

DEPARTMENT OF TAXATION

2001 Fiscal Impact Statement

1. **Patron** Parrish

3. **Committee** Senate Finance

4. **Title** Retail Sales and Use Tax: Federal
Government Contractors

2. **Bill Number** HB 2064

House of Origin:

 Introduced

 Substitute

 Engrossed

Second House:

 X **In Committee**

 Substitute

 Enrolled

5. Summary/Purpose:

This bill would provide a retail sales and use tax exemption for tangible personal property that is purchased by a contractor under a service contract when the property is transferred to the federal (but not state or local) government. Currently, a contractor is required to pay the tax on all tangible personal property purchased under a service contract. Thus, this bill would reverse longstanding policy as applied to federal government contractors and upheld by the federal courts.

This bill would not benefit contractors who contract with state or local governments, and those that contract with private parties. This bill would create different tax results between contracts subject to a federal labor standard and those subject only to a state or local labor standard, or no specific labor standard.

The exemption under this bill would apply to purchases (not contracts awarded) on or after July 1, 2002, even though the tax on such tangible personal property was included in the contract price at the time the contract was awarded. The provisions of this bill would not become effective unless reenacted by the 2002 Session of the General Assembly.

6. **Fiscal Impact Estimates are:** Unknown. (See Line 8.)

7. **Budget amendment necessary:** No.

8. Fiscal implications:

This bill would result in minimal forms revision and taxpayer education expenses for the department.

Precise data is not available on the amount currently spent by federal government contractors in Virginia on tangible personal property that is currently subject to taxation

but that would be exempt under the provisions of this bill. The number of taxpayers exempted by this bill is also unknown. However, it is estimated that there were approximately 3500 federal contractors doing business in Virginia in fiscal year 1999.

Based on an analysis of available federal contract data, the exemption created by this bill would have a total negative impact on General Fund, Transportation Trust Fund, and local revenues estimated in excess of \$10 million beginning in FY 2003.

Walsh Healey Public Contracts Act (WHPCA)

Based on an analysis of 1999 federal contract data from the Federal Procurement Data System Database, August 2000, federal contracts in Virginia governed by the WHPCA generated combined state and local sales and use tax estimated revenues of up to \$15.8 million. The fiscal impact of the WHPCA portion of this bill would be less than this amount because the bill would exempt only that property transferred by the contractor without use or consumption. Property actually used by the contractor would remain taxable.

Task order/purchase order

In regard to the task order portion of this bill, changing the longstanding policy in which the true object test is applied (from the overall contract to each individual task and purchase order under a contract) may result in a substantial loss in state and local revenues. Task orders are usually issued under service contracts. More than 60% of federal contracts awarded in Virginia are of the service contract variety. For federal fiscal year 1999, service contracts awarded in Virginia exceeded \$11 billion.

In evaluating the amount of Virginia retail sales and use tax collected from service contracts with the federal government, TAX reviewed a sample of audits of 228 companies out of an estimated 3,500 federal contractors doing business in Virginia. For the three-year period of July 1, 1997, through June 30, 2000, TAX collected a total of approximately \$14.5 million from audits of the 228 federal contractors included in the sample. During the same period, these contractors paid \$14.0 million directly to TAX in consumer use tax. These collection figures do not include sales tax paid directly to vendors by these contractors. Thus, from the sample data, it is not clear how much total sales and use tax was realized by the Commonwealth on the purchase of property that was delivered to the federal government and that is the subject of this bill.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary:

To clarify that this bill does not apply to real property construction contracts, the following technical amendment is suggested:

Page 4, line 181, After: services.

Insert: This exception does not apply to contractors performing real property construction, reconstruction, installation, repair, or any other services with respect to real estate or fixtures thereon, for the federal government or any of its instrumentalities.

The enactment clause for this bill applies to purchases made on or after July 1, 2002, regardless that the federal contract may have been awarded prior to that date. For contracts awarded before that date, contractors who included the sales tax in the contract will receive a windfall unless the contract is revised to exclude the tax from the contract price. To avoid this dilemma, the bill must be amended to limit the exemption to contracts awarded on or after July 1, 2002.

Page 4, line 195, After: for

Strike: purchases made

Insert: contracts awarded

11. Other comments:

Purpose

This bill would overturn a longstanding policy of the department and would overturn United States court decisions that have affirmed the application of the sales and use tax to federal government contractors.

