DEPARTMENT OF TAXATION
2004 Fiscal Impact Statement

REVISED

1. **Patron** John C. Watkins

2. **Bill Number** SB 682

   House of Origin:
   X **Introduced**
   ___ **Substitute**
   ___ **Engrossed**

   Second House:
   ___ **In Committee**
   ___ **Substitute**
   ___ **Enrolled**

3. **Committee** Senate Finance

4. **Title** Retail Sales and Use Tax: Exemptions for Certain Public Service Corporations

5. **Summary/Purpose:**

This bill would repeal the retail sales and use tax exemption granted to telecommunications companies, certain telephone companies, common carriers of property or passengers, whether by motor vehicle or railway. Furthermore, this bill would exclude any company from claiming the retail sales and use tax exemption available to manufacturers if the preponderance of the property purchased is used in distributing gas, electricity, power, any other source of energy or power, or water.

The effective date of this bill is not specified.

6. **Fiscal Impact Estimates are:** Tentative. (See Line 8 and Attachment 1.)
Revenue Impact:

Fiscal Year	*Dollars*	*Fund*
2003-04	$0	GF
2003-04	$0	TTF
2004-05	$46.5 million	GF
2004-05	$7.9 million	TTF
2005-06	$50.9 million	GF
2005-06	$8.6 million	TTF
2006-07	$51.3 million	GF
2006-07	$8.8 million	TTF
2007-08	$51.7 million	GF
2007-08	$8.8 million	TTF
2008-09	$52.2 million	GF
2008-09	$9.0 million	TTF

2009-10	$52.5 million	GF
2009-10	$9.0 million	TTF

* The fiscal impact of Senate Bill 682 on local sales and use tax revenue is not included above, but is listed in Attachment 2. Local tax revenues are collected by the Department of Taxation and are returned to local governments without being appropriated by the General Assembly.

7. **Budget amendment necessary:** Yes.
   Page 1, Revenue Estimates

8. **Fiscal implications:**

Administrative impact

This bill would have minimal impact on the Department of Taxation.

Revenue impact

Data Limitations

TAX does not collect data on exempt purchases because there is no administrative reason to require taxpayers to submit that information. Without the issuance of exemption numbers to businesses, there may be no method of identifying taxpayers that claim an exemption. For that reason, all revenue estimates must be regarded as highly tentative.

When TAX attempts to estimate the effect of sales and use tax exemptions, TAX must rely on audit data, public information, or data supplied by the affected entity or industry. Generally, data collected in a normal audit is of limited value in making such estimates because TAX is examining taxable transactions, not exempt transactions. During the course of an audit, no data is gathered with respect to exempt purchases. Publicly available data generally does not provide the level of detail on tangible personal property to match the provisions of Virginia's exemptions. In addition, the data may be available only for the U.S. as a whole, rather than being Virginia specific. While industry data is often the best data available, it is a time consuming process to determine the pool of affected entities and then to obtain data from all of the entities affected and to validate the accuracy and completeness of the data. Because of the time limitations associated with the Virginia legislative process, it is often extremely difficult, or even impossible, to gather industry data and validate it within the time constraints necessary to complete a Fiscal Impact Statement.

This Fiscal Impact Statement is being revised to incorporate the data that TAX has gathered since the date this bill was introduced and the Fiscal Impact Statement was last revised. Even with the additional time, TAX has been unable to determine the revenue impact from the repeal of one of the exemptions.

Electric Utilities

Data on electric utilities was obtained from several sources. This information included audit data and Federal Energy Regulatory Commission (FERC) forms for 17 companies. For purposes of the revenue estimate, detailed analysis was made for 2 suppliers that represent 98% of the generating capacity and 89% of transmission and distribution capacity measured by kilowatt hours. The FERC data was supplied by the State Corporation Commission (SCC).

