DEPARTMENT OF TAXATION
2004 Fiscal Impact Statement

1. Patron Phillip A. Hamilton

2. Bill Number HB 5002

House of Origin:
X Introduced
_____ Substitute
_____ Engrossed

3. Committee House Finance

4. Title Retail Sales and Use Tax: Repeal of Commercial and Industrial Exemptions and Media Related Exemptions

Second House:
_____ In Committee
_____ Substitute
_____ Enrolled

5. Summary/Purpose:

This bill would repeal numerous retail sales and use tax exemptions. With the exception of the retail sales and use tax exemption applicable to industrial manufacturers and industrial processors, this bill would repeal all other commercial and industrial sales and use tax exemptions. In addition, this bill would repeal all of the media exemptions. Specifically, this bill would repeal the sales and use tax exemption for 1) real property construction contractor's temporary storage of materials, 2) public service corporations (electric utilities, gas utilities, water and sewer utilities, telecommunications companies and common carriers of property or passengers by motor vehicle or rail), 3) ships and vessels used in interstate and foreign commerce, 4) research and development, 5) airlines operating in intrastate, interstate, or foreign commerce, 6) meals furnished to employees as a part of wages, 7) commercial laundry and linen processors, 8) certified pollution control facilities, 9) taxicab parts, 10) high speed electrostatic duplicators, 11) natural gas and oil exploration, drilling and refining, 12) space flight and space launch activities in the Commonwealth, 13) motion picture film leasing, 14) broadcasting equipment, 15) publications, 16) catalogs and similar printed materials, 17) advertising, 18) audio/visual production and 19) free distribution of educational materials. This bill would also exclude 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.

The effective date of this bill is not specified.

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

Fiscal Year	***Dollars***	***Fund***
2003-04	$51,200	GF

6b. Revenue Impact:

Fiscal Year	*Dollars*	*Fund*
2003-04	$0	GF
2003-04	$0	TTF
2004-05	$89.24 million	GF
2004-05	$15.19 million	TTF
2005-06	$99.86 million	GF
2005-06	$16.99 million	TTF
2006-07	$102.66 million	GF
2006-07	$17.59 million	TTF
2007-08	$105.46 million	GF
2007-08	$18.09 million	TTF
2008-09	$109.36 million	GF
2008-09	$18.79 million	TTF
2009-10	$112.77 million	GF
2009-10	$19.29 million	TTF

* The fiscal impact of House Bill 5002 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:

<u>Line 1, Revenue Estimates</u>
<u>Items 284 and 286, Department of Taxation</u>

8. Fiscal implications:

<u>Administrative Costs</u>

TAX would incur administrative costs of $51,200 in Fiscal Year 2004, for printing and postage to notify the affected industries, if this bill were passed.

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.

Media related exemptions

The repeal of the media related exemptions would result in an unknown positive revenue impact on the General Fund. No estimate is provided because the only data currently available is data contained in the Department of Taxation's 1991 Virginia Sales and Use Tax Expenditure Study. This data is over twelve years old and is not reliable. Since that study was performed, three of the five exemptions in place in 1991 have been amended to expand their scope a total of six times. In addition, two new exemptions have been added to the group. Any attempt to update the 1991 estimate by simply applying an "inflation factor" ignores the substantive changes that have occurred in the various industries since 1991. In order to produce a reliable revenue estimate, TAX would have to repeat the process it used in 1991 to determine the revenue impact. This would require the use of surveys and soliciting input from the affected industries. There is not sufficient time to perform these functions.

Commercial and industrial exemptions

Generally, House Bill 5002 would repeal the same commercial and industrial exemptions as House Bill 1488. Since February 13, 2004, the date House Bill 1488 was introduced, TAX has attempted to determine the revenue impact of repealing the selected sales tax exemptions in this group. Even with the additional time, TAX has been unable to determine the revenue impact from the repeal of some of the exemptions.

Because TAX has no current database of exemptions from which it could make an estimate of the revenue effect, any estimate should be considered highly tentative.

