

DEPARTMENT OF TAXATION

2011 Fiscal Impact Statement

1. **Patron** Mark L. Keam

2. **Bill Number** HB 2444

3. **Committee** House Finance

House of Origin:

 X **Introduced**

 Substitute

 Engrossed

4. **Title** Retail Sales and Use Tax; Commissioner of
the Revenue May Examine Certain Records

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would authorize local commissioners of the revenue to examine the documents of transportation companies to determine which dealers are shipping taxable tangible personal property, and would require the local commissioner to report to TAX on the results of such examination, including reporting to the Tax Commissioner any local use tax that has been incorrectly distributed. The bill would also authorize the local commissioner to examine taxpayer records beyond the three year limitations period if the commissioner has reasonable evidence of fraud or reasonable cause to believe that the person failed to file a return. Under current law, only the Tax Commissioner has the authority to examine a company's books and records for purposes of administering the Retail Sales and Use Tax.

This bill would result in businesses being audited by both TAX and localities, but only TAX would be authorized to issue assessments for additional tax, penalties and interest.

The effective date of this bill is not specified.

6. **Budget amendment necessary:** No.

7. **No Fiscal Impact.** (See Line 8.)

8. **Fiscal implications:**

Administrative Costs

Depending upon the number of local Commissioners of the Revenue that exercise the authority that would be granted to them under this bill and the level of audit activity, there may be a significant impact on TAX. TAX would be required to use the information supplied as the result of the audit by the local commissioner to, at a minimum, verify and correct distributions of local sales and use taxes between localities. TAX currently has a process in place that allows for the reallocation of local sales and use taxes between localities.

However, the information that would be provided to TAX by local commissioners is not limited to information necessary to correct distributions of local sales and use taxes between localities. To the extent that local commissioners have the expectation that TAX use the information provided by them from their audits to institute consumer use tax audits of individuals and businesses that purchase items from out-of-state retailers, there would be a significant impact on TAX. It is extremely unlikely that the information gathered during the course of the audit by the local commissioner of the transportation company, will be sufficient for TAX to accurately determine whether there is a consumer use tax liability or the amount of any such liability. In order to determine whether there is a consumer use tax liability, TAX would be required to contact the purchaser and request information with respect to (i) what was purchased, (ii) what is the use of the item purchased, (iii) the purchase price, (iv) whether tax was collected by the retailer, or (v) whether the purchaser has voluntarily remitted consumer use tax on the purchase. This process will result in many citizens being contacted by TAX and required to provide significant documentation to TAX. Depending on the level of audit of activity by local commissioners, this process either would require TAX to seek a budget amendment to increase its funding to undertake these examinations or to divert resources from other audit activities to this process.

Revenue Impact

Allocation of local use tax

Certain provisions of this bill may lead to local commissioners of the revenue discovering that use taxes have been distributed to the wrong locality, and to the extent that such errors are corrected, would result in a shift of revenue between localities. It is not clear whether the audits conducted by local commissioners of the revenue authorized by this bill would provide sufficient information for TAX to re-allocate local use tax revenues between localities. In order to do so, TAX would need, in addition to the name and address of the buyer and seller in each transaction, evidence of the nature of each item shipped in order to verify that the item was tangible personal property taxable in Virginia. In addition, TAX would need evidence of the selling price of each item and evidence that the seller had not correctly reported each sale on his retail sales and use tax return and had not correctly allocated the sale to the correct locality. As shippers typically would not have that information, TAX typically would be unable to make a change in the allocation of local use tax based solely upon the information gathered by the local commissioner during the audit they perform of the transportation company.

Additional revenue

This bill is expected to have minimal impact on revenue generated from the Retail Sales and Use Tax.

9. Specific agency or political subdivisions affected:

TAX
All localities

10. Technical amendment necessary: No.

11. Other comments:

Generally

Virginia's state and local Retail Sales and Use Tax encompasses three separate and mutually exclusive taxes: 1) a sales tax; 2) a use tax; and 3) a consumer use tax.

