COMMONWEALTH *of* VIRGINIA

Department of Taxation

MEMORANDUM

TO: The Honorable John H. Chichester
The Honorable Harry R. Purkey
The Honorable Vincent F. Callahan, Jr.

FROM: Janie E. Bowen
Tax Commissioner

DATE: December 1, 2006

SUBJECT: 2006 Fiscal Report on Nonprofit Exemptions

Legislation passed in the 2003 General Assembly, Chapters 757 and 758, 2003 Acts of Assembly (HB 2525 and SB 743) simplified 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. Last year's fiscal report to the General Assembly filed on December 1, 2005, provided a more complete fiscal revenue estimate as it reflected the first full year's worth of data, beginning on July 1, 2004 and ending on June 30, 2005. This year's fiscal report to the General Assembly again reflects a full year's worth of data, beginning on July 1, 2005 and ending on June 30, 2006. The estimated 2006 fiscal year sales tax revenue loss from nonprofit exemptions totals $6 million.

Background

Over the 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 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 in order to renew their exemption. 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. This formation was then given to the Division of Legislative Services for drafting legislation to extend the individual exemptions.

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. This legislation simplified the exemption process and enabled more charitable organizations to take advantage of the exemptions, and it 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 requires renewal on a five to seven-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 to New Exemption Process – 2004, 2005 and 2006

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. This bill also 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.

The 2005 General Assembly 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.

The 2006 General Assembly expands the sales and use tax exemption for nonprofit churches exempt from taxation under IRC § 501 (c) (3), or whose real property is exempt from local taxation pursuant to the provisions of Section 58.1-3606 of the Code of Virginia. House Bill 576 (Chapter 338) expands the exemption to include tangible personal property used for recording and reproducing services. The exemption covers a nonprofit church's purchase of video recording equipment, microphones, cassette players, and similar items that are used for recording and reproducing services.

The exemption for nonprofit churches was originally enacted in 1979 and was limited to tangible personal property used by a nonprofit church in its religious worship services or in a regular school of religious education. Since its enactment, the exemption has been expanded several times.

As a result of this change, a nonprofit church has two processes by which they can obtain an exemption for tangible personal property used for recording and reproducing services:

- They may use their self-issued exemption certificate (Form ST-13A) which, while limited, has been expanded by this bill; or

- They may apply to TAX for a broader exemption, which was enacted during the 2003 Virginia General Assembly session.

Finally, House Bill 5002 (Chapter 3, Special Session 1 of 2006) and House Bill 5012 (Chapter 2, Special Session 1 of 2006) modified the criteria that nonprofit entities must meet in order to qualify for a sales and use tax exemption. Previously, one of the criteria required organizations with gross annual revenue of $250,000 or greater during the previous year to provide a financial audit performed by an independent certified public accountant to TAX. These bills change this requirement to allow an entity with between $250,000 and $500,000 of gross annual revenue in the previous year to provide a review of its financial statements in lieu of a full audit. The review must be performed by an independent certified public accountant. Entities with more than $500,000 of gross annual revenue are still required to provide a full audit performed by an independent certified public accountant. Entities with less than $250,000 of gross annual revenue will continue to have no requirement to provide any type of financial audit or review.

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 a Virginia sales and use tax exemption for the first time or renew their exemption certificate (https://www.npo.tax.virginia.gov). Nonprofit Online also permits organizations to print out a Virginia sales and use certificate, edit certain registration information as it changes, as well as reprint lost certificates without having to contact TAX. Approximately 8,399 organizations have accessed the online application since the inception. TAX continues to receive high marks of 94% or higher form organizations that have submitted applications online and is very pleased to have made this convenient, easy-to-use service to the nonprofit community.

<u>Current Year Fiscal Impact</u>

The current year fiscal impact is based on the total estimated taxable purchases made in this fiscal year (beginning July 1, 2005 and ending June 30, 2006) 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 under the new process, the estimated fiscal year 2006 sales and local state tax revenue loss totals $6 million**. The numbers provided for this report were drawn from a nonaudited survey of nonprofit organizations.

The $6 million current year fiscal impact includes $436,641 attributable to nonprofit organizations renewing their existing exemptions. Using the dollar estimates of 2005 taxable purchases provided by organizations that applied for an exemption using the new process, the estimated 2006 revenue loss from newly granted exemptions totals $5.6 million. The chart below illustrates a comparison of estimated purchases made by nonprofit organizations in fiscal years 2005 and 2006.

FY 2005		**FY 2006**	
New Organizations 1946	Renewals 212	New Organizations 1295	Renewals 152
Average Taxable Purchases $310,000	Average Taxable Purchases $3,250,000	Average Taxable Purchases $88,000	Average Taxable Purchases $58,000

While there is a substantial decrease in this year's fiscal impact, there are many factors that contributed to the sharp decrease. The number of new organizations approved during this fiscal year decreased by 33 percent while the renewals decreased by 28 percent. TAX approved a total of 1,447 organizations during fiscal year beginning July 1, 2005 through June 30, 2006 compared to 2,158 in the last fiscal year, which is a 33 percent decrease in organizations this year compared to last year. In addition, the classification of organizations renewing their exemptions in this year typically report lower taxable purchases. These organizations generally are Volunteer Fire and Rescue Departments, Animal Rescue Organizations, Parent Teacher Associations (PTA's) and other small civic organizations. The Volunteer Fire and Rescue Departments represented 98 percent of the organizations renewing their exemptions this year. Organizations renewing their exemptions last year represented a large number of hospitals and institutions of higher learning, whose taxable purchases were much higher than those reported this year by organizations renewing their exemptions.

Conclusion

In conclusion, based on the information provided to TAX by the 1, 447 organizations that took advantage of the administrative process effective July 1, 2005 through June 30, 2006 to apply for an exemption, the current year fiscal impact is $6 million.

In each succeeding year when TAX provides this report, it will update the total fiscal impact to date. Over the next several 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.

cc: The Honorable Jody M. Wagner, Secretary of Finance