Contractor's Temporary Storage

To be eligible to purchase construction materials and to store such materials within Virginia prior to shipping them outside the Commonwealth, a contractor must file a Form ST-11A (exemption certificate) with TAX. In order to qualify for this exemption, the state to which the materials are shipped must also exempt the materials from taxation.

During the last two years contractors 17 different contractors filed a total of 67 exemption certificates. A contractor must file a separate form for each project. With additional time, TAX would have surveyed additional contractors to determine their exempt purchases. It is unknown if all contractors required to apply for an exemption did so. As such, TAX was unable to determine a reliable estimate of the revenue gain. Estimates from previous years suggest that the revenue gain from repeal of this exemption is likely to be relatively small.

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.

Water and Sewer Utilities

The SCC collects Annual Financial and Operating reports from Virginia water companies. From these reports, data from the largest water utility and 26 of the 78 small companies was reviewed. The reports provided to TAX contained segregated expenditure categories, which were identified as those that would become taxable with the repeal of the exemption.

All the newly taxable categories were summed to estimate the increase in the taxable expenditures. The ratio of total companies to sampled companies was applied to this base to approximate an estimate for all affected firms. TAX's estimate assumes that the majority of water companies would be similar in size and activity, which makes the estimate tentative.

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.

Ships and Vessels

In addition to numerous marine suppliers of fuel and materials, there are seven major shipyards and four dredging companies located in Virginia. Nine of the eleven firms agreed to supply data on their activities that are currently exempt. A survey is underway, and some firms have already provided data. An estimate cannot be produced until responses are received from a significant portion of the industry.

Fuels and supplies may be purchased exempt of the tax when used aboard a ship plying the high seas. An estimate of these purchases will be derived from an economic impact study prepared for the Virginia Port Authority in 1997 with 1995 data.

Because these firms are in a transportation industry, they have the opportunity to shift their purchasing activities to another state where they are exempt, if Virginia were to repeal the sales and use tax exemption. This factor will be considered in developing a revenue estimate for this activity.

Research and Development

The National Science Foundation (NSF) published data through 2000 it gathered on industrial research and development expenditures by state. The 2000 expenditures for Virginia were adjusted using growth rates reported over time, adjusted for the extra-ordinary growth in the late 1990s. The NSF survey reported that tangible personal property approximated 14.1 percent of all expenditures.

Virginia's sales tax exemption, which specifies purchases must be used "directly and exclusively in basic research or research and development in the experimental or laboratory sense," is significantly more narrow than the expenditures reported in the NSF survey. On the other hand, the NSF data excludes capital expenditures from purchases reported by industry. As a result, the estimates of revenue that would be realized from repealing this exemption are highly tentative.

The Virginia Manufacturers Association conducted a survey of 18 companies that indicated repeal of this exemption would result in their paying $1.6 million in additional sales and use tax. Because additional companies use the exemption, the revenue gain would be expected to exceed this amount.

Airlines

There is no Virginia-specific data on expenditures by airlines providing service to the state. The estimate for scheduled airline service providers was therefore, based on national financial data published by the Air Transport Association (ATA). Operating expenses of all carriers were adjusted to exclude estimated expenditures on employee compensation and fuel that would remain exempt even with the repeal of the exemption, and to include an estimate of capital outlays now covered by the exemption. Virginia's share of national total expenditures was assumed to equal its share of all U. S. passengers boarding in the Commonwealth, 2.5 percent. The resulting revenue impacts were adjusted to account for the ability of the airline industry to shift purchases to other jurisdictions that retain their tax exemptions.

Airline industry officials have indicated that repeal of the exemption would impose a financial cost to them; however, they have not provided estimates to TAX. It is also possible that purchasing behavior would change and less aircraft repair and maintenance would occur in Virginia if the exemption were repealed. All surrounding states exempt airlines from paying sales tax on such purchases. (See attached table) This would offset some of the revenue gain from the repeal of the exemption.

The estimates include scheduled airlines that can be characterized as primarily freight haulers, as well as passenger carriers. The estimated revenue impacts produced in the 1990 and 1995 SUTES did not include freight carriers.

Meals Furnished to Employees

There is no Virginia-specific data on meals furnished to employees as part of wages. Therefore, the value of food furnished to employees was extrapolated from the Survey of Current Business for 2001. Estimates must be regarded as highly tentative.

