DEPARTMENT OF TAXATION
2005 Fiscal Impact Statement

1. Patron Robert D. Hull

2. Bill Number HB 2852
House of Origin:
X **Introduced**
___ **Substitute**
___ **Engrossed**

3. Committee House Finance

4. Title Retail Sales and Use Tax: Expenditure Study for Miscellaneous and Nonprofit Exemptions

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

5. Summary/Purpose:

This bill would require the Department of Taxation to analyze the fiscal, economic and policy impact of each miscellaneous and nonprofit sales tax exemptions over a five-year period and report the findings to the House and Senate Finance Committees by December 1 of each year. The initial report on miscellaneous exemptions would be due by December 1, 2006. The analysis of the nonprofit exemptions would be conducted over four years, with the first report due on December 1, 2007. No exemption studied under this bill shall be analyzed more frequently than once every five years.

The effective date of this bill is not specified, however, the first report would be due to the appropriate committee chairs no later than December 1, 2006.

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

Expenditure Impact:

Fiscal Year	*Dollars*	*Positions*	*Fund*
2004-05	$0	0	GF
2005-06	$114,306	2	GF
2006-07	$113,495	2	GF
2007-08	$116,780	2	GF
2008-09	$120,163	2	GF
2009-10	$123,648	2	GF
2010-11	$127,238	2	GF

7. Budget amendment necessary: Yes.
Item(s): 284 and 286, Department of Taxation

8. Fiscal implications:

Administrative Costs

This bill would require the Department to conduct an in-depth analysis of the fiscal, economic and policy impacts of all the miscellaneous and nonprofit sales and use tax exemptions annually and to prepare a report of such by December 1 of each year. At a minimum, the Department would incur costs of $114,306 in Fiscal Year 2006, $113,495 in Fiscal Year 2007, $116,780 in Fiscal Year 2008, $120,163 in Fiscal Year 2009, $123,648, in Fiscal Year 2010, and $127,238 in Fiscal Year 2011 for two additional full-time positions to conduct these studies. The Department would also incur other administrative costs for printing, postage and processing, however, these costs are expected to be minimal.

Revenue Impact

This bill would have no impact on state or local revenues.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Similar Study

The 1989 General Assembly passed legislation that required the Department to study all sales and use tax exemptions on a continuous five-year cycle, studying two categories of exemptions each year. The Department was required to publish the Sales and Use Tax Expenditure Study and present it to the Chairmen of the House Finance and Senate Finance Committees in December of each year. The goal of the Sales and Use Tax Expenditure Study was to provide a more complete picture of the revenue impact and policy issues surrounding each of the exemptions contained in the Retail Sales and Use Tax Act. The study included detailed information on the policy, fiscal, and economic impact of the exemptions as well as the apparent rationale for the exemptions and their legislative history. It was believed that the periodic review of sales and use tax exemptions was necessary in order to strengthen oversight and control over the process by which sales tax exemptions are granted. The Department published its last study in December 1995. The 1996 General Assembly repealed the requirement that the Department conduct the study.

Exemption Processes

The process by which an exemption is obtained has changed several times. Concurrent with the implementation of the Sales and Use Tax Expenditure Study process in 1989 and prior to 1995, the patron of any legislation seeking an exemption from the sales and use tax was required to submit information to the Division of Legislative Services prior to consideration of the legislation by the committee.

Beginning In 1995, based upon the recommendations of the Joint Subcommittee of the Senate and House Finance Committee to Develop Criteria for Evaluating Sales and Use Tax Exemption Requests (pursuant to SJR 249, 1993 General Assembly), patrons were required to submit a questionnaire to the Department by November 1 that contained the same information that was previously submitted directly to the Division of Legislative Services. Organizations seeking an exemption under the educational, medical-related, civic and community services, cultural and miscellaneous groupings were required to submit to the Department by November 1 additional information relating specifically to the operation and administration of the organization. By January 5, the Department was required to report on the completeness of the information provided.

Legislation enacted in 1999 established a new reporting requirement for nonprofit organizations exempt from the sales and use tax. Churches were excluded from the new requirement. The legislation also established a June 30, 2001, sunset date for existing nonprofit organization exemptions that did not have a sunset date. By July 1, 2000, all nonprofit organizations qualified for a sales and use tax exemption, except churches, were required to submit to the Department of Taxation updated information relating to the operation and administration of the organization. Organizations were required to submit:

- An estimate of the annual state and local tax savings as a result of the exemption;
- Beneficiaries of the exemption;
- Direct or indirect local, state or federal government assistance received by the organization;
- Extent to which the organization is exempt from the retail sales and use tax in other states;
- Any external statutory constitutional or judicial mandates in favor of the exemption;
- Other state taxes to which the organization is subject;
- Similar organizations which are not entitled to the sales and use tax exemption;
- Other criteria, facts, or circumstances which may be relevant to the request for exemption;
- Verification of exemption from federal income taxation under either § 501(c)(3) or § 501(c)(4) of the Internal Revenue Code;
- The purpose or purposes for which the entity is organized and operated, and the charitable functions and services it offers to Virginia citizens, along with an explanation of such services;
- Proof that no more than forty percent of the organization's gross annual revenue, under generally accepted accounting principles, is spent on general administration and fundraising (e.g, Form 990);
- The location of the organization's detailed financial records available for public inspection and certification that the records are true, accurate, and complete. Salaries, including all benefits, of the five most highly compensated employees;
- Proof of compliance with Chapter 5 of Title 57 (relating to solicitation of contributions) from organizations subject to it; and
- Names and addresses of a volunteer board of directors.

