

DEPARTMENT OF TAXATION

2008 Fiscal Impact Statement

1. **Patron** Timothy D. Hugo

3. **Committee** House Finance

4. **Title** Retail Sales and Use Tax; Application of the
True Object Test to Government Contractors

2. **Bill Number** HB 1246

House of Origin:

 X **Introduced**

 Substitute

 Engrossed

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would codify a provision in the current Appropriations Act that changes the application of the "true object test" for the Retail Sales and Use Tax as it applies to contracts between a government entity and a contractor. The provision requires that, when making a determination as to the taxability of certain items purchased under a government contract, the true object test be applied to each separate work order, statement of work, and task order, rather than the underlying contract. This provision does not apply to materials, equipment, or other tangible personal property purchased by a contractor for use in real estate construction contracts with a government entity.

As a result of budget language first included in the Budget Bill (House Bill 5002, 2006 Acts of Assembly, Chapter 3, Special Session 1), TAX changed its policy with respect to the interpretation of contracts between federal, state, and local governments and contractors. Prior to that time, determinations as to the true object of contracts between a contractor and the federal, state, or local government were made by applying the true object test to the underlying contract, with no attention given to the separate work orders, statements of work, and task orders issued under that contract. Effective July 1, 2006, TAX changed its policy, such that for work orders, statements of work, and task orders executed on or after July 1, 2006, taxability determinations regarding items purchased under a government contract were required to be made by applying the true object test to each separate work order, statement of work, and task order rather than the underlying contract.

The effective date of this bill is not specified.

6. **No Fiscal Impact.**

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

8. **Fiscal implications:**

As this bill codifies TAX's current policy with respect to contractors contracting with federal, state, and local governments, its passage would have no revenue impact.

9. Specific agency or political subdivisions affected:

TAX

10. Technical amendment necessary: Yes.

A technical amendment is necessary to remove the reference Title 23 of the Virginia Administrative Code, § 10-210-4040, which sets forth TAX's regulatory policy regarding the true object test. As this regulation is subject to change, TAX suggests the following amendments to avoid unintended consequences if the regulation is subsequently amended:

Page 1, Line 35, after transaction

Strike: , according to the general principles of true object as set forth in the Virginia Administrative Code § 10-210-4040,

11. Other comments:

Generally

Generally, under the Virginia Retail Sales and Use Tax Act, tangible personal property purchased by contractors for use and consumption in fulfilling contracts with the federal, state, or local government is subject to tax to the contractor at the time of purchase. This applies regardless of whether title to such property passes directly to the government entity upon purchase by the contractor or the contractor is reimbursed directly by the government entity for the cost of such property. The only exception to this treatment is if the credit of the government entity is bound directly and the contractor has been designated as the official purchasing agent of the government entity.

True Object Test Generally

Contracts between a government entity and a contractor that involve both the rendering of a service and the provision of tangible personal property are deemed mixed contracts, and the "true object" of the transaction must be examined to determine the taxability of the transaction. As articulated under the true object test, if the true object of a transaction is the sale of tangible personal property, a contractor may purchase such tangible personal property exempt of the tax using a resale exemption certificate. The tangible personal property may be subsequently resold to the government exempt of the tax. However, if the true object of the transaction is the provision of services, the contractor is deemed to be the taxable user and consumer of all tangible personal property used in performing its services, even though title to the property provided may pass to the government or the contractor may be fully and directly reimbursed by the government or both.

Tax Treatment of Government Contracts Prior to July 1, 2006

Prior to July 1, 2006, TAX applied the true object test to the overall purpose of the contract, without regard to the individual work orders, statements of work, or task orders issued in furtherance of the contract. If a determination was made that the overall objective of the contract is the provision of services, the contractor was required to pay

the tax on all tangible personal property purchased by the contractor in fulfilling the contract. If the overall true object of the contract was the conveyance of tangible personal property to the government entity, the contractor could purchase the tangible personal property exempt of the tax for resale and subsequently sell the property to the government entity without collecting tax on the sale.

Tax Treatment of Government Contracts Executed on and After July 1, 2006

Pursuant to language contained in the current Appropriations Act that changes the application of the true object test as it applies to contracts between a government entity and a contractor, effective July 1, 2006, TAX changed its policy for government contracts. For work orders, statements of work, and task orders entered into on or after July 1, 2006, the tax application to government contracts is based on the application of the true object test to each separate work order, statement of work, or task order. This change in application of the true object test from the underlying contract, to separate work orders, statements of work, or task orders does not relieve government contractors from the sales and use tax liability with respect to real estate construction contracts with government entities.

Emergency Regulation

TAX issued Tax Bulletin 06-4 on July 7, 2006 to announce this change in policy. Also, pursuant to the language in the Appropriations Act, TAX worked with the government contracting industry to promulgate an emergency regulation to implement this new policy. This emergency regulation became effective July 23, 2007. TAX is currently reviewing industry comments regarding the emergency regulation and intends to promulgate a permanent regulation to replace the emergency regulation before July 1, 2008.

Proposal

This bill would codify a provision in the current Appropriations Act that changes the application of the true object test as it applies to contracts between a government entity and a contractor. The provision requires that, when making a determination as to the taxability of certain items purchased under a government contract, the true object test be applied to each separate work order, statement of work, and task order, rather than the underlying contract. This provision does not apply to materials, equipment, or other tangible personal property purchased by a contractor for use in real estate construction contracts with a government entity.

cc : Secretary of Finance

Date: 1/19/2008 KP
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