

**EFFECT OF BUSINESS TAXES ON INDUSTRIAL DEVELOPMENT
IN VIRGINIA**

and

APPORTIONMENT OF INCOME FOR TAX PURPOSES

A Report of the

VIRGINIA ADVISORY LEGISLATIVE COUNCIL

To

THE GOVERNOR

and

THE GENERAL ASSEMBLY OF VIRGINIA



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RICHMOND, VIRGINIA, July 17, 1959.

To:

HONORABLE J. LINDSAY ALMOND, JR., *Governor of Virginia*

and

THE GENERAL ASSEMBLY OF VIRGINIA:

Various proposals have been made in recent years to the General Assembly of Virginia for changes in Virginia's tax laws, particularly those relating to corporations which do business both in Virginia and in other states. Feeling that before action should be taken on a matter of such great importance both to the corporations and other businesses affected by these taxes, and upon the State's revenues, the subject should have careful and thorough consideration and the General Assembly should have all pertinent information which could be made available to it, the Assembly adopted, at its 1958 Regular Session, Senate Joint Resolution No. 11 and Senate Joint Resolution No. 54 which directed study of these important matters by the Virginia Advisory Legislative Council.

These resolutions were as follows:

SENATE JOINT RESOLUTION NO. 11

Directing the Virginia Advisory Legislative Council to study the apportionment of income taxes of foreign corporations under the present tax laws of Virginia.

Whereas, the attraction of industry to Virginia is a matter of vital importance to our continued growth and prosperity; and

Whereas, the opinion is widely held that the present provisions of the tax laws of Virginia regarding the apportionment of the income taxes of foreign corporations doing business in Virginia are detrimental to the attraction of new industries to this State; now, therefore, be it

Resolved by the Senate of Virginia, the House of Delegates concurring, that the Virginia Advisory Legislative Council is directed to make a study of the present tax laws in Virginia relating to apportionment of income taxes of foreign corporations doing business in Virginia and their effect on the possibility of new industries being established in Virginia. The Council shall consider the laws and experience of the several states in this regard, the possibility of adopting other formulas and the effect thereof. The Council shall seek the cooperation of the committees on taxation of the Virginia State Bar and the Virginia State Bar Association and of the State Chamber of Commerce and the Virginia Manufacturers Association in making its study. All agencies of the State shall assist the Council in its study. The Council shall complete its study and make its recommendations to the Governor and General Assembly of Virginia not later than January 1, 1959.

SENATE JOINT RESOLUTION NO. 54

Directing a study of the effect of certain taxes upon existing and potential industrial development in Virginia.

Whereas, the basis of taxation by this Commonwealth upon persons operating warehouses, distribution centers, and other business establishments wherein goods, merchandise, and other products are assembled or stored for sale or distribution within or within and without this State, either in the form in which so assembled or stored or as a component part of other products, may be discriminatory insofar as such goods, merchandise or products are sold or distributed without this State, thus making Virginia relatively less attractive to certain types of business than other jurisdictions; and

Whereas, the continuing prosperity of Virginia depends in part on maintaining a competitive position with other jurisdictions in attracting and holding industry; now, therefore, be it

Resolved by the Senate of Virginia, the House of Delegates concurring, That the Virginia Advisory Legislative Council is directed to study the effect of the present Virginia statutes on capital and other taxes as they affect (1) existing and potential industrial development in this State and (2) warehousemen and distributors of products, goods or merchandise, especially those a large percentage of whose sales or distribution is to points outside of the State. Agencies of the State shall assist the Council on its request. The Council shall complete its study and make a report containing its findings and recommendations to the Governor and the General Assembly not later than July one, nineteen hundred fifty-nine.