It was assumed that the employees who would be furnished a meal by employers would be employees of eating and drinking places and active duty military. Active duty military would remain exempt even with the repeal of the exemption. To account for that, the number of eating and drinking place employees in the U.S. and the number of active duty military (from the Virginia Statistical Abstract 2000 Edition) were totaled and the proportion of the total that are eating and drinking place employees was derived. That percentage was applied to the value of the food furnished to employees. To determine a Virginia estimate, that percentage is multiplied by the percentage of eating and drinking place employees that are in Virginia (from the Virginia Statistical Abstract 2000 Edition).

There are numerous limitations to this methodology. First, assumptions were made about the type of businesses that would furnish meals to employees and the distribution of meals to different types of employees. Next, national data must be adjusted to reflect Virginia. Also, the methodology must account for shifts in behavior. If the sales tax exemption were repealed, employers might stop providing employees with meals as part of their wages. The estimates were adjusted to account for possible changes in employer behavior. No industry information was provided. Industry representatives indicated that many employers would simply stop providing meals as a part of wages if the exemption were repealed.

Laundry and Linen Processors

Based on firms filing with the Virginia Employment Commission, there are 52 firms in Virginia that rent or lease laundered textile products. TAX has not been able to obtain information from any Virginia industry association. In addition, no published data was identified that provided enough information to estimate the revenue impact. Obtaining the necessary data would require a survey of firms by TAX. With the relative large number of firms in the industry and the short amount of time available to conduct a survey, doing so was not judged feasible. Based on estimates made in the past from survey data, the revenue gain from repeal of the exemption is likely to be small.

Pollution Control Equipment

The estimates for certified pollution control equipment were derived from data on the 23 certificates issued in 2003 by TAX of Environmental Quality (air) and from U.S. Census data from 1999 (water and solid waste). The utility industry also supplied supplemental data. Historic data was inflated to the forecast years using the Producer Price Index (PPI).

Because certification by DEQ is necessary to qualify for the exemption, the air pollution component of the estimate is likely to be accurate. In contrast, the Census data that was used for the water and solid waste estimates, which comprise the majority of the estimate, is now five years old, which makes it less reliable as a basis for forecasting.

Taxicab Parts

The industry association provided purchase data for firms representing approximately one-third of the 4,951 licensed taxicabs in Virginia. The number of licensed taxicabs was provided by TAX of Motor Vehicles. Extrapolating data from the sampled firms produced the revenue impact for all taxicab firms. The impact is relatively small and generally consistent with industry-provided data.

High Speed Electrostatic Duplicators

Previous estimates of the revenue gain from repealing the tax exemption for electrostatic duplicators have relied on data provided by the printing industry. The industry is unable to provide any data at this time. Based on past estimates, the impact is likely to be relatively small.

Gas and Oil Production

Resources of both the Department of Mines, Minerals and Energy (DMME) and the Virginia Oil and Gas Association were utilized to generate the estimates. DMME staff were able to estimate typical expenditures for drilling gas wells (very few oil wells are drilled in Virginia). DMME staff reviewed a sample of expenditure reports in order to segregate those costs that would lose their exempt status; the estimates also differentiated between conventional wells, and coalbed methane wells, which are less expensive.

The Virginia Oil and Gas Association provided estimates of field compression and gathering costs. TAX estimates are very similar to the industry's. The estimates do not take into consideration any change in behavior associated with the repeal of the exemption. Industry representatives have indicated that if the drilling costs go up, less drilling activity would likely occur in Virginia.

Orbital or Suborbital Space Facility

Information for this estimate was obtained from the Virginia Commercial Space Flight Authority (VCFSA). Based on information on launch activity, the total of currently exempt purchases made from Fiscal Year 1997 through Fiscal Year 2004 was determined. The effective sales tax rate was applied to the total and a per year average was derived. It is possible that should this exemption be repealed, some companies might move their launches to other states such as Florida or California where there are sales tax exemptions.