For the privilege of making retail sales in Virginia, a seller is subject to a sales tax imposed on its gross receipts from retail sales of tangible personal property. The seller collects the tax from the customer by separately stating the amount of the tax and adding it to the sales price or charge. Retail sales are defined as sales to a consumer or to any person for any purpose other than for resale. The tax also applies to the furnishing of transient accommodations and the lease or rental of tangible personal property as part of an established business.

Generally, any person or business engaged in the sale at retail or distribution of tangible personal property in Virginia constitutes a dealer. The definition of "dealer" set forth in *Va. Code* § 58.1-612 also includes those who rent, lease or furnish items that are subject to the tax in Virginia, or who store such items for use or consumption in Virginia. Any individual or organization meeting the definition of "dealer" who has sufficient activity within the Commonwealth to require registration under *Va. Code* § 58.1-613 must register to collect and remit the tax. Dealers collect the tax from their customers by separately stating the amount of the tax, adding it to the sales price or charge, and subsequently remitting it to TAX. A Virginia dealer is required to file Form ST-9, Virginia Retail Sales and Use Tax Return or Form ST-9 CO, Virginia Retail Sales and Use Tax Return – Consolidated. In addition to these forms, consolidated filers must also file Form ST-9B, Schedule of Local Taxes.

Since the 1960s, all states that impose a sales tax have also imposed a complementary use tax. The primary purpose of this tax is to prevent the sales tax from placing in-state merchants at a competitive disadvantage with retailers outside of the state. In Virginia, the use tax is imposed upon the storage, use, or consumption of tangible personal property within Virginia, and applies to items purchased by Virginia individuals and businesses from retailers who are not located in Virginia. As an example, a Virginia-based Information Technology Service Provider may purchase computer equipment from an out-of-state manufacturer for use in a Virginia contract. In this scenario, use tax is owed on the computer equipment.

The legal liability for the use tax rests with the purchaser. Retailers are only required to register and collect Virginia's Retail Sales and Use Tax if they have some type of physical presence within Virginia. Having a physical location or being legally required to collect the tax is generally considered "nexus." Without nexus, federal case law generally prohibits states from mandating that out-of-state dealers collect sales and use tax. Even so, many out-of-state vendors voluntarily collect the tax and forward it to TAX as a courtesy to their customers. Out-of-state dealers who voluntarily collect the tax must register for Out-of-State Dealer's Use Tax and must file Form ST-8, Virginia Out-of-State Dealer's Use Tax Return, along with Form ST-6B Schedule of Local Taxes.

Finally, the Consumer's Use Tax is imposed upon individuals and businesses that make purchases in excess of \$100 during the taxable year from out-of-state mail order, telephone, or television shopping services, provided the seller did not collect the Virginia Retail Sales and Use Tax. Consumers may also be liable for the consumer's use tax if they purchase an item tax-free outside Virginia and bring the item back to be used within the Commonwealth. However, Virginia grants a credit to any person who purchases tangible personal property in another state and who has paid a sales or use tax on the property in the state of purchase. The credit does not apply if the tax is erroneously charged or incorrectly paid in the other state.

Businesses that do not make any retail sales but incur a use tax liability for their taxable use of property in Virginia must register for Business Consumer Use Tax and file Form ST-7, Virginia Business Consumer's Use Tax Return. On this form, the business reports the cost price of tangible personal property arising from all taxable transactions on which the Virginia Retail Sales and Use Tax was not collected by the seller.

Individuals who owe the Consumer's Use Tax because they were not charged the sales tax on a purchase of tangible personal property are liable for Individual Consumer Use Tax. These individuals must file either a Form CU-7, Virginia Consumer's Use Tax Return for Individual, at the end of the taxable year or report the tax on their Virginia income tax return.

