# DEPARTMENT OF TAXATION
# 2004 Fiscal Impact Statement

**REVISED**

1. **Patron** Frederick M. Quayle

2. **Bill Number** SB 5003
   **House of Origin:**
   _____ **Introduced**
   _____ **Substitute**
   _____ **Engrossed**

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

3. **Committee** House Finance

4. **Title** Retail Sales and Use Tax: Repeals the Exemption for Public Service Corporations and Reduces the Tax on Food for Home Consumption

5. **Summary/Purpose:**

   This bill would repeal the public service corporation retail sales and use tax exemption for: 1) electric utilities, 2) natural gas utilities, 3) water and sewer utilities, 4) telecommunications companies and 5) motor vehicle common carriers. This bill would also exclude electric utilities from claiming the manufacturing exemption for their generation activities, except for raw materials that are inputs to the production of electricity (fuels). This bill would allow public utilities with capped rates to add a surcharge to their customer's bills to recover the value of the sales tax paid as the result of the exemptions repealed by this bill.

   This bill would also reduce the retail sales and use tax on food for home consumption by one-half percent effective July 1, 2004. The bill contains an enactment clause that would provide for the appropriation of an additional 1% reduction in the sales tax on food. This bill also provides that the additional revenue from this bill would be used to fund 20 percent of salary increases for state police, sheriffs and deputy sheriffs, and to restore previous reductions in the Commonwealth's share of per diem payments for the maintenance of prisoners in local and regional jails.

   The effective date of this bill is not specified.

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

   **6a. Expenditure Impact:**

| ***Fiscal Year*** | ***Dollars*** | ***Fund*** |
|---|---|---|
| 2003-04 | $96,520 | GF |
| 2004-05 | $507,240 | GF |

**6b. Revenue Impact:**

| *Fiscal Year* | *Dollars* | *Fund* |
|---|---|---|
| 2004-05 | $6.84 million * | GF |
| 2004-05 | $9.04 million | TTF |
| 2005-06 | $6.97 million | GF |
| 2005-06 | $10.84 million | TTF |
| 2006-07 | $6.16 million | GF |
| 2006-07 | $10.99 million | TTF |
| 2007-08 | $5.15 million | GF |
| 2007-08 | $11.03 million | TTF |
| 2008-09 | $4.31 million | GF |
| 2008-09 | $11.27 million | TTF |
| 2009-10 | $3.33 million | GF |
| 2009-10 | $11.32 million | TTF |

* Assumes effective date of August 1, 2004.

**Note:** The fiscal impact of Senate Bill 5003 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
   Items 284 and 286, Department of Taxation

8. **Fiscal implications:**

**Administrative Costs**

**Administrative Impact**

If the sales tax changes proposed by this bill are effective August 1, 2004, as explained below, TAX would incur administrative costs of $96,520 in Fiscal Year 2004 for systems development, forms, printing and postage costs. TAX would incur administrative costs of $507,240 in Fiscal Year 2005 for systems development, printing and postage to notify the affected industries and to work with the food industry to enact the rate reduction on food for home consumption, if this bill were passed effective August 1, 2004.

If the sales tax changes proposed by this bill are effective on July 1, 2004, this bill would result in administrative costs of $374,880 in Fiscal Year 2004 for systems development, forms, printing and postage costs. TAX would incur administrative costs of $228,880 in Fiscal Year 2005 for printing and postage to notify the affected industries and to work with the food industry to enact the rate reduction on food for home consumption, if this bill were passed effective July 1, 2004.

## Revenue Impact

**Revenue Impact**

This impact statement has been revised to reflect the change in the effective date of the provisions of this bill that would be effective in due course. Article IV, § 13 of the Constitution of Virginia states that all laws enacted during a special session other than the Appropriations Act and emergency legislation will take effect on the first day of the fourth month following the month of adjournment of the special session. As the month of March has expired and the special session has not adjourned, **all laws enacted during a special session effective in due course will become effective on August 1, 2004, assuming the special session adjourns before the end of April.** This impact statement has been revised to reflect an August 1, 2004, effective date for the provisions of this bill.

With an effective date of August 1, 2004, the state revenue impact, as set forth on Line 6b, would be $15.88 million for Fiscal Year 2005, $17.81 million in Fiscal Year 2006, $17.15 in Fiscal Year 2007, $16.18 million in Fiscal Year 2008, $15.58 million in Fiscal Year 2009, and $14.65 million in Fiscal Year 2010. If the effective date of this bill is July 1, 2004, the state revenue impact increases to $17.54 million for Fiscal Year 2005.