Based on experience with auditing electric utilities, TAX identified those categories on the FERC reports that contain expenditures that would become taxable if the exemption were repealed. Audit staff further identified the percentages of taxable items within each category. The categories were also adjusted for wages and freight which are not taxable now and would not be taxable if the exemption were repealed. The appropriate expenditures from the newly taxable categories were summed and assigned to either power, transmission and distribution or administrative classes for purposes of developing a revenue estimate. The totals for these classes were adjusted to represent a statewide amount based on the share of state generating capacity and kilowatt hours that the source companies comprise.

The identified categories took into account the fact that electric suppliers would still be eligible for the manufacturing exemption for any tangible personal property used directly to generate electricity for sale or resale, even if the public service exemption were repealed. (See discussion on Line 11.) The 1995 Sales and Use Tax Expenditure Study (SUTES) did <u>not</u> account for the fact that electricity producers would still be exempt from sales tax on purchases related to the production of electricity.

FERC data uniformity is a potential limitation. TAX adjusted the estimate to account for possible variability in report accounting. The adjustment also accounts for potential imprecision resulting from use of percentage estimates of expenditures within categories.

Industry representatives have provided TAX with estimates of the potential impact from repeal of the exemption. These estimates are lower than those computed by TAX. TAX's estimate may be higher for several reasons. For example, the interpretation of the manufacturing exemption may vary. Industry representatives did not supply any detail on their estimates.

Natural Gas Utilities

Federal Energy Regulatory Commission (FERC) data for gas utility companies was supplied by the SCC. There were ten companies that filed with the SCC. Categories of expenditures within the FERC reports, which would be taxable if the exemption were repealed, were identified and summed. Each aggregated category amount was adjusted to account for company labor expenses.

Nonuniformity of FERC data across companies is a potential limitation. An adjustment was made to the estimate to account for this possible variation.

Telecommunications Companies

The Federal Communications Commission (FCC) provides the SCC with reports filed by some telecommunications companies. Other telecommunication carriers also provide the SCC with Annual Financial and Operating Reports.

According to the SCC, there are a total of 265 total telecommunications carriers in the state of Virginia. Of those, 171 are Competitive Local Exchange Carriers (CLEC's). CLEC's possess little or no property and according to the SCC would have few expenses since they are non-facilities based. The remaining 94 are local, interexchange, PCS, or cellular carriers. The SCC provided TAX with data on 46 large carriers and 13 local carriers.

While the small local carriers filed data that allowed segregation of currently exempt capital outlays and expenses, the large carriers supplied data only in the aggregate.

Financial reports were used to identify spending categories that contained items which would be taxable if the exemption was repealed, which were listed on the financial statements for the local carriers. Amounts were summed to determine the new taxable total for each local company.

The ratio of newly taxable expenditures to all expenditures was calculated. This percentage was applied to the total aggregated expenditures for the large companies to estimate expenditures that would become taxable – an assumption that may not be accurate.

Without auditing the financial reports, there is no way to determine the consistency in the filings of different carriers. Additionally, the estimate assumes the taxable percentage for local carriers applies to large carriers as well. The estimate was adjusted downward to account for these estimating risks.

Industry representatives have provided TAX with estimates of the potential impact from repeal of the exemption. Their estimate of the annual impact would be $34 million. The responding companies have assumed that the repeal of the exemption would cause these companies to effectively reduce capital expenditures.

Motor Vehicle Common Carriers

Since the data was gathered for the last Sales and Use Tax Expenditure Study, which was completed in 1995, the trucking industry has been deregulated. As a result, there is no longer a mandatory financial reporting requirement for motor vehicle common carriers with the SCC or the Department of Motor Vehicles (DMV). As a result of deregulation, there is also no distinction made between common carriers, contract carriers, and brokerages. Due to these changes in the data available, the revenue estimating methodology from the 1995 SUTES motor vehicle common carrier estimate cannot be duplicated.

The SCC and DMV currently do not have complete financial data on common carriers. National data available on motor vehicle common carriers does not segregate the information by common, contract, or brokerage carrier. Therefore, it was determined that industry-provided data would be needed to develop any estimate of the revenue impact from the repeal of the exemption.