Allocating the Local Sales and Use Tax

The state Retail Sales and Use Tax is imposed at a rate of 4%. In addition to the state tax, all Virginia cities and counties impose a 1% local Retail Sales and Use Tax. The law requires that revenue from the local tax be distributed to the locality in which the sale was made, while revenue obtained from out-of-state dealers collecting the local use tax is distributed to the locality to which the tangible personal property is destined. In order to ensure that the proper localities receive the benefit of the tax, in-state retailers must maintain accurate and current records of their retail locations. *Code of Virginia* § 58.1-606(E) also mandates that out-of-state dealers with certificates of registration collecting use tax must, to the extent reasonably practicable, break down their shipments into Virginia by cities and counties so as to show the locality to which the goods are destined. Unassigned use tax revenues are allocated in proportion to the amount of assigned revenues that each locality receives. While TAX administers the distribution of the tax revenue to the various localities, it depends largely upon the accuracy of the retailer's returns to make the proper allocation.

On average, TAX processes 78,916 retail sales tax returns and 13,364 out-of-state dealer returns per month. The vast majority of returns are processed accurately with the local sales tax portion correctly reported and distributed; however, sometimes, errors can and do occur, which may result in the distribution being unassigned or distributed to the incorrect locality.

Efforts to ensure correct local allocation

Pursuant to legislative mandate, TAX issued a report in September, 2009 (HD 191, 2009) detailing the efforts TAX has taken and continues to take to address this issue. This

report presented three actions that TAX took in 2009 and 2010 to ensure the proper allocation of local use tax between localities.

1. Implement GPS Software

TAX has obtained enhanced software that utilizes GPS technology to more accurately determine the assignment of locality codes to business locations during registration. Effective July 1, 2009, TAX implemented a new version of Trillium, an address perfection and standardization software package. This software provides geo-coded Federal Information Processing Standards ("FIPS") code information that significantly improves upon the ZIP code based software previously used by TAX to validate and assign locality codes to businesses' tax accounts. FIPS codes are numeric codes defined by the United States federal government to uniquely identify states and counties within the United States, certain U.S. possessions, and certain freely associated states. The FIPS code assigned to a business' tax account is for the distribution of local sales revenue to a locality for businesses that operate within a single locality. TAX met with numerous vendors and submitted sample addresses for FIPS code assignment and each vendor's test was hand validated by TAX's staff to determine accuracy. This enhancement significantly improved the assignment of FIPS codes for business tax accounts located in areas whose ZIP codes cross locality boundaries. With the implementation of the Trillium Geo-Code Address software, TAX's FIPS code assignment accuracy increased significantly. Performance testing using the new Trillium software resulted in a statistically significant improvement in accuracy in areas in which assigning FIPS codes has been problematic. This tool is being used by both TAX's web-based registration application and by TAX's internal registration system, thereby ensuring that all registrations are validated.

2. Modify Remittance Forms

TAX has also updated the schedule used by consolidated filers, Form ST-9B, Schedule of Local Taxes, to add a column filers must complete providing the number of locations the filer has in a particular locality. A consolidated sales tax filer is a taxpayer with multiple business locations in multiple localities. Many of the largest retailers in Virginia are consolidated filers. Consolidated filers report taxable sales by locality, aggregating the sales for all business locations within each locality. If a consolidated filer incorrectly reports taxable sales for a business location to the wrong locality, then the local distribution will be incorrect. Effective with their July 2009 return, consolidated filers were required to provide the count of business locations in each locality on the Form ST-9B, Schedule of Local Taxes. The information provided by the consolidated taxpayer on each return filed is compared to the business location information maintained in TAX's registration database systems. Whenever the count for a locality reported by the business does not match TAX's system, the account is flagged for review and the discrepancy investigated and resolved.

3. Systems Access by Localities

TAX worked with localities on a list of issues and enhancements to include access to additional information. As a result of this work, localities have almost total access to TAX's systems to view account level data regarding vendors in their locality and other localities.