### Generally

The revenue estimates reflect a positive revenue gain as a result of the repeal of the public service corporation exemptions (and the limitation of the manufacturing exemption for electric utilities to fuel), which is offset by the one-half percent revenue loss as a result of the reduction in the sales tax on food for home consumption. Due to data limitations and time constraints, TAX's revenue estimate for the repeal of the public service exemptions should be regarded as tentative.

### Repeal of Public Utility Exemption

*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, the revenue estimates for the repeal of the public service exemption must be regarded as highly tentative.

Anytime 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.

*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 an exemption for raw materials, i.e. fuels, which are used in the production of electricity. (See discussion on Line 11.) This estimate was based on information from the industry and the FERC data.

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.

For purposes of estimating the effect of allowing electric utilities to retain the exemption for fuels, TAX used FERC data and industry-supplied information to estimate the amount of the exemption that would be repealed.

*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.

**Reduction in Tax on Food for Home Consumption**

This bill, as currently drafted, would reduce the state sales and use tax on food for home consumption from 3% to 2½% **with an effective date of July 1, 2004**. If the effective date of this bill is changed to August 1, 2004, as recommended on Line 10, state revenue is estimated to decrease by $46.05 million in FY 2005, $56.62 million in FY 2006, $58.10 million in FY 2007, $59.56 million in FY 2008, $61.05 million in FY 2009, and $62.58 million in FY 2010. If the effective date remains July 1, 2004, the state revenue is estimated to decrease by $50.58 million in Fiscal Year 2005. These estimates are based on projected sales tax on food for Fiscal Year 2003 and grown by the CPI and population data from November 2003 Standard Forecast.

**9. Specific agency or political subdivisions affected:**

Department of Taxation
Department of Treasury
Department of Accounts
All localities in the Commonwealth

**10. Technical amendment necessary:** Yes.

As currently drafted, this bill provides that the reduction in the sales tax rate on the sale of food for home consumption would be effective July 1, 2004. Based on Article IV, § 13 of the Constitution of Virginia, laws enacted during special sessions will take effect on the first day of the fourth month following the month of adjournment of the special session. Assuming the 2004 Special Session adjourns before the last day of April 2004, the effective date for this reduction in the sales tax rate on food would be effective no earlier than August 1, 2004. Therefore, either the effective date of the food tax rate reduction should be amended to reflect an August 1, 2004 effective date, or an emergency enactment clause should be included that allows the rate reduction to become effective July 1, 2004. Unless the effective date is changed, vendors would be forced to honor refund requests from customers who purchase food between July 1, 2004 and August 1, 2004.

**11. Other comments:**

<u>Repeal of Public Service Corporation Exemption</u>

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 the exemptions for public service corporations, which include electric utilities, natural gas utilities, water and sewer utilities, telecommunications companies, and common carriers by motor vehicles. This bill would also eliminate the manufacturing exemption currently available to electric utilities for the production of electricity. Raw materials used directly in the electrical production process (fuel), however, would remain exempt.

This bill would not repeal the exemption for common carriers of property or passengers by railway.

History of Food Tax Reduction Program

The 1999 General Assembly enacted the Food Tax Reduction Program (Chapters 366 and 466) to reduce the retail sales and use tax on food by 2% over a four-year period. The original plan would have reduced the sales tax on food for home consumption ½% each year over the four-year period. The initial reduction was enacted on January 1, 2000, to reduce the state portion of the tax on food ½%, from 3½% to 3%. Further reductions were not implemented due to shortfalls in revenue growth. Full implementation of this program would have been effective on April 1, 2003 and would have imposed the state sales and use tax on food for home consumption at 1½%, for a total state and local tax on food of 2½%.

Generally

This bill would reduce the state sales and use tax on food for home consumption from 3% to 2½% on and after July 1, 2004. The state revenue generated as a result of the tax being imposed at a 2½% rate will be distributed ½% to the Transportation Trust Fund, 1% to localities based on school-age population and 1% for General Fund purposes.

This bill also provides for the appropriations listed below. Twenty percent of the funding required for the following items is available from this bill, with the balance from general funds appropriated by the 2004 Special Session.

- $5.6 million per year for a special salary action to increase the base salaries of state police officers by 6.42 percent on July 1, 2004.

- $4.5 million per year to address salary compression issues among sworn state police officers.

- $18.6 million per year to increase the base salaries of sheriffs and deputy sheriffs by 6.42 percent on July 1, 2004.