This bill would provide a retail sales and use tax exemption for tangible personal property that is purchased by a contractor under a service contract when the property is transferred to the federal (but not state or local) government. Current law requires the contractor to pay the tax on all tangible personal property purchased under a service contract.

This bill would not benefit contractors who contract with state or local governments, and those that contract with private parties. This bill would create different tax results between contracts subject to a federal labor standard and those subject only to a state or local labor standard, or no specific labor standard.

Current Policy

As established by the Virginia Supreme Court in WTAR Radio-TV v. Commonwealth, 217 Va. 877, 234 S.E.2d 245 (1977), a “true object” test is applied to mixed

transactions calling for both the provision of services and the sale of property. The true object test is used to determine whether the transaction constitutes an exempt service or a taxable retail sale of tangible personal property. The true object test is also applied to determine the purpose of an overall contract, including all task orders and purchase orders issued under the contract.

When the true object of a federal contract is for the retail sale of tangible personal property to the federal government, the contractor may purchase the property exempt of the tax for resale. The subsequent sale of the tangible personal property to the federal government is not taxable pursuant to the exemption granted by Code of Virginia § 58.1-609.1(4).

Conversely, when the true object of a federal contract is for the provision of services to the government, the contractor is generally liable for the sales or use tax on all tangible personal property purchased pursuant to the contract, even though title to the property may pass to the government, or the contractor may be fully and directly reimbursed by the government or both.

Changes in Policy Under this Bill

Walsh-Healey Public Contracts Act: The WHPCA is a federal law that governs the labor practices (such as wages, overtime pay and working conditions) of certain federal government contracts. Generally, the labor practices governed by the WHPCA are applied to those federal government contracts that are categorized by the federal government (but not necessarily by TAX) as calling for the provision of property.

Under this bill, federal contractors would be able to purchase tangible personal property purchased under a WHPCA contract exempt of the tax if the property is purchased for resale to the federal government and not actually used by the contractor. Currently, if TAX determines that the contract is for the provision of services, all property purchased by the contractor is taxable.

Task orders/purchase orders: Under this bill, federal contractors would be able to purchase tangible personal property pursuant to task orders or purchase orders issued under any federal government contract exempt of the tax if the property is purchased for resale to the federal government and not actually used by the contractor.

Currently, the application of the tax depends on the true object of the contract. It is the contract that is the driving force behind any subsequently issued task order or purchase orders. Also, government contracts are generally awarded through an open bidding process by which several contractors offer proposals, and public funds are made available to the contractor based on the bidding process. Subsequent task orders or purchase orders are generally not awarded through the open bidding process, but are simply issued under authority of the underlining contract.

“Actual use” is not defined under the current statutes; nor is it defined by this bill. Actual use of tangible personal property would be interpreted by TAX as “to perform a factual, real act of putting the property into service.” TAX interprets “actual use” to exclude the act of buying tangible personal property merely for immediate transfer to the federal government when the property is not put into service or action by the federal contractor.

Study

The application of the retail sales and use tax to the federal government contractors doing business in Virginia was studied in a report made to the Commission to Study Virginia’s State and Local Tax Structure for the 21st Century in December 2000. This study, *The Retail Sales and Use Taxation of Contractors Doing Business in Virginia with the Federal Government*, was mandated by Senate Joint Resolution 150 and House Joint Resolution 158 of the 2000 Session of the General Assembly. A working group consisting of representatives of the Virginia federal contracting industry and TAX jointly prepared the report. The Commission did not recommend a change in policy.

Administrative Issues

Under this bill, the true object test would be applied to each individual task or purchase order under a contract. Currently, the true object test is applied to the entire contract. Examining each individual task order to determine whether it is for the purchase of tangible personal property or for the provision of a service, and determining if the property was “actually used” by a federal contractor, may require the taxpayer and TAX to devote more time to the audit process. Determining the correct application of the tax to several individual task orders and purchase orders may also create more disputes over its proper application.

Contractors who contract with the federal government as well as with state and local governments or private parties will need to apply two different tax treatments to their contracts. The laws and rules for contracts with the federal government will be significantly different than those applicable to other contracts. The taxation of contracts with state and local governments would continue to be administered under the current rules.

Technical Amendments

Two technical amendments are suggested on Line 10. The first clarifies that this bill does not apply to real property construction contracts. The second amendment limits the application of this bill to contracts awarded on or after July 1, 2002.

cc: Secretary of Finance

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