

PUBLIC SERVICE CORPORATION EXEMPTION REPEAL GUIDELINES

August 30, 2004

These guidelines are published by the Department of Taxation (TAX) to provide guidance to certain public service corporations, vendors and the public in general regarding the repeal of the retail sales and use tax exemption provided under *Code of Va.* § 58.1-609.3(3), effective September 1, 2004. Pursuant to House Bill 5018, enacted by the 2004 Special Session of the Virginia General Assembly and signed by Governor Warner June 3, 2004, the development and publication of these guidelines is exempt from the provisions of the Administrative Process Act (§ 2.2-4000 *et seq.*) of the *Code of Virginia*. These guidelines supplement TAX's existing Retail Sales and Use Tax Regulations (23 Virginia Administrative Code 10-210-10 *et seq.*). To the extent that there is a conflict between the existing regulations and these guidelines, these guidelines supersede the regulations. As necessary, additional guidelines may be published and posted on TAX's web page at www.tax.state.va.us.

General Overview

Effective September 1, 2004, the retail sales and use tax exemption available to public service corporations for the purchase or lease of tangible personal property used or consumed directly in the rendition of their public service is repealed. Those public service corporations losing their exemption include electric suppliers, telecommunications companies, certain telephone companies, gas, water and sewer utilities and motor vehicle common carriers. Common carriers of property or passengers by railway do not lose their exemption. In addition, to the extent public service corporations, generating electric power, qualify for the manufacturing exemption under *Code of Va.* § 58.1-609.3(2), they will be prohibited from claiming the manufacturing exemption, except for raw materials that are consumed in the production of electricity, including fuel.

Additionally, House Bill 5018 authorizes any public utility that is, as a result of the passage of this legislation, subject to a sales and use tax on tangible personal property purchased or leased for use or consumption by such utility in the rendition of its public service, to impose a surcharge to recover from each customer that customer's pro rata share of the additional sales and use taxes incurred by the utility.

Exemption Being Repealed

Since the inception of the Virginia Retail Sales and Use Tax in 1966, public service corporations have been entitled to a sales and use tax exemption for all tangible personal property purchased or leased and used directly in the rendition of their public service. Administrative items and items not used directly in the rendition of their service were subject to the tax.

Items of tangible personal property that are used directly in the rendition of a public utility service are those that are both indispensable to the actual provision of a utility service and used or consumed immediately in the performance of such service. The fact that a particular item may be considered essential to rendering a public utility service because its use is required either by law or practical necessity does not, of itself, mean that the property is used directly in the rendition of a public utility service.

Items of tangible personal property that are to be incorporated into and will become a part of a utility's production, transmission or distribution systems are deemed to be used directly in the rendition of a public service; however, tangible personal property used in administrative and managerial activities and activities other than those noted above are deemed not to be used directly in the rendition of a public service and, therefore, are subject to the tax.

Tangible personal property, including equipment, machinery, apparatus, supplies and appliances that are used immediately in production, generation or initiation activities, is deemed to be used directly in the rendition of a utility's public service. Such exempt property also includes equipment, machinery, supplies, tools, and repair parts used to keep in operation exempt production devices and fuel or power used to operate such production devices.

Tangible personal property, including equipment, machinery, apparatus, supplies, fuel and power, appliances, pipes, wires, mains, etc., that is used immediately in the transmission or distribution of gas, water, electricity, and telephone or telegraph communications to the public, is used directly in the rendition of a utility's public service.

Additionally, equipment, machinery, tools, repair parts, and supplies and such vehicles and their equipment as are specially designed and equipped for such use are exempt from the tax when used to keep a utility's transmission or distribution system in operation or repair.

With the deregulation of the electric utilities, TAX determined that companies providing electric power, not subject to the public service corporation exemption, are to be treated as industrial manufacturers or processors and are entitled to the retail sales and use tax exemption under *Va. Code* § 58.1-609.3(2). Therefore, electric utilities with generation facilities qualify for the manufacturing exemption

for many of the purchases currently exempt under the public service corporation exemption. However, under the new law, the manufacturing exemption is largely denied to public service corporations. See the later discussion in these guidelines under the heading “Other Exemptions”.