Exercising the authority conferred upon it by the General Assembly in Senate Joint Resolution No. 32 to consolidate into single studies such cognate studies as might be referred to it, the Council combined these two studies and assigned them to Senator E. E. Willey as Chairman of a Committee to make the initial study and report back to it. Selected to serve with Senator Willey on the Committee were the following: David Carpenter, Attorney at Law, Arlington; Roy B. Davis, former member of the House of Delegates, Paces; Ralph B. Douglass, Smith-Douglass Fertilizer Company, Norfolk; W. Gibson Harris, Attorney at Law, Richmond, C. H. Morrisett, State Tax Commissioner, Robert J. Parks, Smithfield Packing Company, Smithfield; Louis C. Purdey, Industrial Commissioner, Newport News; John F. Rixey, Attorney at Law and member of the House of Delegates, Norfolk; Sydney Small, Vice-President, Norfolk and Western Railway, Roanoke; Eugene B. Sydnor, Jr., member of the Senate of Virginia, Richmond; R. O. Van Dyke, Tazewell; Erwin H. Will, Virginia Electric and Power Company, Richmond; J. W. Wood, Sr., Colonial Stores, Norfolk; Landon R. Wyatt, member of the Senate of Virginia, Danville and Wilbur Winfree, Glamorgan Pipe and Foundry Company, Lynchburg.

At its organization meeting, the Committee elected Senator Sydnor as Vice-Chairman. John B. Boatwright, Jr. and G. M. Lapsley served as Secretary and Recording Secretary, respectively, to the Committee.

The Committee held a public hearing which was widely advertised throughout the State at which it solicited the views of business men concerning possible tax changes which might be advantageous. It subsequently formed itself into subcommittees dealing with the three major phases of its study—the apportionment of corporate income for tax purposes, capital and other taxes as they affect industrial development, and taxation of warehousemen and distributors of products, goods and merchandise. These subcommittees then pursued their several studies in more

detail, conferring with those particularly concerned in each field, and reported to the full Committee, which in turn made its report to the Council. The Council, having considered the report of the Committee, now submits the following recommendations, for the reasons hereinafter set forth:

SUMMARY OF RECOMMENDATIONS

1. Virginia should change its present formula for apportionment of corporation income for tax purposes to a three factor formula similar to that in effect in a majority of the other states; and should collect such taxes from all corporations of the classes to which the State income tax law applies where such corporations derive income from Virginia sources.

2. The rate of tax on capital of trades and businesses not otherwise taxed should be reduced from 75¢ to 65¢ on every \$100 of actual value.

3. If and when a general retail sales tax is imposed, the State license tax rate applicable to wholesale merchants should be reduced and a limit should also be imposed on the localities' power to levy local license taxes on wholesale merchants.

APPORTIONMENT OF CORPORATE INCOME FOR TAX PURPOSES

In connection with the phase of the study relating to apportionment of corporate income derived from interstate business for income taxation we have considered both the recommendations which have been made for changes in the apportionment formula and the effect of such changes on the corporations which would be affected thereby and on the State's revenues.

The Council recommends that the State adopt the formula for apportionment of income which is in effect in the majority of the other states of the Union—the so-called "Massachusetts Formula". We are aware of the fact that this will initially result in a loss of revenue to the State and that it will adversely affect some existing corporations now doing business in Virginia. We believe, however, that from a long-range viewpoint the loss in revenue will be more than overcome by business development which will be stimulated by the change and that the adverse effect on certain corporations can be offset materially by other changes in the tax laws.

At the outset, the Council would like to call attention to the fact that Senate Joint Resolution No. 11, which is the directive under which the study was made, does not correctly state the problem. The resolution directs "a study of the present tax laws in Virginia relating to apportionment of income taxes of foreign corporations doing business in Virginia and their effect on the possibility of new industries being established in Virginia." Obviously, there can be no income tax applicable only to foreign corporations. Such a tax would be considered as fatally discriminatory. Accordingly, any change in the formula which may be made will affect Virginia corporations and foreign corporations now doing business in Virginia as well as new corporations which might desire to establish branches or to do business in this State and the Council has carefully borne this fact in mind in making its investigations.