9. Specific agency or political subdivisions affected:

Department of Taxation
Virginia Commercial Space Flight Authority
All localities in the Commonwealth
Virginia Film Office

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:

Generally

There are currently thirteen commercial and industrial retail sales and use tax exemptions. This category of exemptions includes exemptions for public utilities, airlines, taxicabs, and the shipping industry; exemptions for manufacturers, processors, miners and gas and oil production; exemptions for laundry and linen processors, contractor's temporary storage in the Commonwealth, research and development, electrostatic duplicators, pollution control equipment and facilities, meals furnished to restaurant employees, and orbital or suborbital space facilities. This bill would repeal all of the commercial and industrial exemptions, with the exception of the exemption for industrial manufacturers and processors. In addition, this bill would repeal the seven media related exemptions. This category includes exemptions for motion picture film leasing, broadcasting equipment, publications, catalogs and similar printed materials, advertising, audio/visual production and the free distribution of educational materials.

The following sales and use tax exemptions would be eliminated.

Exemptions to be Repealed

- Contractor's Temporary Storage (Enacted 1973, Amended 1978): Exempts purchases of construction materials, temporarily stored in Virginia, by a contractor that are to be used outside of Virginia in an exempt construction project. The exemption is limited to construction materials that are to be incorporated into exempt real property construction and could be purchased tax free by the contractor in the other state or foreign country. The tax applies to property that is not incorporated into realty, such as equipment, tools, supplies, etc., used in the performance of the construction project.

- Public Service Corporation (Enacted 1966, Amended 1978 and 1988): Exempts tangible personal property purchased or leased by a public service corporation, telecommunications company, or common carrier of property and passengers by motor vehicles or railway when used directly in the rendition of the utility's or common carrier's public service.

- Ships and Vessels (Enacted 1966, Amended 1996): Provides an exemption for: (i) vessels used exclusively or principally in interstate, intrastate, or foreign commerce and repairs and alterations to such vessels; (ii) fuel and supplies for use or consumption on vessels plying the high seas; and (iii) materials used in the building, conversion or repair of any of the vessels in (i) and (ii).

  The exemption is applicable also to dredges, their supporting equipment, attendant vessels, and fuel and supplies for use or consumption aboard such vessels.

- Research and Development (Enacted 1966, Amended 1980): Exempts tangible personal property purchased for use or consumption **directly and exclusively** in basic research or research and development in the experimental or laboratory sense. Research activities that qualify for this exemption include any activity that has as its goal the advancement of existing knowledge or technology; the development of new uses for existing products, technology or processes; or the improvement of existing products, technology or processes.

  The exemption applies to a wide range of experimental or laboratory research activities including; (i) medical research to find cures for diseases; (ii) the development of computer software; (iii) research to improve crops; and (iv) research in advanced technologies such as robotics, fiber-optics, composite materials, and biotechnology.

- Airlines (Enacted 1966, Amended 1972, 1980 and 1995): Provides an exemption for items sold to an airline operating in intrastate, interstate or foreign commerce as a common carrier that provides regularly scheduled flights to Virginia airports at least one day per week. The items sold must be used or consumed by the airline directly in the rendition of its common carrier service. The Virginia Supreme Court held in the 1978 United Airlines decision that meals, snacks and beverages furnished by an airline to passengers are not used or consumed directly in the rendition of an airline's common carrier service and are not exempt from the tax. However, the Court also determined that items such as anti-hijacking equipment, ticketing and reservation system equipment, and passenger and baggage service equipment are used directly in the rendition of an airline's common carrier service and qualify for the exemption.

- Meals Furnished to Employees (Enacted 1978): Provides an exemption for all meals and drinks given to employees, conditionally as part of wages paid to restaurant or food service employees, by restaurants or food service operators.

- Laundry and Linen Processors (Enacted 1980): Provides an exemption for tangible personal property used by an industrial processor engaged in commercial leasing of laundered textile products. The exemption applies only to tangible personal property used directly in preparing and maintaining textile products for taxable lease or rental.