Effective Date of Repeal

The effective date of House Bill 5018’s repeal of the public service corporation exemption is in due course. Article 4, Section 13 of the *Constitution of Virginia* provides that the effective date of general legislation enacted during a Special Session of the General Assembly is the first day of the fourth month following the month of adjournment of the Special Session. Accordingly, the effective date of the repeal of the public service exemption is September 1, 2004.

The repeal of the public service corporation exemption coincides with the ½% state sales and use tax increase, which also becomes effective September 1, 2004. Tangible personal property previously exempt from the retail sales tax will be subject to the tax at the rate of 5% on and after September 1, 2004.

Transitional Rules

The following rules are provided to clarify when purchases or leases of tangible personal property, previously exempt from the retail sales tax, are subject to the tax.

Taxable

- Tangible personal property purchased on and after September 1, 2004
- Tangible personal property delivered to a purchaser **and** paid for on or after September 1, 2004, regardless of when the property was ordered
- Installment sales, when the date the contract is entered into is on or after September 1, 2004

Exempt

- Tangible personal property ordered, delivered and paid for prior to September 1, 2004
- Tangible personal property ordered and delivered prior to September 1, 2004, but paid for on or after September 1, 2004

- Installment sales, when the date the contract is entered into is prior to September 1, 2004, regardless of when the property is delivered or when payment is made

Long-term Leasing Contracts

Notwithstanding the September 1, 2004 repeal of the public service corporation exemption, no sales and use tax will be imposed on the lease payments for any tangible personal property leased pursuant to a bona fide contract that was entered into on or before March 1, 2004, provided that such tangible personal property was delivered to or placed into service by a public service corporation on or before September 1, 2004¹. A “bona fide” contract is one that includes specific, set terms and a payment schedule with a fixed duration.

Extension of Contracts

Generally, the extension of a bona fide leasing contract does not constitute a new contract and such equipment would remain exempt if the original contract is extended, provided the original contract was entered into on or before March 1, 2004 and the extension is executed prior to September 1, 2004. Extension of a bona fide contract after September 1, 2004 constitutes a new contract and property leased under that contract will become taxable.

Other Changes in the Terms of a Contract

Other changes in the terms of the contract, e.g., pricing, lease payments, finance charges, etc., will not change the exempt status of the tangible personal property provided the original contract was entered into on or before March 1, 2004 and the change to the bona fide contract is executed prior to September 1, 2004. Changes in terms occurring on or after September 1, 2004 shall be viewed as a new contract for purposes of taxation.

Assignment of a Contract

The assignment of a bona fide contract does not constitute a new contract provided there is no change in the terms of the contract or the original contract terms are not extended as a result of the assignment.

¹ The date contained in the 4th Enactment Clause of HB 5018 relating to the transitional rule with respect to long-term bona fide contracts is August 1, 2004, based upon the assumed effective date of the repeal of the exemption. Because the effective date of the repeal was, in accordance with the *Constitution of Virginia*, delayed until September 1, 2004, the August 1, 2004 date is moved back by these guidelines to September 1, 2004.

Inventory on Hand

Tangible personal property purchased prior to September 1, 2004, under the public service corporation exemption, and placed in a tax-exempt inventory, will not lose its exempt status with the repeal of the public service corporation exemption effective September 1, 2004. Such property will also maintain its exempt status upon the withdrawal from inventory and put in use in a taxable manner.

Temporary Storage

Prior to the repeal of the exemption, tangible personal property temporarily stored in Virginia for subsequent shipment to and for use in another state could be purchased exempt of the tax as long as such property qualified for the Virginia exemption. Absent an exemption, tangible personal property temporarily stored in Virginia for subsequent shipment to and for use in another state is taxable in Virginia.²

Effective September 1, 2004, tangible personal property brought into and stored in Virginia by a public service corporation, regardless of the fact the tangible personal property may be used out-of-state in an exempt capacity is subject to tax. For example, if a public service corporation has its central purchasing and warehousing operation in Virginia for its entire nationwide operation, all tangible personal property warehoused in Virginia would be subject to the Virginia sales and use tax, unless such property qualifies for an existing Virginia exemption. Tax shall be accrued on such tangible personal property in the month the property is acquired by the public service corporation and brought into Virginia and remitted by the 20th day of the month following the month of acquisition or importation into Virginia.

