

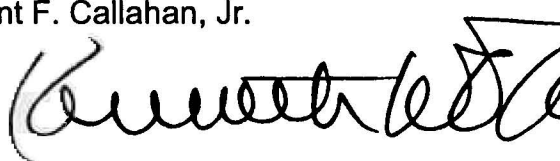


COMMONWEALTH of VIRGINIA

Department of Taxation

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, 2005

SUBJECT: 2005 Fiscal Report on Nonprofit Exemptions, a \$62.5 Million
Sales Tax Revenue Loss

Executive Summary

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 ("TAX") 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. On December 1, 2004, TAX filed its first such annual fiscal report on nonprofit exemptions. This first report reflected less than a full year of activity and covered the period between July 1, 2004 and October 31, 2004 only.

This year's fiscal report to the General Assembly provides a more complete fiscal revenue impact estimate, as it reflects a full year's worth of data, beginning on July 1, 2004 and ending on June 30, 2005. **The estimated 2005 fiscal year sales tax revenue loss from nonprofit exemptions totals \$62.5 million.**

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



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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 TAX 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 TAX 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. TAX 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.

Enactment of New Exemption Process

House Bill 2525 and Senate Bill 743 were based on recommendations made by the 2003 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 TAX, an entity must meet all the applicable criteria:

- 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 financial audit, if its gross annual revenues are equal to or exceed \$250,000.

The process still requires renewal on a five to seven-year cycle, but eliminates the need for legislative action. Entities holding valid exemption certificates under the old

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system will continue to enjoy their exempt status, but are required to file under the new process when their exemption sunsets.

Technical Amendments to New Exemption Process

In 2004, certain technical amendments were made to the law. Chapters 515 and 536, 2004 Acts of Assembly (HB 515 and SB 585), clarified that churches have two options. They may continue using their self-issued exemption certificate, which will entitle them to the sales and use tax exemption available under the law as it existed on June 30, 2003, 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 IRC §§ 501(c)(3) or 501(c)(4) status could obtain an exemption via the new process from July 1, 2004 through June 30, 2006. Because the original exemption enacted in 1972 did not require organizations to have a federal designation of IRC §§ 501(c)(3) or 501(c)(4), this two-year window allowed these organizations time to contact the IRS to apply for IRC §§ 501(c)(3) or 501(c)(4) designation in order to qualify under the new process. 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 TAX is authorized to refuse to grant exemption certificates to applicants that fail to disclose their total taxable purchases for the preceding year. While TAX has been granted this authority, to date no applications for exemption have been denied for this reason.

The 2005 General Assembly also passed a technical amendment clarifying the law as it applies to taxable services for certain organizations. Under Chapters 42 and 89, 2005 Acts of Assembly (HB 2100 and SB 1105), organizations holding a valid exemption as of June 30, 2003 would continue to purchase taxable services exempt of the tax, provided they complied with certain procedures and met certain requirements. This legislation affected the exemption status of only twelve organizations, some of which actually renewed under the new process, and two of which will not qualify under the new process, as they have a federal designation of IRC § 501(c)(19), and will lose their grandfathered exemption June 30, 2006.

Online Exemption Process

Beginning July 1, 2004, nonprofit organizations were permitted to apply online for a sales and use tax exemption, via Nonprofit Online, a quick, efficient and secure way created and developed by TAX for organizations to apply for and print out a Virginia sales and use tax exemption certificate (<http://www.tax.virginia.gov/nonprofit>). Nonprofit Online also permits organizations to edit certain registration information as it changes, as well as reprint lost certificates without having to contact TAX. Vendors can also

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verify the exempt status of nonprofit organizations online. Since the inception of Nonprofit Online, 6,679 organizations have accessed the online application. From the organizations that actually completed and submitted their applications online, the application was given positive marks of 94% or higher, indicating that the online application is easy to use. TAX is very pleased to have made this convenient, easy-to-use service to the nonprofit community.

Current Year Fiscal Impact

The current year fiscal impact is based on the total estimated taxable purchases made in this fiscal year (beginning July 1, 2004 and ending June 30, 2005) by organizations acquiring an exemption under the new process. The total consists of a combination of the revenue loss from new organizations and organizations that have renewed their exemption under the new process. Using 2005 estimated taxable purchases provided by the organizations applying for exemptions under the new process, **the estimated fiscal year 2005 sales tax revenue loss totals \$62.5 million.** This number is based on applications filed for the exemption.

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. It should be kept in mind that these numbers were drawn from a nonaudited survey of nonprofit organizations. 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 (for example, a new hospital).

The \$62.5 million current year fiscal impact includes \$33.9 million attributable to nonprofit organizations renewing their existing exemptions. Using the dollar estimates of 2005 taxable purchases provided by the 2,158 organizations that applied for an exemption using the new process, **the estimated 2005 revenue loss from newly granted exemptions totals \$28.6 million.**

Several caveats are in order in interpreting this estimate. Many of the approximately 2,158 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

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centralized purchases for an existing organization, this revenue loss would be included in the \$28.6 million from newly granted exemptions.

In addition, churches are included in the current revenue loss 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.

Conclusion

In conclusion, based on the information provided to TAX by the 2,158 organizations that took advantage of the new administrative process effective July 1, 2004 to apply for an exemption, **the current year fiscal impact is \$62.5 million.**

In each succeeding year when TAX 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, TAX will have a more complete estimate of the total impact of exempting nonprofit organizations.

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