

# DEPARTMENT OF TAXATION

## 2004 Fiscal Impact Statement

1. **Patron** Timothy D. Hugo

2. **Bill Number** HB 1375

3. **Committee** House Finance

**House of Origin:**

X **Introduced**

       **Substitute**

       **Engrossed**

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

**Second House:**

       **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 title to the property will pass to the Commonwealth, any political subdivision of the Commonwealth, or the United States Government. Currently, a government contractor is required to pay the tax on all tangible personal property purchased under a service contract.

The exemption under this bill would apply to purchases made (not contracts awarded) on or after the effective date (presumably, July 1, 2004), even though the tax on such tangible personal property was included in the contract price at the time the contract was awarded.

The effective date of this bill is not specified.

6. **Fiscal Impact Estimates are:** Not available. (See Line 8.)

#### 6a. **Expenditure Impact:**

| <i><b>Fiscal Year</b></i> | <i><b>Dollars</b></i> | <i><b>Positions</b></i> | <i><b>Fund</b></i> |
|---------------------------|-----------------------|-------------------------|--------------------|
| 2003-04                   | \$46,000              | 0                       | GF                 |
| 2004-05                   | \$35,000              | 0                       | GF                 |
| 2005-06                   | \$35,000              | 0                       | GF                 |
| 2006-07                   | \$36,050              | 0                       | GF                 |
| 2007-08                   | \$37,130              | 0                       | GF                 |
| 2008-09                   | \$38,240              | 0                       | GF                 |
| 2009-10                   | \$39,390              | 0                       | GF                 |

7. **Budget amendment necessary:** Yes (See Line 8).

8. **Fiscal implications:**

## Expenditure Costs

This bill would result in administrative costs for employee set-up and salaries for the Department of \$46,000 in FY 2004, \$35,000 in FY 2005, \$35,000 in FY 2006, \$36,050 in FY 2007, \$37,130 in FY 2008, \$38,240 in FY 2009, and \$39,390 in FY 2010.

## Revenue Impact

The impact of this bill is unknown but is potentially large. 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 would be exempt under the provisions of this bill. The number of taxpayers exempted by this bill is also unknown. However, it is estimated from the latest available data (FY 1999) that there are approximately 3,500 federal contractors doing business in Virginia.

TAX analyzed federal contract data from the Federal Procurement Data System and federal and state/local government expenditure data for services from the Bureau of Economic Analysis. Based on an analysis of this data, the exemption created by this bill is estimated to have a total negative impact on General Fund, Transportation Trust Fund, and local revenues estimated in excess of \$48.4 million each year (\$32 million in General Fund revenues annually). These revenue figures assume a “steady state” growth rate. In other words, the estimate does not take into account for future inflation and contracting industry growth.

For subsequent years, the revenue loss is expected to be higher than the above amount because the long-term growth trend in federal expenditures in Virginia is expected to continue. For each of the last five years, Virginia has ranked second only to California in total federal procurement dollars. In FY 1997, total federal procurement for Virginia was \$16.2 billion versus \$25.2 billion for California. The federal procurement data shows that the procurement gap between California and Virginia is rapidly closing. In FY 2001, total federal procurement for Virginia had grown to \$26.0 billion versus \$27.4 billion for California. While the service procurement for Virginia has shown steady growth, that trend may see a more dramatic increase in future years because of the potential impact of the Homeland Security Department on government contracting activities in Northern Virginia.

### **9. Specific agency or political subdivisions affected:**

Department of Taxation  
Department of Treasury  
Department of Accounts

### **10. Technical amendment necessary: Yes.**

The exemption under this bill would apply to purchases made on or after July 1, 2004, regardless that the federal contract may have been awarded prior to that date. For contracts awarded before that date, contractors who included sales tax in the contract bid price would receive a windfall unless the contract is revised to exclude the tax from the

contract price. To avoid this dilemma, it is suggested that the bill be amended to limit the exemption to contracts awarded on or after July 1, 2004, as follows:

Page 1, line 36, After: entity.

Insert: This exclusion applies to tangible personal property purchases pursuant to a contract awarded on or after July 1, 2004.

## **11. Other comments:**

### 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 government certifies that title to the property will transfer to the United States government, the Commonwealth, or political subdivisions of the Commonwealth. Current law requires the contractor to pay the tax on all tangible personal property purchased under a service contract regardless of whether any federal, state or local government entity is a party to the contract.

This bill would not benefit contractors who contract with other state governments, political subdivisions thereof, or the private sector. This bill would create different tax results for service contracts (including real property construction services) between those performed for the government and those performed for the private sector, other states, political subdivisions of other states, and foreign governments.

### 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 a transaction constitutes an exempt service or the taxable retail sale of tangible personal property. The true object test is also applied to determine the purpose of an overall contract, including all tasks 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

This bill would overturn the Department's well established policy 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 affect the current treatment for government service contractors, including contractors who provide real property construction services.

Under this bill, government service contractors would be able to purchase tangible personal property exempt of the tax if title to the property will pass to the federal government, the Commonwealth, or any political subdivision of the Commonwealth. Currently, if the Department determines that the contract is for the provision services, all property purchased by the contractor is taxable.

Contracts with federal government, the Commonwealth, and political subdivisions of the Commonwealth generally mandate that title to the property purchased by the contractor passes to the government at the time of purchase. Accordingly, this bill would exempt from taxation the bulk of the contractor's purchases.

## 2000 Study

The application of the retail sales and use tax to the federal government contractors doing business in Virginia was studied in a report mad to the Commission to Study Virginia's State and Local Tax Structure for the 21<sup>st</sup> 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 the Department jointly prepared the report. The Commission did not recommend a change in policy.

## Pilot Audit Program

Since the 2000 study, the Department has been meeting with industry representatives to consider various administrative solutions to the issues raised by the industry. Starting in 2004, the Department, with the cooperation with the government contractor industry, is conducting a pilot program to fairly determine whether an administrative change is feasible. This pilot audit program will be conducted during 2004.

## True object test

Currently, the true object test is applied to all government contracts. Notwithstanding this bill, the true object test would continue to apply to those contracts that are with private parties. Thus, this bill creates and exception to the true object test in determining the proper tax application to contracts.

### Disparate treatment between government contracts and private contracts

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

### Technical Amendment

A technical amendment is suggested in Item 10 to limit the application of this bill to purchases made pursuant to contracts awarded on or after July 1, 2004.

### Similar Legislation

House Bill 720 and Senate 91 are identical to this bill.

cc: Secretary of Finance

Date: 1/30/2004 wbs