COMMONWEALTH of VIRGINIA

Department of Taxation

September 26, 2005

The Honorable John H. Chichester
Chairman, Senate Finance Committee
Post Office Box 904
Fredericksburg, Virginia 22404

The Honorable Harry J. Parrish
Chairman, House Finance Committee
8898 Bond Court
Manassas, Virginia 20110

The Honorable Vincent F. Callahan, Jr.
Chairman, House Appropriations Committee
Post Office Box 1173
McLean, Virginia 22101

Re: Federal Contractor Sales and Use Tax Pilot Audit Program Compensation Procedures

Dear Chairmen:

The 2005 Appropriation Act authorized the Governor to spend up to $500,000 from the unappropriated balances in the Act to compensate businesses for participation in the Department of Taxation's federal contractor sales and use tax pilot audit program. Pursuant to Item 286 H.1. of the 2005 Appropriation Act, the Department was charged with developing procedures for the payment of compensation to businesses participating in this pilot audit program and report such procedures to the Chairmen of the Senate Finance, House Finance, and House Appropriations Committees. This letter presents those compensation procedures. The Act also noted that, prior to disbursement of such funds, the Governor shall notify the Chairmen of the Senate Finance, House Finance, and House Appropriations Committees.

The enclosed document outlines the background, legislative activity, pilot program objectives and approach and the procedures to distribute the $500,000.

Please let me know if you have any questions about the report.

Sincerely,

Kenneth W. Thorson
Tax Commissioner

Enclosure

Procedures for Compensation for Pilot Audit Program

INTRODUCTION

In the spring of 2003, TAX met with industry representatives and agreed to develop a pilot audit program to evaluate the effect of extending the resale sales and use tax exemption to federal government contractors who purchase tangible personal property for resale to the federal government under service contracts. The purpose of the pilot program was threefold: (1) to get a better understanding of the administrative burden that TAX auditors and federal contractors would encounter when auditing federal contracts based on the true object of individual task orders, rather than the true object of the entire contract; (2) to determine how a change in policy would affect sales and use tax revenues; and (3) to determine how a change might affect the number of contested audits.

The following summarizes the background leading to the pilot, the pilot audit approach, and the recommended appropriations language for the Government Contractor Pilot study to distribute the compensation to the pilot participants.

BACKGROUND

General Sales and Use Tax Policy: As set out in TAX's regulation 23 VAC 10-210-693, TAX administers the application of the tax to government contractors based on the true object of the contract. Simply stated, the "true object" test examines the wording of the original contract to determine whether the contract is, on the whole and at its inception, predominantly for goods or predominantly for services. The sales and use tax treatment of the goods purchased under contract varies according to that determination.

If the true object of the contract is for the provision of property to the government, the contractor may purchase the property exempt of the tax for resale. The subsequent sale of that property to the government is also exempt. Conversely, if the true object of the contract is for the provision of services, the contractor, as a service provider, is deemed to be the taxable user or consumer of all property used in performing its services, even if that property is ultimately provided to the government.

Administrative Solutions: Although looking at the true object of the entire contract is the normal procedure, TAX previously issued determinations that describe conditions in which the application of the test is dependent on the true object of individual task orders or delivery orders (and not of the entire contract). In Public Document ("PD") 01-6 (01/04/01), the issue was an indefinite duration, indefinite quantity ("IDIQ") contract that did not obligate the government to purchase any goods or services until a delivery order is executed. In PD 02-39 (4/01/02), the issue was a Basic Ordering Agreement in which neither party is bound until a delivery order is executed. In both situations, the underlying contract provides little or no evidence of the government's true object, and each task order or delivery order is accompanied by its own Statement of Work.

In these cases, the Tax Commissioner determined that the test would be applied to the true object of each task order or delivery order separately.