The apportionment formula under which Virginia now collects income taxes from corporations which do a portion of their business in Virginia and a portion in other states has been on the statute books unchanged for thirty-three years. However, of recent years, with the adoption by more

and more states of the so-called Massachusetts Formula, and especially since the State of North Carolina made this change in 1957, there has been increasing criticism of Virginia's formula and growing pressure for a change. We do not think that this criticism has been entirely well founded or that the supposed inequities of the Virginia formula have been so burdensome as has been claimed by some critics. We feel that the charge that Virginia is a "high-tax state" does not accord with the facts. Our income tax rate, for instance, is lower than that of our neighbor to the South and the total burden of taxes on a business operating in Virginia, when the low local rates of taxes on physical properties are considered, does not unduly influence new industry against Virginia as a location.

Nevertheless, Virginia's formula is at variance with those of a majority of the states. This formula is set forth in § 58-131.1 of the Code of Virginia and provides for taxation of income from that portion of the interstate business of a corporation which the corporation shows on its books by separate accounting as being Virginia business; or if the books of the corporation do not show Virginia business separately, the tax is on the proportion of the entire net income of the corporation which the fair market value of the real estate and other physical assets in this State and the amount of total gross receipts in this State bears to the aggregate of these factors both within and without this State. However, the law further recognizes that there could be cases under which the formula would appear to bear inequitably upon certain corporations and provides for an alternative method of allocation to be allowed by the Department of Taxation when a corporation can show that the above allocation formula is unjust in its application.

In contrast to the Virginia formula, the formula as set forth in the Uniform Division of Income for Tax Purposes Act, which was approved and recommended for enactment by the National Conference of Commissioners on Uniform State Laws in 1957, apportions all business income by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three. It will be readily apparent that the most significant difference between the proposed formula and the present Virginia formula is the inclusion of salaries, wages and other compensation as one of the determinants in the apportionment of income for tax purposes.

As noted above, a similar formula is in effect in a majority of the States and the formula has the endorsement of the American Bar Association.

The formula cannot be wisely adopted in Virginia in its original language, and it must be suitably revised to meet Virginia conditions, but the fundamental principles can be adhered to.

It is obvious that any change in the existing Virginia formula would benefit some corporations and might adversely affect others. The vast majority of Virginia corporations do no interstate business and accordingly would not be affected one way or another. However, of the corporations affected, many are among the largest taxpayers in the State. The Committee accordingly selected 656 corporations and sent questionnaires to them requesting that they compute their tax according to the new formula. An analysis of the replies to these questionnaires follows:

QUESTIONNAIRES SENT TO 656 OF THE CORPORATIONS
 APPORTIONING A PART OF THEIR INCOME TO VIRGINIA

Total number of questionnaires mailed to corporations.....	656
Domestic corporations.....	285
Foreign corporations.....	371
Total number of corporations responding to questionnaire....	249
Corporations for which application of proposed formula would cause no material change of tax	69
Corporations for which application of proposed formula would cause a change in tax.....	180
Total number of corporations for which application of pro- posed formula would cause a change in tax.....	180
Domestic corporations	38
Foreign corporations	142
Of the 180 corporations reporting changes in tax:	Amount
132 reported decreases in tax	\$2,128,351.68
48 reported increases in tax	610,072.22
	\$1,518,279.46
Net decrease in tax (loss to State)	

It thus appears that three out of every four (73.33%) of the responding corporations would have a tax decrease and the average amount of the decreases would be \$16,123.88. One out of every four of the corporations would have an increase in taxes under the proposed formula by an average of \$12,709.84.

The Council recommends that the State adopt the three-factor formula for the reasons which are hereinafter set out:

It would remove any possibility that the apportionment formula might be considered as discriminatory by a corporation which is considering operating in Virginia rather than in some other state. We are advised by those who have had experience with the reasons for which corporations select sites for new plants or operations that the tax factor is rarely the major determining factor in making a decision; but it is considered and may be the decisive factor if the other elements are nearly equal. Certainly, other states which have changed their formulas have advertised this fact widely in their effort to secure new industrial development and the Council believes that this change would greatly facilitate the activities of those State agencies and other organizations which are seeking to attract new industries for this Commonwealth.