Localities have tools at their disposal to curtail the erroneous allocation of local sales and use taxes. Localities maintain lists of taxpayers for purposes of the local business license tax, the personal property and the merchants capital tax that contain information as to businesses within the locality. Also, TAX provides localities with a variety of reports that can be used to monitor local Retail Sales and Use Tax allocations on a monthly basis. For example, each locality receives the Locality Distribution Report, which contains information concerning the local distribution, as well as the amount of funds distributed to the 300 unassigned account. TAX also distributes monthly a New Sales Dealers for the Month Report with information regarding newly registered businesses and changes to previously registered businesses. Localities also have access to sales tax accounts maintained in IRMS for businesses. Localities can use these tools to play a larger role in identifying allocation errors. Some localities have been diligently utilizing the reports provided by TAX to identify errors, while others are not able to devote resources to this effort.

Audit authority

Currently, the Tax Commissioner is authorized to examine the books, records, and other documents of all transportation companies, agencies, firms, or persons that conduct their business by truck, rail, water, airplane, or otherwise to determine what dealers are importing or otherwise shipping taxable tangible personal property.

Under current law, the Tax Commissioner must assess Retail Sales and Use Tax within three years of the date on which the tax becomes due, unless there is a false or fraudulent return with intent to evade payment, or a failure to file a return, in which case, the Tax Commissioner has six years from the due date to make an assessment. The law prohibits the Tax Commissioner from examining any person's records beyond the three-year period of limitations unless he has reasonable evidence of fraud or reasonable cause to believe that the person was required by law to file a return and failed to do so.

Proposal

This bill would authorize local commissioners of the revenue to examine the documents of transportation companies to determine which dealers are shipping taxable tangible personal property, and would require the local commissioner to report to TAX on the results of such examination as soon as practicable, including reporting to the Tax Commissioner any local use tax that has been incorrectly distributed.

The bill would also authorize the local commissioner to examine taxpayer records beyond the three year limitations period if the commissioner has reasonable evidence of fraud or reasonable cause to believe that the person failed to file a return. The local commissioner

would be required to report the results of the examination to the Commissioner, as soon as practicable.

It is extremely unlikely that the information gathered during the course of the audit by the local commissioner of the transportation company, will be sufficient for TAX to accurately determine whether there is a consumer use tax liability or the amount of any such liability. In order to determine whether there is a consumer use tax liability, TAX would be required to contact the purchaser and request information with respect to (i) what was purchased, (ii) what is the use of the item purchased, (iii) the purchase price, (iv) whether tax was collected by the retailer, or (v) whether the purchaser has voluntarily remitted consumer use tax on the purchase. This process will result in many citizens being contacted by TAX and required to provide significant documentation to TAX.

This bill would result in businesses being audited by both TAX and localities, but only TAX would be authorized to issue assessments for additional tax, penalties and interest.

The effective date of this bill is not specified.

Similar Bills

House Bill 1676 and **House Bill 2183** would provide dealers seeking to register with TAX for the Retail Sales and Use Tax and out-of-state contractors subject to the special local use tax in Virginia the option of registering with the local commissioner of the revenue, rather than registering with the Tax Commissioner.

Senate Bill 1226 would: 1) authorize local commissioners of the revenue and treasurers to enter into agreements with the Commissioner of DMV to act as an agent and maintain a branch office; 2) change the formula for funding nonautomated DMV agencies; 3) give dealers seeking to register for sales and use tax and out-of-state contractors subject to the special use tax in Virginia the option of registering with the local commissioner of the revenue, rather than the Tax Commissioner; 4) give local commissioners the authority to examine the documents of transportation companies to determine which dealers are shipping taxable tangible personal property; and 5) require local commissioners to verify that taxpayers seeking a local business license have satisfied all the licensing requirements.

cc : Secretary of Finance

Date: 1/30/2011 KP
DLAS File Name: HB2444F161.doc