Legislative History: The 2000 General Assembly ("GA") enacted SJR 150 and HJR 158 that mandated a study on the application of the retail sales and use tax to federal government contractors doing business in Virginia. A working group consisting of representatives of Virginia's federal contracting industry and TAX personnel presented its findings in November 2000 to the Commission to Study Virginia's State and Local Tax Structure for the 21st Century.

The 2001 GA considered a number of bills (primarily HB 2064 and SB 1106) that would have applied the true object test based on the contracts' federal labor provisions or each task order issued under the contract. These bills would apply to federal contractors, but would exclude state and local government contracts. The negative fiscal impact of these bills was estimated to be in excess of $10 million per year. None of the 2001 bills were enacted.

The 2002 GA considered SB 169. This bill was similar to the 2001 legislation in that it would apply only to federal contracts. Also, the application of the tax would be dependent in large part on the contracts' federal labor provisions. The negative fiscal impact of this bill was estimated to be in excess of $6.2 million per year. This bill was continued to the 2003 Session and was left in Senate Finance.

The 2003 GA considered HB 2306 that would exempt tangible personal property that is purchased by a contractor when title to the property passes to the federal government, the Commonwealth, or political subdivisions of the Commonwealth. The negative fiscal impact of this bill was estimated to be in excess of $46 million per year, and the bill was left in House Finance.

The 2004 GA considered a number of bills (HB 720, HB1375, and SB 91) that would exempt tangible personal property that is purchased by a contractor under a service contract when title to the property passes to the federal government, the Commonwealth, or political subdivisions of the Commonwealth. The negative fiscal impact of these bills was estimated to be in excess of $48.4 million each year and the bills were left in the House and Senate Finance Committees.

The 2005 GA considered HB 2092 that would exempt tangible personal property that is purchased by a contractor under a service contract when title to the property passes to the federal government, the Commonwealth, or political subdivisions of the Commonwealth. The negative fiscal impact of this bill was estimated to be in excess of $72.6 million per year. The bill passed the House, but failed in the Senate Finance Committee.

The impact studies have been very difficult to complete. In all cases, TAX used the best information available to perform the impact studies. Most of the data used has come directly from the Federal Government. The revenue loss is expected to be higher than the above estimates because the long-term growth trend in federal expenditures in Virginia is expected to continue. For each of the last five years, Virginia has ranked second only to California in total federal procurement dollars. One of the major issues with the 2000 study and the subsequent legislative activity concerned the fiscal impact of the proposed changes. Industry claimed that TAX was overstating the fiscal impact of adopting a “task order” approach to federal government contracts.

Throughout 2001, TAX attempted to collect information from federal contractors to develop a more precise revenue impact. TAX estimated there were approximately 3,500 federal contractors doing business in Virginia in FY 1999. TAX had hoped to capture a representative sample of (1) sales tax paid by federal contractors to vendors, and (2) consumer use tax voluntarily remitted by federal contractors. Although TAX’s compliance staff devoted close to 400 hours to this project, it was not successful. Most contractors elected not to participate because of cost and staff time concerns as well as concerns about the potential for mishandling of confidential financial data.

During a meeting in November 2002, Senator William Wampler directed TAX and industry representatives to develop an administrative solution to the issues raised by the government contractor industry. The effort to reach an administrative solution led to the possibility of using a pilot audit program. This directive resulted in a meeting held in the spring of 2003 to iron out details for a pilot.

PILOT PROGRAM

Objective: The objective of the pilot is to identify the potential effects of a policy change on:

- Revenue – Based on the pilot results, can we confirm prior estimates by TAX or Industry Groups as to how much revenue would be lost from the expanded exemption?
- Audit Time – How much audit time would be consumed if audits of federal government contractors become more complex requiring additional audit hours? Can we quantify the opportunity cost of the change, *i.e.*, how much revenue would the audit staff generate in the additional time spent on these audits?
- Appeals – Will the number of appealed audits increase and, if so, by how many?