We further feel that this change is desirable because it will make our law more nearly uniform with those of a majority of the other states and would thus tend to simplify the accounting problems of many large corporations which do business in more than one state. This appears to be a sound approach from the point of view of the theory of tax legislation and it will be another indication of the desirable business climate of Virginia.

The Council believes that the indicated loss in revenue is not of the greatest importance. The maximum estimate of net loss in the case of all corporations affected (not merely those responding to the questionnaire) which the Committee received was \$2,000,000.00 a year. The experience in other states, particularly North Carolina, which has made a similar

change in recent years, has shown that the losses rarely were as great as anticipated. To the extent that the change in the formula accelerates Virginia's industrial development, the revenue loss will be reduced and the Council strongly feels that in the long run the change will prove to be of financial benefit to this State.

Futhermore, there have been recent decisions of the Supreme Court of the United States which apparently have broadened the State's ability to tax those corporations which are actually engaged in income-producing activities in the State but which have no physical facilities within the State such as have previously been thought necessary to sustain a state's jurisdiction to tax. Other states have exercised this right to tax and more will do so under these new decisions. We recommend that Virginia's tax laws be so amended as to permit Virginia also to tax such corporations on their income-producing activities in Virginia. While it is probable that this will not prove a very large revenue source, we feel that to some extent it will decrease the anticipated loss of revenue from the change in formula.

The Council is aware that there are corporations now in Virginia which have made much contribution to the revenues of this State and which will be adversely affected by the proposed change and it has been urged that action not be taken which will adversely affect existing corporations merely on the chance that other corporations will be induced to come into the State. The Council, however, feels that the overall welfare of the State is paramount and, in addition, that the proposed change dealing with the taxation of inventories will benefit the group which will be adversely affected by the proposed change in formula and will accordingly offset to some extent such adverse effect.

TAXES ON CAPITAL NOT OTHERWISE TAXED

Section 58-411 of the Code of Virginia defines capital of a trade or business for tax purposes as including inventory, excess of bills and accounts receivable over bills and accounts payable, money on hand and on deposit and all other taxable personal property of any kind whatever with the exception of certain specific items which are excluded by § 58-412. Such capital is taxed at a rate of 75¢ on every \$100 of actual value by § 58-418 of the Code. This rate has not been changed for thirty years. By far the greater part of this tax is paid on the inventories of manufacturing concerns.

Senate Joint Resolution Number 54 raises the question as to whether Virginia is not, by this tax, putting herself at a competitive disadvantage with other states and directs the Council to study this aspect of the tax.

Virginia's tax system differs, as to this type of property, from that of other states in that the inventories of manufacturers are taxed only at the State level in Virginia, whereas in other states the general rule is that they are taxed by the localities.

The Council recommends that no drastic change be made with respect to the form or manner of the taxation of business capital, which includes inventories; it does feel, however, that there are certain groups of taxpayers who pay a larger amount of inventory taxes in Virginia than they would pay if their businesses were located in some of the nearby states and the Council recommends that the State capital tax be reduced by 10¢ per \$100, that is to say, from 75¢ per \$100 to 65¢.

Being aware that the proceeds of the tax on inventories account for so large a percentage of the revenues derived by the State from the tax on

capital not otherwise taxed, and that the large tobacco companies pay a considerable proportion of this tax, the Committee requested the Department of Taxation to determine from these companies how the tax system of Virginia operates comparatively with those of two of the other states which are important in the raising and processing of tobacco. These companies were most cooperative in supplying information from which it was learned that in North Carolina the taxation of leaf tobacco inventories is a local matter; as a result, in some places there will be paid a higher rate of tax on leaf tobacco stored for aging than in Virginia, whereas in other places the tax will be lower. In Kentucky throughout the state, there is a much lower rate of taxation applying to leaf tobacco inventories. It was also learned that the rate of cigarette manufacture as indicated by the internal revenue service collections from taxes on cigarettes increased, over a decade, at a considerably more rapid rate in North Carolina and in Kentucky than in Virginia. It is impossible to say what bearing, if any, the different rates of tax applicable to leaf tobacco inventories in the three states had on this fact.