The intent was for the General Assembly to use this information when considering whether to extend the exemptions due to expire in a particular year.

Under each of the above processes, even if an entity submitted all of the required information to either the Division of Legislative Services or to the Department, it still required specific action on the part of the General Assembly to grant the entity an exemption.

In 2003, as the result of recommendations made by the House Special Study Committee Studying Sales and Use Tax Exemptions made through the Joint Subcommittee to Study and Revise Virginia's State Tax Code, the General Assembly enacted House Bill 2525 (Chapter 757, 2003 Acts of Assembly) and Senate Bill 743 (Chapter 758, 2003 Acts of Assembly) that created an administrative process for granting sales and use tax exemptions to nonprofits and established standard criteria that would be used to qualify nonprofit organizations for sales and use tax exemptions. Effective July 1, 2004, all Internal Revenue Code § 501(C)(3) and charitable § 501(c)(4) organization could qualify for the sales and use tax exemption if they met the criteria established by this legislation. The Department of Taxation formed a business unit totally dedicated to the administration of this process and the granting of exemption to qualifying organizations.

In order to qualify for an exemption under the new process, a nonprofit entity must meet <u>all</u> of the applicable criteria:

- The entity is exempt from federal income taxation under IRC § 501(c)(3) or, if organized for a charitable purpose, exemption under IRC § 501 (c) (4). Alternatively, the entity has annual gross receipts of less than $5,000 and is organized for at least one of the purposes set forth in IRC § 501(c)(3) or (4).

- The entity is in compliance with all applicable state solicitation laws, and where applicable, provides appropriate verification of such compliance.

- The entity's annual general administrative costs, including salaries and fundraising, relative to its annual gross revenue, under generally accepted accounting principles, is not greater than 40 percent.

- If the entity's gross annual revenue was $250,000 or greater in the previous year, the entity must provide a financial audit performed by an independent certified public accountant.

- If the entity filed an IRS Form 990 or 990 EZ, it must provide a copy of such form to the Department. If the entity did not file an IRS Form 990 or 990 EZ, the entity must provide a list of the Board of Directors or other responsible agents of the entity, composed of at least two individuals and the location where the financial records of the entity are available for public inspection.

Current nonprofit exemptions were grandfathered under the terms and conditions of the exemption as it existed on June 30, 2003. A filing process was established for grandfathered organizations to provide the same information required of new nonprofit organization seeking an exemption. The current process also requires the Department of Taxation to file an annual report with the Chairmen of the House Finance Committee, the

House Appropriations Committee, and the Senate Finance Committee by December 1 of each year setting forth the revenue impact of the nonprofit exemptions.

<u>This Proposal</u>

This bill would require the Department to do a more in-depth analysis of not only the nonprofit sales and use tax exemptions, but also the miscellaneous exemptions found in § 58.1-609.10. In addition to the fiscal impact of these exemptions, the report would also include the following as they relate to each exemption:

- Beneficiaries of the exemption;
- Direct or indirect local, state, or federal government assistance received by the person having the exemption;
- The extent to which the person, property, service, or industry is exempt from the retail sales and use tax in other states, especially states neighboring the Commonwealth;
- Any external statutory, constitutional, or judicial mandates in favor of the exemption;
- Other Virginia taxes to which the person, property, service, or industry is subject;
- Similar taxpayers who are not entitled to a retail sales and use tax exemption; and
- Other criteria, facts or circumstances that may be relevant to the exemption.

Currently, there are seventeen different categories of miscellaneous exemptions under *Virginia Code* § 58.1-609.10. These exemption categories include:

- Heating Fuels for Domestic Consumption
- Occasional sales
- Leasebacks
- Interstate and Foreign Commerce Deliveries
- Food Stamp Program and WIC Voucher
- Nuclear Regulatory Commissions
- Professional Documents
- School Lunches and Textbooks
- Medicines and Drugs
- Prosthetic Devices
- Drugs and Supplies Used in Dialysis
- Special Equipment Installed on Motor Vehicles for the Handicapped
- Special Computers and Equipment used by the Handicapped
- Non-prescription Drugs and Proprietary Medicine
- Donations to Nonprofits
- Church Exemption
- Medical Products and Supplies to Medicare/Medicaid Recipients

The bill would also require that each of the nonprofit organizations with a sales and use tax exemption under Virginia Code § 58.1-611 be examined in the same manner. When the new administrative exemption process was enacted in 2003, the Department estimated that 22,000 nonprofit organizations in Virginia may benefit from the new exemption process. At that time there were 7,700 churches in Virginia that may also benefit from the new process. Currently, the Department issues a report each December 1 that reports on the fiscal impact to the exemptions granted to nonprofit organizations.

cc : Secretary of Finance

Date: 1/30/2005 WBS
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