COMMONWEALTH *of* VIRGINIA

Department of Taxation

MEMORANDUM

TO: The Honorable Charles J. Colgan
The Honorable Harry R. Purkey
The Honorable Lacey E. Putney

FROM: Janie E. Bowen
Tax Commissioner

DATE: December 1, 2008

SUBJECT: 2008 Fiscal Report on Nonprofit Exemptions

Summary

The 2003 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. 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, 2007 and ending June 30, 2008 is $65 million. This report will further provide a cumulative account of the sales and use tax exemption for all nonprofit organizations and will also explain the substantial increase in revenue loss for this period.

Background

Prior to the 2003 General Assembly, there was no general exemption from Virginia's Retail Sales and Use Tax for nonprofit organizations. Virginia's Retail Sales and Use Tax exemptions were generally tailored for specific nonprofit organizations, although any organization meeting the exemption criteria would qualify for the exemption. 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. With the passage of this legislation, the process was simplified and many nonprofit organizations may now apply to TAX to receive an exemption certificate provided they meet certain qualifications. The legislation also grandfathered the exemptions held by nonprofit organizations under the old exemption system for a limited time. This legislation grants to qualifying nonprofit organizations an exemption from paying, and in some cases collecting, retail sales and use tax on purchases of tangible personal property. Additionally, certain grandfathered entities are allowed an exemption from the retail sales and use tax on services that are subject to the tax.

To be granted an exemption by TAX, an entity must meet all the applicable criteria:

- Exemption from federal income taxation 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 be in compliance with state solicitation laws, if applicable.

- The entity must have annual administrative costs that are 40% or less of annual gross receipts.

- If the entity's gross annual revenue was $1 million or greater in the previous year, then the entity must provide a financial audit performed by an independent certified public account. If the entity's gross annual revenue was between $750,000 and $1 million, then the entity must provide either a financial audit performed by an independent certified public accountant or a financial review performed by an independent certified public accountant.
- The entity must provide TAX with a copy of its federal Forms 990 or 990 EZ or a list of its Board of Directors.
- The entity must provide TAX with an estimate of its total taxable purchases.

The process requires renewal on a five to seven-year cycle, but eliminates the need for legislative action. Nonprofit organizations that held a valid exemption certificate under the old system would enjoy their exemption status, but are required to file under the new process when their exemption sunsets. As shown below, all of the original exemption groups have expired and many have applied for an exemption using the new process.

Original Exemption Sunset Dates

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

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 the 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 was 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

Since June 2003, over 12,000 nonprofit organizations have accessed Nonprofit Online. Nonprofit Online, (https://www.npo.tax.virginia.gov) 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. Customers accessing Nonprofit 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. 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, 2007 and ending June 30, 2008) by 1,210 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 2007 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 $65 million. The $65 million represents $5.7 million that is attributable to 923 nonprofit organizations applying to TAX for the first time and $59.3 is attributable to 287 organizations renewing their existing exemption. The numbers provided for this report were drawn from an unaudited survey of nonprofit organizations.

The estimated 2008 fiscal year sales tax revenue loss is substantially higher than last year's sales tax revenue loss of $6 million. This year's fiscal impact includes groups such as nonprofit hospitals, retirement /nursing facilities and nonprofit clinics. Although the numbers of organizations renewing their exemption appear small, these groups typically purchase higher dollar equipment than the average nonprofit organization. The purchases made by these organizations averaged $4.2 million.

Conclusion

The chart below illustrates the estimated sales tax revenue loss based on information provided by organizations using the new exemption process for fiscal years 2004 through 2008. The cumulative first year revenue loss for all nonprofit exemptions granted between July 1, 2004 and June 30, 2008 is $198.7 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 fluctuate accordingly.

Estimated Sales Tax Revenue Loss

2004 Fiscal Year Sales Tax Revenue Loss	$56.2 million
2005 Fiscal Year Sales Tax Revenue Loss	$62.5 million
2006 Fiscal Year Sales Tax Revenue Loss	$6 million
2007 Fiscal Year Sales Tax Revenue Loss	$9 million
2008 Fiscal Year Sales Tax Revenue Loss	$65 million

Total Sales Tax Revenue Loss - $198.7 million

c: The Honorable Richard D. Brown, Secretary of Finance