The Council does not believe that Virginia can adjust its tax system to meet the competition of all other states in all respects without disastrous effects on the Commonwealth's revenues. However, it believes that some adjustments from time to time may be made and in this instance we recommend a reduction in the rate of capital tax in the expectation that, among other things, this will benefit to a large extent the same group of taxpayers who may be adversely affected by the adoption of the three-factor formula for apportionment of income for tax purposes which is elsewhere recommended. The Council also believes that a reduction in the rate of the capital tax will help materially in attracting new manufacturing plants of all classes.

It has been suggested that an adjustment in the tax base in the case of leaf tobacco inventories might be made because of the fact that leaf tobacco is held in warehouses for several years prior to manufacture and thus is subjected to the levy each year. We would call attention to the fact that leaf tobacco inventories in Virginia are assessed for taxation by the use of a formula, fixed administratively, which recognizes the peculiarities of the tobacco industry.

TAXATION OF WHOLESALE MERCHANTS

In considering the phase of the study relating to the State wholesale merchants' license tax and its effect upon the development of industry in Virginia the Council carefully considered the facts available to it relative to this tax and its effect on Virginia business, and conferred with persons especially informed on and concerned with this tax.

The Council recognizes that wholesale merchants in Virginia are in some respects at a competitive disadvantage compared to similar businesses in certain of the adjoining States. But it must be pointed out that the State license tax on merchants in Virginia is expressly declared by the statute to be in lieu of a State property tax on the capital of merchants (Code of Va., § 58-337). Therefore, no State capital tax is imposed on the capital of merchants in Virginia. In Maryland and in the District of Columbia there is no State or District license tax which is comparable

to the Virginia State license tax on wholesale merchants; in North Carolina there is a State tax of 5¢ per hundred dollars of sales, and a limit is imposed on the localities' power to tax these businesses. Tennessee levies a tax measured by capital invested, rather than by sales or purchases. West Virginia, however, does levy a tax measured by sales at a rate which is higher than the Virginia rate effective in 1959.

Local wholesale merchants license taxes in many cities are high in Virginia, and combined with the State levy represent a real burden to many wholesalers, particularly in fields such as groceries and tobacco products where a large volume of business is conducted at a small margin of profit. And yet it must be pointed out here also that local license taxes on merchants are almost always in lieu of a local property tax on the capital of merchants.

It is true that all the adjoining States and the District of Columbia, with the exception of Kentucky, impose taxes on retail sales, which are collected by the merchants. But these are passed on to their customers as taxes, whereas the Virginia license tax is not passed on to the customers as a tax.

The competitive feature has become more important with improved highways and increased usage of truck transportation. The maximum economic range for service from a distribution warehouse in the wholesale grocery field, for instance, is stated to be a 250-mile radius. On this basis, a wholesaler located in Washington or its vicinity could serve customers throughout the whole of Virginia except the far Southwest; and a warehouse in Bristol, Tennessee could be within economic range of the greater part of the State. In neither instance would there be a license tax comparable to the Virginia license tax.

Figures set forth elsewhere in this report showing the wholesale merchants' license tax collections in Virginia for a number of years do not indicate that there has been any reduction in the volume of wholesale business in Virginia. But allegations of specific instances have been brought to our attention of choice of location outside of Virginia by large distributing businesses which might otherwise have come to this State.

Also, there is a tendency on the part of manufacturers and processors, especially in the field of food and grocery products, to establish their plants, for reasons of convenience and economy, in proximity to important distribution centers. To the extent, if any, that the wholesale merchants' license tax militates against the attraction of wholesale distributors and chain store warehouses to Virginia, it correspondingly diminishes the probability of the attraction to this State of new manufacturers who might desire to locate in proximity to important distribution centers.