- Pollution Control Equipment and Facilities (Enacted 1972, Amended 1984, 1995, and 2003): Exempts pollution control equipment and facilities as defined in § 58.1-3660. § 58.1-3660 defines pollution control equipment and facilities to include, but are not limited to, any real or personal property, equipment, facilities, or devices, used primarily for the purpose of abating or preventing pollution of the Commonwealth. Equipment or facilities are certified by (i) the State Water Control Board and the State Air Pollution Control Board for water and air pollution, respectively, (ii) the Department of Mines, Minerals and Energy for coal, oil and gas production; (iii) the Virginia Waste Management Board for waste disposal facilities; or (iv) any interstate agency authorized to act in place of a certifying authority of the Commonwealth.

- Taxicab Parts (Enacted 1984, Amended 1987): Provides an exemption for repair parts, tires, meters and dispatch radios sold or leased to taxicab operators for use on taxicabs. All other items purchased by a taxicab operator are subject to the tax.

- High Speed Electrostatic Duplicators (Enacted 1986): Provides an exemption for high speed electrostatic duplicators. To qualify for the exemption the machine must have a printing capacity of at least 4,000 impressions per hour and it is purchased or leased by person primarily engaged in the printing or photocopying of products for sale or resale.

- Gas and Oil Production (Enacted 1994): Exempts raw materials, fuel, power, energy, supplies and machinery used directly in the drilling, extraction, refining or processing of natural gas and oil and the reclamation of the well area, provided that such reclamation is required by state or federal law.

  Va. Code § 45.1-361.1 defines "gas" or "natural gas" to mean all natural gases, including hydrocarbons, hydrogen sulfide, helium, carbon dioxide, nitrogen, hydrogen, and casing head gas. That same statute defines "coalbed methane gas" to be occluded natural gas produced from coalbeds and rock strata associated with the coalbeds.

  For an item to be "used directly," it must be an integral part of the exempt activity. Items used in activities such as general maintenance or administration are not "used directly." Further, the exemption does not extend to tangible personal property used in pre-drilling exploration.

  This exemption applies only to the mining and processing of gas and oil, but does not affect the application of the tax to the mining and processing of coal, mineral, rock or similar ores.

  Gas and oil production are specifically excluded from the sales and use tax exemption for industrial manufacturing or processing activities.

- Orbital and Suborbital Space Facility (Enacted 1997): Provides an exemption for space flight activities in Virginia. The exemption is applicable to the sale, lease, use, storage, consumption, or distribution of:

  - An orbital or suborbital space facility, space propulsion system, space vehicle, satellite, or space station when used to conduct spaceport activities;

  - Tangible personal property, including space flight fuels, placed on or used aboard any orbital or suborbital space facility, propulsion system, space vehicle, satellite, or space station when used to conduct spaceport activities, and

- Machinery and equipment used exclusively for space flight activities and the sale or goods and services provided to operate and maintain launch facilities, payload processing facilities and payload processing equipment used to conduct spaceport activities.

The term “spaceport activities” refers to activities directed or sponsored at a facility that is owned, leased, or operated by or on behalf of the Virginia Commercial Space Flight Authority. The Authority is a political subdivision of the Commonwealth whose purposes are to disseminate knowledge pertaining to scientific and technological development among public and private entities in the area of commercial space flight, and to promote economical development.

- <u>Motion Picture Film Leasing (Enacted 1976, Amended 1989)</u> - Exempts leasing, renting or licensing of copyright audio or video tapes, and films for public exhibition at motion picture theatres or by licensed radio and television stations.

- <u>Broadcasting Equipment (Enacted 1966, Amended 1980, 1995, 1997, 1999)</u> - Exempts broadcasting equipment and parts and accessories thereto and towers used by commercial radio and TV stations, wired or land based wireless cable TV systems, common carriers or video programming using open video systems, and amplification, transmission and distribution equipment used by cable and video systems. In addition, the exemption includes computer hardware and software, servers, hosting equipment, and distribution equipment purchased by an Internet service provider.

- <u>Publications (Enacted 1966, Amended 1983, 1995)</u> - Exempts any newspaper, magazine or other publication issued daily, weekly, bi-weekly, monthly, or regularly at average intervals not exceeding three months. Advertising supplements and other printed materials distributed with or as part of nontaxable publications are also exempt. Also, back copies of exempt publications are exempt. Newsstand sales of such publications are taxable.

