock by DuPont will be treated first as reducing the basis of the DuPont stock. To this point the Federal rule and the Virginia rule produce the same result. After the recovery of basis, additional values received are taxed for Federal purposes at the favored capital gains rate. Since there is no distinction in Virginia between the rate of tax applying to capital gain and to ordinary income, the tax advantage of the new legislation under Virginia law ceases after the recovery of the basis of the stock with respect to which the distribution of the divested stock is made.

MISCELLANEOUS TAX ENACTMENTS

Other tax legislation by the 1964 General Assembly includes a provision for tax deeds upon the sale of real estate of a corporation the charter of which has been cancelled,³⁴ the addition of special provisions for a bulk importer under the motor fuel tax³⁵ and the payment of the tax by mail,³⁶ the revision of the tax on bank stock to exempt stock held by bank holding companies to the extent that the stock of the bank holding company is held by insurance companies and charities,³⁷ a change in the gift tax filing and payment dates to May 1³⁸ to conform with the present income tax requirements, the allowance of a child placed for adoption to be claimed as a dependent for income tax purposes,³⁹ an exemption from the requirement of filing Virginia income tax returns by certain nonresidents who commute to work in Virginia and are subject to income tax by their states of residence,⁴⁰ a limitation on the income tax credit for taxes paid by a resident to a state of non-residence to a ratio of net income,⁴¹ an exemption from the recording tax for any deed arising out of a contract to purchase real estate to the

34. ACTS, 1964, ch. 399, adding § 58-1053.1.

35. ACTS, 1964, ch. 180, adding § 58-687(5a).

36. ACTS, 1964, ch. 311, amending § 58-721.

37. ACTS, 1964, ch. 52, amending generally CHAPTER 10 of Title 58. The same rule always has applied to bank stock held directly by insurance companies and charities.

38. ACTS, 1964, ch. 392, amending §§ 58-223 and 58-238.

39. ACTS, 1964, ch. 123, amending § 58-98. See INTERNAL REVENUE CODE OF 1954, SECTION 152(b)(2).

40. ACTS, 1964, ch. 454, adding § 58-104.1 on a reciprocal basis only.

41. ACTS, 1964, ch. 454, amending § 58-103.

extent that the tax was paid when the contract was recorded⁴² and an increase in the State license tax on automobiles.⁴³

The General Assembly of Virginia succeeded once more in delaying the enactment of a State general sales tax. Mounting pressure for the enactment of such a tax is certain to continue, particularly in view of the anticipated spread of such taxes on the part of the cities of the State.

42. Acts, 1964, chs. 19 and 361, amending § 58-61.

43. Acts, 1964, ch. 218, amending § 46.1-149.

