DEPARTMENT OF TAXATION
2008 Fiscal Impact Statement

1. Patron Mark D. Obenshain

2. Bill Number SB 543

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

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

3. Committee Senate Finance

4. Title Retail Sales and Use Tax Exemption; Qualifications for Nonprofit Schools

5. Summary/Purpose:

This bill would exempt any nonprofit school accredited by an entity approved by the Department of Education and any school licensed by the Department of Education as a school for students with disabilities from having to meet the requirement of submitting an audit or a financial review to the Department of Taxation in order to obtain an exemption from the Retail Sales and Use Tax. A qualifying school would only be excused from this requirement if it submitted a federal 990 or 990 EZ tax form.

Under current law, nonprofit entities must meet certain audit requirements, among other requirements, in order to be eligible for exemption from the Retail Sales and Use Tax. A nonprofit entity with gross annual revenues in the previous year of $1 million or greater is required to provide a full financial audit performed by an independent certified public accountant, while nonprofits with gross annual revenues between $750,000 and $1 million in the previous year are given the choice of providing a full financial audit or a financial review, both of which must be performed by an independent certified public accountant.

The effective date of this bill is not specified.

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

7. Budget amendment necessary: No.

8. Fiscal implications:

<u>Administrative Costs Impact</u>

TAX has not assigned any administrative costs to this proposal because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, TAX considers implementation of this bill as “routine,” and does not require additional funding.

TAX will provide specific administrative costs on any legislation that is not “routine.” Additionally, TAX will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, TAX will identify the costs at that time.

Revenue Impact

This bill would result in a revenue loss of unknown magnitude. The change in the nonprofit audit requirements will likely allow more nonprofit schools to claim an exemption from the Retail Sales and Use Tax, as qualifying schools will be permitted to submit a Form 990 or 990 EZ in lieu of meeting the financial audit requirements.

9. Specific agency or political subdivisions affected:

TAX

10. Technical amendment necessary: No.

11. Other comments:

History of Exemption Process for Nonprofit Entities

Prior to July 1, 2004, the sales tax portion of Virginia's Tax Code separately listed and exempted over 180 nonprofit entities from Virginia's sales tax. Entities not exempt under the Code were required to seek redress through the Virginia General Assembly. Legislation enacted in the 2003 Virginia General Assembly, which became effective in July of 2004, altered the process by eliminating the need for exempt organizations to seek new sales tax exemptions through the legislature. Instead, the Assembly grandfathered those organization's exemptions for a specified term and required that, upon expiration, the organization would have to adhere to a three-part process to include applying to TAX, meeting applicable criteria, and being issued a certificate of exemption from TAX. For those organizations that were not previously granted an exemption, they too would have to follow the process set forth above in order to obtain an exemption. The result of this legislation was that organizations no longer needed to apply to the General Assembly to receive an exemption or to renew an exemption, so long as they met the applicable criteria and performed all the necessary procedures. If all requirements were met, TAX could grant the organization a sales tax exemption for an additional period to expire in no less than five and no more than seven years, at which time the process could be repeated.

Current Requirements

To qualify for the nonprofit exemption, an organization must currently meet the following requirements:

- The entity is exempt from federal income taxation under either § 501(c)(3) or § 501(c)(4) of the Internal Revenue Code;
- The entity is in compliance with all applicable state solicitation laws, and where applicable, provides appropriate verification of such compliance; and

- 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; and
- If the entity's gross annual revenue was $1 million or greater in the previous year, the entity must provide a financial audit performed by an independent certified public accountant. If the entity's gross annual revenue fell between $750,000 and $1 million, then the entity is given the choice of providing a full financial audit or a "financial review," both of which must be performed by an independent certified public accountant.
- If the entity filed a federal 990 or 990 EZ tax form, or the successor forms to such forms, with the IRS, then it must provide a copy of such form to the Department of Taxation, and if the entity filed neither a federal 990 or 990 EZ form with the IRS, then it must provide the Department of Taxation with information including a list of its Board of Directors and the location of its financial records.

Prior to 2006, nonprofit entities were required to provide TAX with a copy of a full financial audit if their gross annual revenues were equal to or exceeded $250,000. As a result of budget language included in the Budget Bill (House Bill 5002 (Chapter 3, Special Session 1 of 2006) and House Bill 5012 (Chapter 2, Special Session 1 of 2006)), a nonprofit organization with gross annual revenue ranging from $250,000 to $499,999 was authorized to submit a "review of its financial statements" in lieu of a full financial audit. This requirement has since been changed to allow organizations with gross annual revenues between $750,000 and $1 million to choose between providing a full financial audit or a financial review, both of which must be performed by an independent certified public accountant. Organizations with gross annual revenues of $1 million or greater are required to submit a full financial audit.

The American Institute of Certified Public Accountants (AICPA) in its Statements on Standards for Accounting and Review Services identifies "compilation, review, and audit as the three forms of financial examination and distinguishes between the audit and review of financial statements. According to the AICPA, a "review" process entails, "performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with generally accepted accounting principles." In contrast, an "audit" provides the accountant with a "reasonable basis for expressing an opinion regarding the financial statements taken as a whole." The *Standards for Auditing*" require that an accountant conducting an audit state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles (AICPA PROFESSIONAL STANDARDS, AR § 110.01). An audit will entail obtaining an understanding of internal control, assessing control risk, testing accounting records, and responding to inquiries by obtaining corroborating evidential matter through inspection, observation, or confirmation. Of these two forms of examination, the audit is clearly the most stringent procedure.

Federal Requirements for Filing Form 990, 990 EZ

Organizations exempt from income tax under Internal Revenue Code section 501, including organizations described in section 501(c) must generally file Form 990 or Form 990 EZ based on their gross receipts for the tax year. For purposes of this test, gross receipts is the organization's total revenues from all sources during its annual accounting period, without subtracting any costs or expenses. Organizations with gross receipts in excess of $25,000 must file Form 990 or Form 990 EZ. If the organization's gross receipts during the year are less than $100,000 and its total assets at the end of the year are less than $250,000, it may file Form 990 EZ instead of Form 990. Even if the organization meets this test, it can still file Form 990. Several nonprofit entities that meet these requirements are exempted from the mandate of filing the Form 990 or 990 EZ. Among these exceptions are schools below college level that are affiliated with a church or operated by a religious order.

Proposal

This bill would allow any nonprofit school accredited by an entity approved by the Department of Education and any school licensed by the Department of Education as a school for students with disabilities to submit a federal 990 or 990 EZ tax form in lieu of meeting the financial audit requirements necessary for a nonprofit organization to qualify for exemption from the Retail Sales and Use Tax.

Similar Legislation

House Bill 1284 is identical to this bill.

Senate Bill 459 would add organizations exempt from federal income taxation under I.R.C. §501(c)(19) to those nonprofit entities that may be eligible for a sales and use tax exemption on their purchases of tangible personal property.

Senate Bill 468 would exempt 4-H clubs from having to collect the Retail Sales and Use Tax on sales made by the club in fundraising.

cc : Secretary of Finance

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