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 27, 2007

SUBJECT: 2007 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 annual fiscal report and subsequent reports have been filed each fiscal year thereafter. TAX reported the sales tax revenue loss as it applied to newly eligible nonprofit organizations applying for an exemption for the first time, as well as organizations renewing their expiring exemption under the new process. The estimated sales tax revenue loss for fiscal year beginning July 1, 2006 and ending June 30, 2007 is $9 million. This report will further provide a cumulative account of the sales and use tax exemptions for all nonprofit organizations.

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 information 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 revenue is $250,000 or greater.

Nonprofit organizations that held a valid exemption certificate on June 30, 2003 would continue to enjoy their exemption until it expired. Grandfathered exemptions would expire and organizations would need to apply for a new exemption under the new process based on the following filing schedule:

Exemption Group	Deadline
Civic and community service (first half) (58.1-609.8)	July 1, 2004
Civic and community service (second half) (58.1-609.8)	July 1, 2005
Cultural and Miscellaneous (58.1-609.9, 58.1-609.10)	July 1, 2006
Educational (58.1-609.4)	July 1, 2007
Medical-Related (58.1-609.7)	July 1, 2008

The new 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 law will continue to enjoy their exempt status, but will be required to file under the new process when their exemption sunsets.

Technical Amendments to New Exemption Process

There have been several technical amendments made to this process over the last four years. In 2004, Chapters 515 and 536, Acts of Assembly (HB 515 and SB 585), clarified that churches have two options. They may continue using the self-issued exemption certificate, which entitles them to the sales and use tax exemption available under the law as it existed on June 30, 2003, or they could 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 fundraiser sales 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.

In 2005, the 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 did not qualify under the new process, as they have a federal designation of IRC § 501(c)(19) and no longer qualified for an exemption.

The 2006 General Assembly expanded 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. Under Chapter 338, Acts of Assembly (HB 576) expanded the exemption to include tangible personal property used for recording and reproducing services. The exemption includes 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.

During the Special Session of the 2006 General Assembly, 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 revenues 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 would continue to have no requirement to provide any type of financial audit or review.

The 2007 General Assembly passed legislation that modified the audit requirement for nonprofit organizations applying for a retail sales and use tax exemption. House Bill 2545 (Chapter 698), House Bill 3062 (Chapter 704) and Senate Bill 743 (Chapter 709) now allow nonprofit organizations that have gross annual revenues between $750,000 to $1,000,000, the choice of providing a full "financial audit" or a "financial review" in lieu of a full financial audit, both of which must be performed by an independent certified public accountant. Nonprofit organizations with gross annual revenues of $1 million or greater must provide a full financial audit performed by an independent certified public accountant. Entities with less than $750,000 of gross annual revenue would have no requirement to provide any type of financial audit or review.

Finally, legislation passed in 2007 also expanded 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 2724 (Chapter 758) expanded the exemption to include tangible personal property used in the care or maintenance of any property owned by these churches. The exemption would include, but not be limited to, such items as mowing equipment and building materials that are installed by the church rather than through a contract.

Online Exemption Process

TAX continues to see an increase in organizations applying for retail sales and use tax exemption. Nonprofit Online, an online application was developed to provide a quick, efficient and secure way for an organization 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). Organizations applying online may print out a copy of their Virginia sales and use certificate, edit certain registration information as it changes, as well as reprint lost certificates without having to contact TAX. Approximately 9,900 organizations have accessed the online application since its inception. TAX continues to receive high marks for its online application from organizations that have submitted applications online.

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, 2006 and ending June 30, 2007) by organizations acquiring an exemption under the new process. The totals consist of a combination of the revenue loss for new organizations and organizations that have renewed their exemption under the new process. Using the 2006 estimated taxable purchases provided by organizations, the estimated fiscal year 2007 state and local sales tax revenue loss from organizations taking advantage of the new exemption process in fiscal year 2007 totals $9 million. The $9 million represents $6.2 million that is attributable to nonprofit organizations renewing their existing exemptions and $2.8

million to those organizations applying for an exemption for the first time. The numbers provided for this report were drawn from an unaudited survey of nonprofit organizations.

As of July 1, 2007, TAX has issued 7,153 retail sales and use tax exemptions to nonprofit organizations. The chart below illustrates the sales tax revenue loss based on information provided by organizations using the new exemption process for fiscal years 2004 through 2007. The cumulative first year revenue loss for all nonprofit exemptions granted between July 1, 2004 and June 30, 2007 is $133.7 million. The revenue impact is based solely on data supplied by the organizations with respect to estimated purchases made. TAX has no data to support or to refute the assumption that the projected revenue loss in the year the organization obtains the exemption will increase, decrease or stay constant in subsequent years. To the extent any organization may have overstated or understated its estimated purchases, the fiscal impact would be overstated or understated.

Sales Tax Revenue Loss

2004 Fiscal Sales Tax Revenue Loss	2005 Fiscal Year Sales Tax Revenue Loss	2006 Fiscal Year Sales Tax Revenue Loss	2007 Fiscal Year Sales Tax Revenue Loss
$56.2 million	$62.5 million	$6 million	$9 million

Total Sales Tax Revenue Loss - $133.7 million

Conclusion

In conclusion, based on the information provided to TAX by the 7,153 organizations currently holding a retail sales and use tax exemption as of July 1, 2007, the total fiscal impact on the nonprofit exemptions is $133.7 million. Nonprofit hospitals represent the final category holding exemption certificates under the old process, which is set to expire July 1, 2008. Once this group renews their exemptions under the new process, TAX will have a more complete estimate of the total impact of exempting nonprofit organizations.

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