MEMORANDUM

TO: The Honorable John H. Chichester
The Honorable Harry J. Parrish
The Honorable Vincent F. Callahan, Jr.

FROM: Kenneth W. Thorson
Tax Commissioner

DATE: December 1, 2004

SUBJECT: 2004 Fiscal Report on Nonprofit Exemptions

In 2003, the General Assembly enacted Chapters 757 and 758, 2003 Acts of Assembly (HB 2525 and SB 743) to simplify the process of qualifying nonprofit organizations for sales and use tax exemptions. As part of this legislation, the Department of Taxation is required to file an annual report by December 1 of each year disclosing the annual fiscal impact of the sales and use tax exemptions for nonprofit entities. This is the first such report and reflects information obtained since the changes in the law went into effect on July 1, 2004.

Background

In recent years there has been a marked increase in the number of entities seeking sales and use tax exemptions. When the sales and use tax first took effect in 1966 there were 22 exemptions. By 2003 this number had increased to 1,702. In general, sales and use tax exemptions were granted through legislative action by the General Assembly. An organization seeking an exemption could acquire one in two ways. If the organization met the statutory language of an existing exemption by classification, it could apply directly to the Department of Taxation for an exemption by providing evidence that it met the statutory classification. If the organization did not meet the criteria of an existing classification, the organization had to acquire one by designation through the enactment of a new exemption or the amendment of an existing exemption.

With the exception of certain sales and use tax exemptions that applied to broad classes of businesses, most exemptions were enacted with a sunset date. Virginia law required that nonprofit organizations periodically update information about the organization with the Department of Taxation on a five-year filing schedule based on the exemption category. This information was identical to the information required when an organization requested a new exemption. The Department reviewed the information and certified that the organization met the requirements. The information was then given to the Division of Legislative Services for drafting legislation to extend the individual exemptions.

Changes to the Exemption Process Under 2003 House Bill 2525 and Senate Bill 743

House Bill 2525 and Senate Bill 743 were based on recommendations made by the House Special Study Committee Studying Sales and Use Tax Exemptions. In order to simplify the exemption process and enable more charitable organizations to take advantage of the exemptions, these bills created an administrative process to qualify nonprofit organizations for general sales and use tax exemptions. To be granted an exemption by the Department of Taxation, an entity must meet all the applicable criteria:

- The entity must be either a 501(c)(3) or 501(c)(4) organization, 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 the Department with an estimate of its total taxable purchases.
- The entity must provide the Department with a copy of its Form 990 or a list of its board of directors.
- The entity must provide the Department with a copy of a financial audit, if its gross annual revenues are over $250,000.

The process still requires renewal on a five-year cycle, but eliminates the need for legislative action. Entities holding valid exemption certificates under the old system will continue to enjoy their exempt status, but are required to file under the new process when their exemption sunsets.

Technical Amendments Under 2004 House Bill 515 and Senate Bill 585

In 2004, certain technical amendments were made to the law. House Bill 515 and Senate Bill 585 clarified that churches have two options. They may continue using their self-issued exemption certificate, or they can apply for a general exemption certificate under the new process. An additional provision was added to ensure that nonprofit organizations that provide rescue or firefighting services, but do not have 501(c)(3) or 501(c)(4) status could obtain an exemption via the new process from July 1, 2004 through June 30, 2006. Furthermore, this bill grandfathered the exemption from collecting sales tax on sales made at a fundraiser that was enjoyed by certain organizations, and clarified that the Department of Taxation is authorized to refuse to grant exemption certificates to applicants that refuse to disclose their total taxable purchases for the preceding year.

The Revenue Impact of the New Process

In 2003, to estimate the revenue impact of changing the exemption process, the Department used information from the National Center for Charitable Statistics to determine the impact of an expanded exemption for all 501(c)(3) organizations located in Virginia that were required to file an IRS Form 990. Adjustments were made to reflect the smaller number of 501(c)(4) organizations that would qualify for an exemption. Additional adjustments were made to account for those smaller organizations that were not required to file a Form 990 because their gross receipts were less than $25,000. Using information from the Department of Taxation's nonprofit database, the value of the current exemptions was subtracted to determine the expected net revenue impact of expanding the nonprofit exemption.

2005 Estimates of Tax Loss	Dollar Amount
Pre-existing exemptions	$94.9 million[1]
Exemptions granted under new process	$9.3 million
Total Loss	$104.2 million[2]

Current Year Fiscal Impact

The current year fiscal impact is based on the total number of taxable purchases estimated to be made in this fiscal year by organizations acquiring an exemption under

[1] These figures were adjusted to take into account the new 5 percent tax rate.
[2] This estimate does not include churches, which are not required to file a Form 990 with the IRS and are not required to go through the new process.

the new process. Using dollar estimates of 2005 taxable purchases provided by the organizations applying for exemptions under the new process, **the estimated 2005 sales tax revenue loss totals $56.2 million**.

It is important to note that the current year fiscal impact is based on taxable purchases estimated by all organizations obtaining an exemption under the new process, and therefore includes nonprofits renewing their existing exemption certificates. The impact also reflects newly eligible nonprofits obtaining exemption certificates for the first time, as well as new legal entities applying in previously exempt categories.

The $56.2 million current year fiscal impact includes $32.8 million attributable to nonprofit organizations renewing their existing exemptions. The estimated 2005 revenue loss from newly granted exemptions totals $23.4 million.

Several cautions are in order in interpreting this estimate. Many of the more than 850 organizations that obtained exemptions under the new process were in exemption categories that existed prior to the implementation of the new process. While they are new to the process, these organizations would have been eligible to make tax-exempt purchases under the old system. For example, a significant amount of the estimated revenue loss is attributed to purchases made by hospitals. While hospitals were previously exempt, if an organization created a new hospital as a separate legal entity or changed its purchasing process so that a new legal entity made centralized purchases for an existing organization, this revenue loss would be included in the $23.4 million from newly granted exemptions.

In addition, dozens of churches are included in the current estimate. They were excluded from the 2003 estimate. Although churches enjoyed a limited self–issued exemption prior to the implementation of the new process, many decided to apply this year to receive a broader exemption. The revenue impact is based solely on data supplied by the organizations with respect to estimated purchases for 2005. To the extent any organization may have overstated or understated its estimated purchases, the fiscal impact would be overstated or understated. Also, 133 organizations granted exemptions under the new process provided no purchase data. Because this report was prepared mid-year, more nonprofits may apply before the end of the year, resulting in a larger revenue loss than now estimated.

Conclusion

In conclusion, based on the information provided to the Department by more than 850 organizations that took advantage of the new administrative process effective July 1, 2004 to apply for an exemption, **the current year fiscal impact is $56.2 million**. The next report to the General Assembly will provide a more complete fiscal revenue impact estimate, as it will reflect a full year's worth of data. Each year when the Department provides this report, it will update the total fiscal impact to date. Over the next six years, as all nonprofits are required to apply for exemption under the new process, the Department will have a more complete estimate of the total impact of exempting nonprofit organizations.

cc: The Honorable John M. Bennett, Secretary of Finance