- $13.2 million per year to restore previous reductions in the Commonwealth's share of per diem payments for the maintenance of prisoners in local and regional jails.

cc : Secretary of Finance

Date: 4/5/2004 WBS

ATTACHMENT 1

## SB 5003 Revenue Impacts - State Revenue Only

(Millions)
Effective 8/1/04

| Exemption | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|---|---|---|
| **Electric Utilities-Only Fuel Exempt** | | | | | | |
| General Fund - Unrestricted | 15.20 | 18.26 | 18.44 | 18.61 | 18.77 | 18.94 |
| General Fund - Restricted | 7.60 | 9.13 | 9.22 | 9.30 | 9.39 | 9.47 |
| Transportation Trust Fund | 3.90 | 4.69 | 4.74 | 4.78 | 4.82 | 4.87 |
| State Total | 26.70 | 32.08 | 32.40 | 32.69 | 32.98 | 33.28 |
| **Natural Gas Utilities** | | | | | | |
| General Fund - Unrestricted | 4.27 | 5.10 | 5.20 | 5.20 | 5.30 | 5.30 |
| General Fund - Restricted | 2.09 | 2.60 | 2.60 | 2.60 | 2.60 | 2.70 |
| Transportation Trust Fund | 1.09 | 1.30 | 1.30 | 1.30 | 1.40 | 1.40 |
| State Total | 7.45 | 9.00 | 9.10 | 9.10 | 9.30 | 9.40 |
| **Water and Sewer Utilities** | | | | | | |
| General Fund - Unrestricted | 0.18 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 |
| General Fund - Restricted | 0.09 | 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 | 0.32 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 |
| **Telecommunications Companies** | | | | | | |
| General Fund - Unrestricted | 15.64 | 18.80 | 19.00 | 19.10 | 19.30 | 19.50 |
| General Fund - Restricted | 7.82 | 9.40 | 9.50 | 9.60 | 9.70 | 9.70 |
| Transportation Trust Fund | 4.00 | 4.80 | 4.90 | 4.90 | 5.00 | 5.00 |
| State Total | 27.45 | 33.00 | 33.40 | 33.60 | 34.00 | 34.20 |
| **Motor Vehicle Common Carriers** | | | | | | |
| General Fund - Unrestricted | | | | | | |
| General Fund - Restricted | | Unknown | See text of fiscal impact statement. | | | |
| Transportation Trust Fund | | | | | | |
| State Total | | | | | | |
| **All Exemptions** | | | | | | |
| General Fund - Unrestricted | 35.29 | 42.36 | 42.84 | 43.11 | 43.57 | 43.94 |
| General Fund - Restricted | 17.60 | 21.23 | 21.42 | 21.60 | 21.79 | 21.97 |
| Transportation Trust Fund | 9.04 | 10.84 | 10.99 | 11.03 | 11.27 | 11.32 |
| State Total | 61.93 | 74.43 | 75.25 | 75.74 | 76.63 | 77.23 |
| **Reduce Sales Tax on Food 1/2%** | | | | | | |
| General Fund - Unrestricted | -46.05 | -56.62 | -58.10 | -59.56 | -61.05 | -62.58 |
| **All Provisions** | | | | | | |
| General Fund - Unrestricted | -10.76 | -14.26 | -15.26 | -16.45 | -17.48 | -18.64 |
| General Fund - Restricted | 17.60 | 21.23 | 21.42 | 21.60 | 21.79 | 21.97 |
| Transportation Trust Fund | 9.04 | 10.84 | 10.99 | 11.03 | 11.27 | 11.32 |
| State Total | 15.88 | 17.81 | 17.15 | 16.18 | 15.58 | 14.65 |

ATTACHMENT 2

## SB 5003 Revenue Impacts - Local Option

(Millions)
Effective 8/1/04

| Exemption | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|---|---|---|
| **Electric Utilities-Only Fuel Exempt** | | | | | | |
| Local Option | 7.81 | 9.38 | 9.47 | 9.56 | 9.64 | 9.73 |
| **Natural Gas Utilities** | | | | | | |
| Local Option | 2.18 | 2.60 | 2.70 | 2.70 | 2.70 | 2.70 |
| **Water and Sewer Utilities** | | | | | | |
| Local Option | 0.09 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| **Telecommunications Companies** | | | | | | |
| Local Option | 8.00 | 9.60 | 9.70 | 9.80 | 9.90 | 10.00 |
| **Motor Vehicle Common Carriers** | | | | | | |
| Local Option | Unknown | See text of fiscal impact statement. | | | | |
| **All Provisions** | | | | | | |
| Local Option | 18.08 | 21.68 | 21.97 | 22.16 | 22.34 | 22.53 |