The Virginia Trucking Association conducted a survey to obtain the amount of exempt purchases made by its members. According to the Association, the survey had a very low response rate (only 21 responses). The industry was unable to provide TAX the percentage of all common carriers that the 21 responders represented or the total number of companies. Based on the survey responses, the revenue gain from eliminating the exemption for motor vehicle common carriers would be $600,000 for the 21 responders. TAX does not believe that at this time, it can make a reliable revenue estimate of the gain from repealing this exemption.

Railway Common Carriers

The only data available on railway common carriers was provided by the industry, which cannot be independently verified. TAX received information on exempt purchases from railway companies that make up 99.1% of the assessed value of all railways in Virginia.

TAX reviewed the industry classifications of exempt purchases to confirm the tax-exempt status of such purchases. The effective tax rate was applied to the industry estimates to determine the amount that would be gained from repealing the sales tax exemption. This methodology does not take into account the potential for shifts in purchasing behavior by the railway companies. If the sales tax exemption for locomotive diesel fuel were repealed, for example, railway companies could shift fuel purchases to a neighboring states that exempt locomotive diesel fuel. (Maryland offers a full exemption and North Carolina offers a prorated exemption.) This would offset some of the revenue gain from the repeal of the exemption. To adjust for potential shifts in purchasing behavior, the locomotive diesel fuel purchases were removed from the calculation.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

This bill would limit the “overlap” of the public service exemption and the manufacturing exemption by excluding any business from claiming the manufacturing exemption for the purchase of any tangible personal property where the preponderance of its use is in distributing gas, electricity, power, any other source of energy, or water to customers. *(See Line 11.)*

As drafted, companies providing electric power would still qualify for the manufacturing exemption for their generation activities. If the intent is to eliminate any “overlap” of the public service exemption and the manufacturing exemption, a technical amendment is necessary. Should such an amendment be adopted, the state and local revenue impact of this bill would increase.

11. Other comments:

Public Service Corporation Exemption

As enacted in 1966, the Virginia Retail Sales and Use Tax Act contained exemptions applicable to purchases made by “Public Service Corporations,” subject to regulation and taxation by the State Corporation Commission (SCC). Generally, the rates charged to consumers by these companies were regulated because they enjoyed a protected monopoly and provided a necessary service for the public good. The exemption, as originally set forth, was applicable to the purchase of tangible personal property by a “public service corporation subject to a state franchise or license tax upon gross receipts … and … a public service corporation engaged in business as a common carrier of property or passenger by motor vehicle...” Furthermore, the sales and use tax exemption for public service corporations required that for the tangible personal property purchased to be exempt, it must be used directly in the rendition of the public service to the general public. TAX has interpreted the terms “public service” and “used directly,” as they relate to public service corporations, in their broadest and most inclusive sense to include any product or commodity furnished by any public utility and the equipment, apparatus, appliances, and facilities devoted to the rendition of the service to the general public.

Evolution of the Public Service Exemption

As the regulatory environment changed, the level of control exercised over these companies by the SCC declined. In 1978, as the result of becoming subject to the corporate income tax instead of taxation by the SCC, railroads were specifically added to the list of companies exempt from the sales tax as public service corporations. In 1988, when telecommunications companies were shifted from the SCC gross receipts tax to the corporate income tax, the exemption was amended to ensure that telecommunications companies retained the exemption. As a result of deregulation of the common carrier industry by the ICC Termination Act of 1995, the distinction between exempt common carriers and taxable contract carriers became blurred. Effective January 1, 1995, the SCC stopped issuing certificates of public convenience and necessity to motor vehicle carriers of property (except household goods movers). Finally in 1999, legislation was enacted to shift the taxation of electric suppliers from the SCC’s gross receipts tax to the corporate income tax.