- <u>Catalogs and Similar Printed Materials (Enacted 1976, Amended 1977, 1979, 1985, 1989, 1994, 1995)</u> - Exempts catalogs, letters, brochures, reports, and similar printed materials that are stored in Virginia for 12 months or less and distributed outside of Virginia.

- <u>Advertising (Enacted 1985)</u> - Exempts charges by advertising businesses for advertising placed in the media.

- <u>Audio/Visual Production (Enacted 1995)</u> - Exempts the lease, rental, license, sale, other transfer, or use of any audio or video tape, film or other audiovisual work. The exemption also applies to the provision of production services or fabrication related to the production of any portion of a qualifying audiovisual work. Includes scriptwriting, photography, sound, musical composition, special effect, animation, adaptation, dubbing, mixing, editing, cutting and provision of production facilities or equipment.

- Free Distribution of Educational Materials (Enacted 1998) - Exempts textbooks and other educational materials withdrawn from inventory by book-publishing distribution facilities and distributed free of charge to professors and other individuals who have an educational focus.

Industrial Manufacturing and Processing Exemption

If this bill is enacted, the only remaining commercial and industrial exemption would be the exemption for industrial manufacturing, processing and mining. An exemption is provided for industrial materials, machinery and tools and their repair parts, fuel, power, energy and supplies used directly in manufacturing, processing or mining products for sale or resale. In order to qualify for this exemption, a business must be manufacturing products for sale or resale, and the production process must be industrial in nature.

In order for an item to be exempt, it must be "used directly" in the manufacturing. To be considered "used directly," it must be an integral part of the production of a product. Items used in such activities as general maintenance or administration are not "used directly" in manufacturing.

An item used directly in both taxable and exempt activities is fully taxable if 50% or more of the item's use is in taxable activities. Conversely, an item is fully exempt if the preponderance of its use is in exempt manufacturing activities.

The provisions of this exemption apply to the mining and processing of coal, rock, minerals, gravel and other similar resources but not to the mining and processing of natural gas and oil.

This bill would exclude 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.

Overlap of Exemptions

The repeal of an exemption does not necessarily result in the total loss of exemption. In some cases there are overlapping exemptions. For example, the repeal of the Public Service exemption for some electric utilities would not result in the loss of the total value of the exemption.

TAX has 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 is to eliminate any "overlap" of the public service exemption and the manufacturing exemption, a technical amendment is necessary.

It is possible that other businesses that would lose the exemption being repealed by this bill would still be fully or partially exempt under another sales and use tax exemption.

National Trends

The attached chart (Attachment 3) provides information with respect to the status of available exemptions for the industries affected by the repeal of the commercial and industrial exemptions in the states that border Virginia or have similar types of industries. Time constraints prohibit determining this same information for industries that would lose their exemption due to the repeal of the media related exemptions.

cc : Secretary of Finance

Date: 3/18/2004 mch

ATTACHMENT 1

HB 5002 Revenue Impacts - State Revenue Only
(Millions)

Exemption	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Contractor's Temporary Storage						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
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
Water and Sewer Utilities						
General Fund - Unrestricted	0.20	0.20	0.20	0.20	0.20	0.20
General Fund - Restricted	0.10	0.10	0.10	0.10	0.10	0.10
Transportation Trust Fund	0.05	0.05	0.05	0.05	0.05	0.05
State Total	0.35	0.35	0.35	0.35	0.35	0.35
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
Ships and Vessels						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total			Survey of affected firms in process			

ATTACHMENT 1

HB 5002 Revenue Impacts - State Revenue Only
(Millions)