It was originally thought that the pilot would consist of 10 to 15 contractors based on time and resource constraints. TAX approached 53 companies seeking participation in the pilot. Of the 53, 32 refused participation, leaving 21 in the pilot. To date, 14 have been completed with 5 having no usable results to contribute to the pilot. The reasons these participant’s results will not be included in the pilot report are that they have no tax liability, they have only pure service contracts with no mixed transactions, or they have only pure resale contracts. There are 7 audits still in progress. Several are large contractors and the audit staff is working diligently to complete them in time to be included in the pilot.

Audit Methodology: The pilot approach is based on the "True Object Test" applied at the task order level, rather than at the overall contract level. Applying the "True Object Test" at the task order level allows the resale exemption to apply to purchases under task orders that normally would have been taxable if the task order was under an overall service contract.

The audit methodology, as set out in the original proposal, is for the auditors to capture the amount of sales tax paid to vendors, consumer use tax paid directly to the Commonwealth, and consumer use tax discovered during the audit. These amounts will be compiled separately under the following three policy approaches:

- **The current "true object of the overall contract" policy**
- **The proposed alternative "true object of the task order" approach**
- **The proposed alternative allowing the resale exemption for purchases made under a service contract that are totally unrelated to the contract statement of work**

It should be noted that the results of the audit, as determined using current policy, would be assessed (tax, penalty, and interest) to the taxpayer just as would be the case in a routine, scheduled audit.

Pilot Participant's Compensation Procedures

In 2004, the following Appropriation Language was included in the 2005 Appropriations Act. The compensation recommended to be paid to the participating contractors is based on this language.

> *H.1. The Department of Taxation shall continue the pilot audit program of entities that contract to do business with the federal government in order to develop an estimate of the potential revenue impact and administrative costs associated with policy alternatives relating to the retail sales and use tax treatment of federal government contracts. Business entities shall agree prior to January 15, 2005, to participate in the audit program based on terms and conditions established by the Department shall be eligible for compensation.*
> *The Department shall develop procedures for the payment of compensation to businesses participating in the pilot audit program and shall report such procedures to the Chairmen of the Senate Finance, House Finance, and House Appropriations Committees. The compensation granted to each participating business entity shall be calculated at the conclusion of the pilot program. The development of*

such procedures shall be exempt from the provisions of the Administrative Process Act (Section 2.2-4000 et seq. of the Code of Virginia).

2. *The Governor is authorized to spend up to $500,000 from the unappropriated balances in the Act to compensate participating businesses for participation in the pilot audit program. Prior to disbursement of such funds, the Governor shall notify the Chairmen of the Senate Finance, House Finance, and House Appropriations Committees.*

The formula for compensating contractors participating in the pilot program is based predominately on two principles. Compensation should be awarded based upon:

- Those most affected by TAX's policy (true object test)

- Those most inconvenienced by the pilot, i.e. entities having the most exempt transactions using the alternative policy were required to do the most work above and beyond normal audit activity

In order to ensure that all participating contractors are fairly compensated:

- A maximum payment of $40,000 and minimum of $15,000 will be the upper and lower limits of compensation for eligible, participating contractors.
- In no event can more compensation be paid than the $500,000 allowed in the Appropriation Act. Should the calculated compensation exceed $500,000, the compensation will be prorated among the eligible participants according to the amounts resulting from the calculation.
- Participants not affected by the two principles will not receive any compensation.

Formula For Payments to Participating Federal Contractors: The contractor's savings using the task order approach will be divided by the total savings of all contractors in the pilot, and multiplied by the total amount appropriated in the Act [$500,000 from the unappropriated balances] for such compensation.

$$\frac{\text{Value of business entity's savings}}{\text{Total value of savings for all participants}} = \text{Participant's Percentage}$$

Participants would receive their percentage of the $500,000 subject to the limits above.

Final Report and Fiscal Impact Study

The pilot program being performed and fiscal impact study reporting the results of the pilot will be completed by TAX late this fall and will be ready to be presented to the committees by January 1, 2006. The results will report the revenue and administration cost as a result of the pilot.