Current State of the Public Service Corporation Exemption

As the exemption is currently written, the public service corporation exemption applies to telecommunication entities, telephone mutual companies, common carriers of property or passengers by motor vehicle or rail, and water companies subject to state franchise tax or license tax upon gross receipts. The effect of the 1999 legislation with respect to electrical companies was to disqualify them from the public service corporation exemption.

Prior to the 1999 law change affecting electric suppliers, TAX determined that companies providing electric power, not subject to the public service exemption, are treated as industrial manufacturers or processors and are entitled to the retail sales and use tax exemption under *Va. Code* § 58.1-609.3(2). Therefore, electric utilities with generation facilities, will qualify for the manufacturing exemption for their non-distribution purchases currently exempt under the public service exemption. Such businesses would still qualify to makes purchases of tangible personal property used directly in their generation operations exempt of the tax. If the intent of this bill is to eliminate any “overlap” of the public service exemption and the manufacturing exemption, a technical amendment is necessary.

Impact of Legislation

This bill would repeal the retail sales and use tax exemption enjoyed by telecommunications companies, certain telephone mutual companies, common carriers of property or passengers, whether by motor vehicle or railway, and any company claiming the manufacturing exemption, if the preponderance of the property purchased is used in distributing gas, electricity, power, any other source of energy or power, or water. As water companies are still subject to the SCC tax on gross receipts, such companies would still qualify for the public service exemption.

cc: Secretary of Finance

Date: 3/19/2004 mch

ATTACHMENT 1

SB 682 Revenue Impacts - State Revenue Only
(Millions)

Exemption	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Electric Utilities						
General Fund - Unrestricted	6.60	7.20	7.20	7.30	7.40	7.40
General Fund - Restricted	3.30	3.60	3.60	3.70	3.70	3.70
Transportation Trust Fund	1.70	1.80	1.90	1.90	1.90	1.90
State Total	11.60	12.60	12.70	12.90	13.00	13.00
Natural Gas Utilities						
General Fund - Unrestricted	4.70	5.10	5.20	5.20	5.30	5.30
General Fund - Restricted	2.30	2.60	2.60	2.60	2.60	2.70
Transportation Trust Fund	1.20	1.30	1.30	1.30	1.40	1.40
State Total	8.20	9.00	9.10	9.10	9.30	9.40
Telecommunications Companies						
General Fund - Unrestricted	17.20	18.80	19.00	19.10	19.30	19.50
General Fund - Restricted	8.60	9.40	9.50	9.60	9.70	9.70
Transportation Trust Fund	4.40	4.80	4.90	4.90	5.00	5.00
State Total	30.20	33.00	33.40	33.60	34.00	34.20
Motor Vehicle Common Carriers						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Railways						
General Fund - Unrestricted	2.50	2.80	2.80	2.80	2.80	2.80
General Fund - Restricted	1.30	1.40	1.40	1.40	1.40	1.40
Transportation Trust Fund	0.60	0.70	0.70	0.70	0.70	0.70
State Total	4.40	4.90	4.90	4.90	4.90	4.90
All Provisions						
General Fund - Unrestricted	31.00	33.90	34.20	34.40	34.80	35.00
General Fund - Restricted	15.50	17.00	17.10	17.30	17.40	17.50
Transportation Trust Fund	7.90	8.60	8.80	8.80	9.00	9.00
State Total	54.40	59.50	60.10	60.50	61.20	61.50

ATTACHMENT 2

SB 682 Revenue Impacts - Local Option
(Millions)

Exemption	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Electric Utilities						
Local Option	3.40	3.70	3.70	3.80	3.80	3.80
Natural Gas Utilities						
Local Option	2.40	2.60	2.70	2.70	2.70	2.70
Telecommunications Companies						
Local Option	8.80	9.60	9.70	9.80	9.90	10.00
Motor Vehicle Common Carriers						
Local Option		Unknown	See text of fiscal impact statement.			
Railways						
Local Option	1.30	1.40	1.40	1.40	1.40	1.50
All Provisions						
Local Option	15.90	17.30	17.50	17.70	17.80	18.00