Vendor Notification

It is the responsibility of the public service corporation losing the sales tax exemption to notify all vendors that any exemption certificate or direct payment permit previously submitted is invalid on and after September 1, 2004. Effective September 1, 2004, the vendor making sales to a public service corporation should begin charging the tax on all tangible personal property sold to the public service corporation. In the event the vendor fails to charge the tax on taxable purchases or is not required to be registered to collect Virginia sales tax, it is the responsibility of the public service corporation to accrue and remit the use tax.

Use tax may be remitted either on Line 2 of Form ST-9, Virginia Retail Sales and Use Tax Return, or on Form ST-7, Virginia Consumer's Use Tax Return. All

² "If a taxable event occurs in Virginia, subsequent delivery of property outside this State does not immunize the taxable event." *Commonwealth of Virginia, Department of Taxation v. Miller-Morton Company*, 220 Va. 852, 263 S.E. 2d 413 (1980).

public service corporations remitting use tax are required to complete a local tax distribution schedule, in a format prescribed by the Tax Commissioner. A purchase made in Virginia is subject to the local tax in the county or city where the purchase was originally made. A purchase made outside Virginia is subject to the local tax in the county or city where the property is first used.

Direct Payment Permits

Under Virginia law, the Tax Commissioner may authorize a manufacturer, mine operator, or public service corporation that is the user, consumer, distributor, or lessee to which sales, distributions, leases, or storage of tangible personal property are made under circumstances that normally make it impossible at the time of purchase to determine the manner in which such property will be used to pay the tax directly to the Tax Commissioner and waive the collection of the tax by the dealer. With the repeal of the public service corporation exemption, regardless of the use of the property, all purchases of tangible personal property made by public service corporations will be subject to tax, except in the case of limited purchases qualifying for other exemptions. *See Other Exemptions.*

Effective September 1, 2004 all direct payment permits issued to public service corporations losing their exemption are hereby cancelled. Holders of direct pay permits are required to notify each of their vendors that the permit has been cancelled and future purchases are subject to the tax. Such permits shall be surrendered to the Department of Taxation no later than September 15, 2004.

Temporary Transitional Treatment

In the event a public service corporation, formerly authorized to file using a direct payment permit, is unable to make the necessary internal accounting changes to determine the proper amount of sales tax paid, such company may apply to the Tax Commissioner to operate temporarily under a special filing authority. Any public service corporation requesting this special authority **must agree to all** of the following conditions:

1. The company must have held a valid direct payment permit as of August 31, 2004.
2. This special authority will expire one year from the date it is granted or 30 days after the conclusion of a rate making hearing with the State Corporation Commission that grants such company the authority to include the additional, incremental retail sales and use tax incurred as a result of the repeal of the public service corporation exemption under House Bill 5018 in such company's base rates, whichever is earlier.
3. Self-assessed taxes paid by a public service corporation filing under this special authority shall be paid on an accrual basis. That is, payment shall

be accrued on tangible personal property in the month the property is acquired by the public service corporation and remitted by the 20th day of the month following the month of acquisition. For purposes of this special filing authority, property is deemed to be “acquired” on the earlier of the date the invoice is received from the vendor or the date the invoice is paid.

4. All public service corporations filing under this special authority will be required to complete a local tax distribution schedule, in a format prescribed by the Tax Commissioner. A purchase made in Virginia is subject to the local tax in the county or city where the purchase was originally made. A purchase made outside Virginia is subject to the local tax in the county or city where the property is first used.
5. No exemption shall be allowed for tangible personal property brought into and stored in Virginia by a public service corporation, regardless of the fact the tangible personal property may ultimately be used out-of-state in an exempt capacity. For example, if a public service corporation has its central purchasing and warehousing operation in Virginia for its entire nationwide operation, all tangible personal property warehoused in Virginia would be subject to the Virginia sales and use tax, unless such property qualifies for an existing Virginia exemption. Tax shall be accrued on such tangible personal property in the month the property is acquired by the public service corporation and brought into Virginia and remitted by the 20th day of the month following the month of acquisition or importation into Virginia.
6. No discount under *Va. Code* § 58.1-622 shall be allowed to a public service corporation filing under this special authority.

The Tax Commissioner reserves the right to cancel for cause any such special filing authority granted to a public service corporation.

Vendor Notification

Public service corporations granted permission to file under this special authority shall notify each of their vendors that all previous exemption certificates or direct payment permits are no longer valid. Any public service corporation wishing to make exempt purchases pursuant to this special filing authority must furnish each vendor a new exemption certificate issued pursuant to such special filing authority. Any exemption certificate issued under this section shall expire on a date not later than one year from the date the special filing authority is granted.