Exemption	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Research and Development						
General Fund - Unrestricted	5.70	6.80	7.40	8.10	8.90	9.70
General Fund - Restricted	2.80	3.40	3.70	4.10	4.50	4.90
Transportation Trust Fund	1.50	1.70	1.90	2.10	2.30	2.50
State Total	10.00	11.90	13.00	14.30	15.70	17.10
Airlines						
General Fund - Unrestricted	18.30	21.00	22.00	23.10	24.20	25.40
General Fund - Restricted	9.20	10.50	11.00	11.10	12.10	12.70
Transportation Trust Fund	4.70	5.40	5.60	5.90	6.20	6.50
State Total	32.20	36.90	38.60	40.10	42.50	44.60
Meals Furnished to Employees						
General Fund - Unrestricted	2.00	2.20	2.20	2.30	2.30	2.30
General Fund - Restricted	1.00	1.10	1.10	1.10	1.20	1.20
Transportation Trust Fund	0.50	0.60	0.60	0.60	0.60	0.60
State Total	3.50	3.90	3.90	4.00	4.10	4.10
Linen Processors						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Pollution Control						
General Fund - Unrestricted	1.30	1.40	1.40	1.40	1.40	1.40
General Fund - Restricted	0.70	0.70	0.70	0.70	0.70	0.70
Transportation Trust Fund	0.30	0.40	0.40	0.40	0.40	0.40
State Total	2.30	2.50	2.50	2.50	2.50	2.50
Taxicab Parts						
General Fund - Unrestricted	0.12	0.13	0.13	0.13	0.13	0.14
General Fund - Restricted	0.06	0.07	0.07	0.07	0.07	0.07
Transportation Trust Fund	0.03	0.03	0.03	0.03	0.03	0.03
State Total	0.21	0.23	0.23	0.23	0.23	0.24
High Speed Electrostatic Duplicators						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Gas and Oil Production						
General Fund - Unrestricted	0.80	0.90	0.90	0.90	0.90	0.90
General Fund - Restricted	0.40	0.40	0.40	0.40	0.40	0.50
Transportation Trust Fund	0.20	0.20	0.20	0.20	0.20	0.20
State Total	1.40	1.50	1.50	1.50	1.50	1.60
Orbital or Suborbital Space Facility						
General Fund - Unrestricted	0.04	0.04	0.04	0.04	0.04	0.04
General Fund - Restricted	0.02	0.02	0.02	0.02	0.02	0.02
Transportation Trust Fund	0.01	0.01	0.01	0.01	0.01	0.01
State Total	0.07	0.07	0.07	0.07	0.07	0.07

ATTACHMENT 1

HB 5002 Revenue Impacts - State Revenue Only

(Millions)

Exemption	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Motion Picture Film Leasing						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Broadcasting Equipment						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Publications						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Catalogs and Similar Printed Materials						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Advertising						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Audio/Visual Production						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
Free Distribution of Educational Materials						
General Fund - Unrestricted						
General Fund - Restricted						
Transportation Trust Fund						
State Total		Unknown	See text of fiscal impact statement.			
All Provisions						
General Fund - Unrestricted	59.46	66.57	68.47	70.57	72.87	75.08
General Fund - Restricted	29.78	33.29	34.19	34.89	36.49	37.69
Transportation Trust Fund	15.19	16.99	17.59	18.09	18.79	19.29
State Total	104.43	116.85	120.25	123.55	128.15	132.06

ATTACHMENT 2

HB 5002 Revenue Impacts - Local Option
(Millions)

Exemption	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Contractor's Temporary Storage						
Local Option		Unknown	See text of fiscal impact statement.			
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
Water and Sewer Utilities						
Local Option	0.10	0.10	0.10	0.10	0.10	0.10
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
Ships and Vessels						
Local Option		Survey of affected firms in process				
Research and Development						
Local Option	2.90	3.50	3.80	4.20	4.60	5.00
Airlines						
Local Option	9.40	10.80	11.30	11.90	12.40	13.10
Meals Furnished to Employees						
Local Option	1.00	1.10	1.10	1.20	1.20	1.20
Linen Processors						
Local Option		Unknown	See text of fiscal impact statement.			
Pollution Control						
Local Option	0.70	0.70	0.70	0.70	0.70	0.70
Taxicab Parts						
Local Option	0.06	0.07	0.07	0.07	0.07	0.07
High Speed Electrostatic Duplicators						
Local Option		Unknown	See text of fiscal impact statement.			
Gas and Oil Production						
Local Option	0.40	0.50	0.50	0.50	0.50	0.50
Orbital or Suborbital Space Facility						
Local Option	0.02	0.02	0.02	0.02	0.02	0.02
Motion Picture Film Leasing						
Local Option		Unknown	See text of fiscal impact statement.			
Boadcasting Equipment						
Local Option		Unknown	See text of fiscal impact statement.			
Publications						

