DEPARTMENT OF TAXATION
2007 Fiscal Impact Statement

1. Patron Clarke N. Hogan

2. Bill Number HB 2545

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

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

3. Committee House Finance

4. Title Retail Sales and Use Tax Exemption; Modifies Audit Requirements for Nonprofits

5. Summary/Purpose:

This bill would modify the criteria for nonprofit organizations to receive an exemption from the Retail Sales and Use Tax by permitting nonprofit organizations that have gross annual revenue of $250,000 or more to provide TAX with a "financial review" performed by an independent certified public accountant, rather than a "financial audit."

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:

Administrative Costs Impact

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 loss of revenue of unknown magnitude. The procedural changes proposed in this bill would allow more nonprofit organizations to qualify for exemption from the Retail Sales and Use Tax due to the relaxed audit requirement. The expense of obtaining a full financial audit has deterred some nonprofit organizations from applying for a Retail Sales and Use Tax exemption in the past.

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 Code of Virginia separately listed and provided a sales tax exemption for over 180 categories of non-profit entities. Entities not exempt by statutory classification were required to seek exemption through the Virginia General Assembly. Legislation enacted in the 2003 Virginia General Assembly, which became effective in July 1, 2004, altered the process by eliminating the need for exempt organizations to renew their sales tax exemptions through the legislature. The legislature extended those organizations' exemptions for a specified term and required that, upon expiration, the organizations 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. Organizations that were not previously granted an exemption were also required 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, provided that they met the applicable criteria and performed all the necessary procedures. If all requirements were met, TAX could grant each 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 organization would have to reapply for exemption status.

Current Requirements

The new exemption process requires that nonprofit organizations meet the following criteria to be eligible for exemption:

- The entity must be either an organization exempt under Internal Revenue Code ("IRC") §§ 501(c)(3) or 501(c)(4), or have annual gross receipts of less than $5,000 and be organized for a charitable purpose.
- The entity must have annual administrative costs that are 40% or less of annual gross receipts.
- The entity must be in compliance with state solicitation laws, if applicable.
- The entity must provide TAX with an estimate of its total taxable purchases
- The entity must provide TAX with a copy of its Form 990 or a list of its board of directors.

* The entity must provide TAX with a copy of a full financial audit, if its gross annual revenues are $500,000 or more. A nonprofit organization with gross annual sales ranging from $250,000 to $499,000 is subject to "financial review" rather than a full financial audit, and must present documentation of that review to TAX. An entity with less than $250,0000 of gross annual revenue is not required to provide any type of financial audit or review.

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, rather than $500,000. 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 may submit a "review of its financial statements" in lieu of 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.

<u>Proposal</u>

Under the provisions of this bill, nonprofit entities with gross annual revenues of $500,000 or more could qualify for exemption from the Retail Sales and Use Tax by providing TAX with a copy of a "financial review," rather than a full "financial audit," and satisfying the remaining requirements for eligibility. The 2006 Budget language discussed above already permits a "financial review" for nonprofit organizations with gross annual sales ranging from $250,000 to $499,000.

<u>Similar Legislation</u>

House Bill 1948 and **Senate Bill 743** would provide a Retail Sales and Use Tax exemption for volunteer fire departments, rescue squads and related organizations without meeting the statutory requirements imposed on other nonprofit organizations.

House Bill 2088 would permit nonprofit schools to circumvent two of the five criteria applicable to other nonprofit organizations in order to qualify for exemption from the Retail Sales and Use Tax.

cc : Secretary of Finance

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