Filing Information

All requests for special filing authority must be submitted in writing to the Department of Taxation, Customer Satisfaction Team, P.O. Box 546, Richmond,

Virginia 23218-0546. Requests must include the company's Virginia account number and name of the company as it appears on the existing direct payment permit.

Front-End Agreements

Any and all front-end agreements currently in force between TAX and any public service corporation are hereby cancelled effective September 1, 2004. Any public service corporation desiring to enter into a new front-end agreement to self assess tax on a monthly basis shall contact TAX. Taxable percentages must accurately reflect the repeal of the exemption and are subject to verification by TAX.

Other Exemptions

In addition to the repeal of the public service corporation exemption, the 2004 General Assembly also eliminated the manufacturing exemption currently available to public service corporation electric utilities for the production of electricity, except for raw materials that are consumed in the production of electricity, including fuel. Despite the loss of the public service corporation exemption, other overlapping exemptions may be available to a public service corporation. Other sales tax exemptions that may be available include, but are not limited to the exemption for research and development, certified pollution control equipment, resale and for tangible personal property for use or consumption by the Commonwealth, any political subdivision of the Commonwealth, or the United States.

Contractor's Use Tax

Prior to September 1, 2004, contractors purchasing and installing exempt tangible personal property under contract with an exempt public service corporation were allowed to "stand in the shoes" of the exempt public service corporation and could purchase all such property tax exempt using a Construction Contractors Exemption Certificate (Form ST-11A).

Effective September 1, 2004, contractors purchasing and installing tangible personal property for a public service corporation that is directly used in the rendition of its public service, will be considered the user and consumer of all tangible personal property consumed by them in the performance of the contract and must pay the sales or use tax on such property at the time of purchase. (See *Incremental Tax for Surcharges* in this document).

Incremental Tax Recoverable through Surcharges to Customers

Any public service corporation, which is determined to be a public utility by the State Corporation Commission, is entitled to recover the amount of additional sales and use tax paid due to the repeal of the exemption as a surcharge on the customer's bill. The recoverable tax shall be calculated based on the combined state and local sales and use tax rate effective September 1, 2004.

Taxes Paid by Contractors

The taxes incurred by a contractor as the result of the repeal of the public service corporation exemption, and the repeal of the manufacturing exemption for electric utilities, are recoverable by the public utility through a separate line item surcharge allowed under law. Only the incremental sales and use tax expense incurred as a result of the exemption repeal is recoverable. All recoverable taxes paid by contractors must be documented and open for audit by the State Corporation Commission and the Department of Taxation. The taxes paid by a contractor as a result of the repeal of the public service corporation effective September 1, 2004, will be considered to be the incremental sales tax cost to the public service corporation for purposes of computing the surcharge.

Verification of Surcharge by State Corporation Commission

The State Corporation Commission (SCC) is charged with reviewing and verifying surcharge amounts annually, based on data provided in an annual filing or other information provided to the SCC. Such review and verification shall neither constitute a rate case nor be the subject of a rate case. If the SCC determines that the amount of the surcharge differs from the actual sales and use tax paid as a result of the repeal of the exemption, a surcharge adjustment will be applied in the following year. Any excess in the surcharge will be credited to the utility's customer in the following year; likewise, any shortfall in the surcharge will be recoverable through a surcharge increase in the subsequent year.

Characterization of Surcharge

The federal courts have held that "the legal incidence of the Virginia sales and use tax is on the purchaser."³ With the repeal of the retail sales and use tax exemption for public service corporations, the legal incidence of the sales and use tax falls on the utilities and not their customers. However, the legislation authorizes the public utility to recover from each customer that customer's pro rata share of the actual expense incurred by the public utility by means of a sales and use tax surcharge. Any such surcharge for the recovery of incremental

³ See United States v. Forst, 442 F. Supp. 920 (W.D. Va. 1977) aff'd, 569 F.2d 811 (4th Cir. 1978)

taxes paid as a result of the exemption repeal shall not be considered to be a sales or use tax imposed on the customer.

WHERE TO GET INFORMATION

For information and updates about the new sales and use tax laws, as well as other legislative changes for 2004, please visit TAX's web page at www.tax.state.va.us.