ATTACHMENT 2

Exemption	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Local Option		Unknown	See text of fiscal impact statement.			
Catalogs and Similar Printed Materials						
Local Option		Unknown	See text of fiscal impact statement.			
Advertising						
Local Option		Unknown	See text of fiscal impact statement.			
Audio/Visual Production						
Local Option		Unknown	See text of fiscal impact statement.			
Free Distribution of Educational Materials						
Local Option		Unknown	See text of fiscal impact statement.			
All Provisions						
Local Option	30.48	34.09	35.09	36.39	37.39	38.69

ATTACHMENT 3

Multi-State Sales and Use Tax Exemption Comparison

Exemption	District of Columbia	Kentucky	Maryland	North Carolina	Tennessee	West Virginia
Gas, electric & water companies	Exempt	Exempt (fuel only) Narrower	Taxable	Taxable (reduced rate)*	Exempt	Exempt (refund)
Telecommunications companies	Exempt	Taxable	Taxable	Taxable (reduced rate)*	Taxable	Exempt (refund)
Research & Development	Taxable	Taxable	Exempt	Taxable (reduced rate)*	Taxable	Exempt (refund)
Common carriers (motor vehicle)	Taxable	Exempt Narrower	Exempt Broader	Exempt (refund) Broader	Taxable	Exempt
Railways	Exempt	Exempt	Exempt	Exempt (refund)	Exempt	Exempt
Airlines	Taxable	Exempt	Exempt	Exempt (refund)	Exempt	Exempt
Pollution Control	Taxable	Exempt	Exempt	Taxable (reduced rate)*	Exempt	Exempt
Gas & Oil Exploration, Etc.	Taxable	Exempt Narrower	Taxable	Taxable	Taxable	Exempt Broader
Contractor's Temporary Storage	Exempt	Taxable	Exempt (refund)	Exempt	Taxable	Taxable
Employee Meals	Exempt Narrower	Exempt	Exempt	Exempt Broader	Taxable	Exempt
High Speed Electrostatic Duplicators	Taxable	Taxable	Exempt	Taxable	Exempt	Exempt
Linen Processors	Taxable	Taxable	Exempt	Taxable (reduced rate)*	Taxable	Taxable
Taxicab Parts	Taxable	Taxable	Taxable	Taxable	Taxable	Exempt

* Taxed at 1% or $80, whichever is less.

Exemption	Virginia	California	Florida
Spaceport Activities			
Space vehicles and satellites	Exempt	Exempt	Exempt
Property aboard space vehicle	Exempt	Exempt	Exempt
Fuels used for space flight	Exempt	Exempt	Taxable
Machinery and equipment used in spaceport activities	Exempt	Taxable	Exempt

ATTACHMENT 3

Multi-State Sales and Use Tax Exemption Comparison

Exemption	District of Columbia	Kentucky	Maryland	North Carolina	Tennessee	South Carolina	Georgia	Florida	Louisiana	Mississippi
Ships and Vessels										
Vessels	Taxable	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Partially Taxable	Exempt	Exempt
Repairs	Taxable	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Partially Taxable	Exempt	Exempt Broader
Ship Building	Taxable	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Partially Taxable	Exempt	Exempt Narrower
Fuel/ Supplies	Partially Taxable	Exempt	Exempt	Exempt Narrower	Taxable	Exempt	Exempt	Partially Taxable	Partially Taxable	Exempt

Exemption	New Jersey	New York	Rhode Island	Massachusetts	Connecticut	Maine	California	Texas
Ships and Vessels								
Vessels	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt
Repairs	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Exempt
Ship Building	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Partially Taxable	Exempt
Fuel/ Supplies	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Partially Taxable	Exempt

Note: "Narrower" indicates the exemption is not as broad as compared to the Virginia exemption.
"Broader" indicates the Virginia exemption is narrower when compared to the other state's exemption.