The wholesale license tax has become increasingly important as a source of revenue for the Commonwealth. This is shown by the following tabulation, showing collections for the years 1945 through 1958.

STATE WHOLESALE MERCHANTS LICENSES: TAXES AND
PENALTIES AND ISSUANCE FEES ASSESSED BY COM-
MISSIONERS OF THE REVENUE DURING THE FISCAL
YEARS INDICATED

Fiscal Year Ending June 30	Total Taxes and Penalties	Issuance Fees	Total Taxes Penalties and Fees
1945	\$ 692,587.95	\$ 1,885.25	\$ 694,473.20
1946	783,261.91	2,185.50	785,447.41
1947	1,013,771.47	2,558.00	1,016,329.47
1948	1,226,535.81	2,662.00	1,229,197.81
1949*	1,842,511.29	2,769.75	1,845,281.04
1950	1,821,427.89	2,928.25	1,824,356.14
1951	2,049,039.52	2,942.75	2,051,982.27
1952	2,309,153.51	3,182.00	2,312,335.51
1953	2,407,214.19	3,252.50	2,410,466.69
1954	2,417,031.30	3,315.25	2,420,346.55
1955	2,424,430.36	3,442.25	2,427,872.61
1956	2,638,185.49	3,558.25	2,641,743.74
1957	2,776,250.46	3,624.00	2,779,874.46
1958	2,810,491.13	3,679.50	2,814,170.63

* Rate increase enacted by General Assembly of 1948 (Acts 1948, c. 159)

Compiled from Reports of the Department of Taxation.

The General Assembly has already taken specific action looking to the relief of wholesale merchants. In 1956 it changed the tax rate measured by purchases in excess of \$10,000 a year from the 20¢ rate which had been in effect since 1949 to the former rate of 13¢ on every \$100 of purchases. This change, which went into effect on January 1, 1959, was a reduction of 35% in the rate, and it will cause a considerable loss of revenue. We do not feel that the Commonwealth can afford to go farther at this time; but if and when a general retail sales tax is imposed by the State we believe that its imposition should be accompanied by a reduction in the State license tax on wholesale merchants to a rate comparable to the rate in North Carolina, to wit, five cents per \$100 of sales.

Of course, it is common knowledge that the State tax is in many cases not the only license tax paid by wholesale merchants. All of the cities and some of the counties impose local license taxes on wholesale merchants measured by volume, and in some localities the critical need for local revenues has caused the imposition of such taxes at rates that are higher than the rate of the State levy. It would not benefit the wholesalers for the State tax to be reduced if the reduction were to be added to the local rates.

We are not unmindful of the need of local units of governments for funds to meet the steadily increasing demands for local services. But one of the major reasons why there may be an increase in State taxation at sometime in the future is the possible need for increased State aid to the localities, and any revenue loss to the localities by a limitation on their power to levy wholesale merchants' license taxes would be more than made up by increases in State aid.

We, therefore, recommend that, if and when it is possible for the State license tax rate to be further reduced, a limit be set on local license taxation of wholesale merchants so that no local license tax rate would exceed the maximum to be fixed by State law.

The Council is indebted to the Staff of the Department of Taxation and to the other individuals and corporations who assisted by providing information and advice during the course of this study. It also expresses to the members of the Committee its appreciation for the contribution of their time and thought to assist the Council in its deliberations.

Respectfully submitted,

JOHN H. DANIEL, Chairman
C. W. CLEATON
JOHN WARREN COOKE
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STATEMENT OF SENATOR ROBERT Y. BUTTON

This report refers to Section 58-411 of the Code of Virginia, but does not recommend any change or amendment of that Section. I have doubted for some time the wisdom of including "all money on hand and on deposit" as capital for taxation, and I reserve the right later, if I am so advised at that time to do so, to sponsor an amendment to Section 58-411 omitting paragraph 3 therefrom, which is the language quoted above. I raise no other objections to the report as drafted.

ROBERT Y. BUTTON