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Emergency Regulation and Notice of Intended Regulatory Action (NOIRA) Agency Background Document

Agency name	Virginia Department of Taxation
Virginia Administrative Code (VAC) citation	23 VAC 10-210-693
Regulation title	Retail Sales and Use Tax
Action title	Amendment of the Retail Sales and Use Tax Government Contractors regulation section to conform to Item 268 of the 2006 Budget Bill.
Date this document prepared	June 18, 2007

This form is used when an agency wishes to promulgate an emergency regulation (to be effective for up to one year), as well as publish a Notice of Intended Regulatory Action (NOIRA) to begin the process of promulgating a permanent replacement regulation.

This information is required for executive branch review and the Virginia Registrar of Regulations, pursuant to the Virginia Administrative Process Act (APA), Executive Orders 36 (2006) and 58 (1999), and the *Virginia Register Form, Style, and Procedure Manual*.

Preamble

The APA (Code of Virginia § 2.2-4011) states that an “emergency situation” is: (i) a situation involving an imminent threat to public health or safety; or (ii) a situation in which Virginia statutory law, the Virginia appropriation act, or federal law requires that a regulation shall be effective in 280 days or less from its enactment, or in which federal regulation requires a regulation to take effect no later than 280 days from its effective date.

- 1) Please explain why this is an “emergency situation” as described above.
- 2) Summarize the key provisions of the new regulation or substantive changes to an existing regulation.

Item 268 of the 2006 Appropriations Act (House Bill 5002, Chapter 3, 2006 Acts of Assembly, Special Session I) changed the application of the Retail Sales and Use Tax “true object test,” as it applies to businesses contracting with the United States, the Commonwealth, or any political subdivision or instrumentality thereof. The true object test is used to determine the application of the Retail Sales and Use Tax in transactions that involve the provision of both tangible personal property and services. Prior

to this legislation, government contractors applied the “true object test” to the **contract** between the contractor and the government entity to determine the application of the Retail Sales and Use Tax. Item 268 requires that, effective July 1, 2006, for task orders, work orders, or statements of work executed on or after July 1, 2006, application of the sales and use tax to government contracts is determined based upon the true object of each separate **task order, work order, or statement of work**, issued in furtherance of the contract, rather than the overall contract. This regulatory action amends the Government Contractor regulation as mandated by Item 268.

Item 268 further provides that “(t)he Tax Commissioner shall work with the government contracting industry to promulgate an emergency regulation on or before June 30, 2007, to implement the provisions of this paragraph.” (Emphasis added.)

As the General Assembly has mandated that this regulatory activity be promulgated as an emergency regulation prior to July 1, 2007, an emergency situation exists and this regulatory activity qualifies as an emergency regulation.

Legal basis

Other than the emergency authority described above, please identify the state and/or federal legal authority to promulgate this proposed regulation, including: 1) the most relevant law and/or regulation, including Code of Virginia citation and General Assembly chapter number(s), if applicable, and 2) promulgating entity, i.e., agency, board, or person. Describe the legal authority and the extent to which the authority is mandatory or discretionary.

Code of Virginia § 58.1-203 provides that the “Tax Commissioner shall have the power to issue regulations relating to the interpretation and enforcement of the laws of this Commonwealth governing taxes administered by the Department.” Item 268 of the 2006 Appropriations Act (House Bill 5002, Chapter 3, 2006 Acts of Assembly, Special Session I) provides that the “Tax Commissioner shall work with the government contracting industry to promulgate an emergency regulation on or before June 30, 2007, to implement the provisions of this paragraph.” The authority for the current regulatory action is mandatory.

Purpose

Please describe the subject matter and intent of the planned regulatory action. Also include a brief explanation of the need for and the goals of the new or amended regulation.

Title 23 of the Virginia Administrative Code, § 10-210-693 explains the application of the retail sales and use tax to transactions entered into between businesses and government entities. The regulation provides that the appropriate tax treatment of purchases of tangible personal property by persons contracting with government entities is based upon whether the **contract** is for the sale of tangible personal property or the provision of an exempt service. If a contract is for the sale of tangible personal property, a contractor may purchase such tangible personal property exempt from the tax to be resold to the government. If the contract is for the provision of services, the contractor is deemed the taxable user and consumer of all tangible personal property used in performing its services, even though title to the property provided may pass to the government or the contractor may be fully and directly reimbursed by the government or both.

Although the current regulation does not address the issue, under general principles applicable to the Retail Sales and Use Tax, the “true object test” is used to determine the application of the Retail Sales and Use Tax in transactions that involve the provision of both tangible personal property and services.

Item 268 of the 2006 Appropriations Act (House Bill 5002, Chapter 3, 2006 Acts of Assembly, Special Session I) mandates that the true object test now be applied to each **individual work order, task order, or statement of work** executed on or after July 1, 2006 under a contract between a contractor and a government entity. The determination is made as to the true object of these individual orders, and the transaction is classified as taxable or exempt of the tax, based upon the true object of the order. This modified review of contracts at the order level rather than the contract level will **not** apply to contracts with a government entity to perform construction or reconstruction with respect to real property (real property contracts).

This regulatory action is intended to provide an explanation of the new application of the true object test, with respect to orders issued under government contracts. The amendments provide a summary of the law applicable prior to July 1, 2006, and describe the change in law as a result of the budget language. Definitions for key terms are provided. The amendments also provide an explanation and examples as to the treatment of subcontractors to a governmental contract. In addition, as mandated by Item 268, the amendments include examples to illustrate when a contractor is deemed to have exercised taxable interim use of tangible personal property purchased pursuant to a government contract, as well as examples where exempt interim use is made incidental to a resale to the government.

Need

Please detail the specific reasons why the agency has determined that the proposed regulatory action is essential to protect the health, safety, or welfare of citizens. In addition, delineate any potential issues that may need to be addressed as the regulation is developed.

Government must have a predictable and adequate revenue to provide for the health, safety and welfare of its citizens. Tax regulations enhance customer service and voluntary compliance. The interpretations, examples, and other guidance in tax regulations ensure uniform application of the tax laws to taxpayers. Business taxpayers in particular find regulations essential in predicting the tax consequences of transactions and avoiding unanticipated tax assessments as the result of audits. Tax regulations also ensure that audits and other compliance activity cause the assessment and collection of the correct amount of tax.

Substance

Please detail any changes that will be proposed. Please outline new substantive provisions, all substantive changes to existing sections, or both where appropriate.

For changes to existing regulations, use this chart:

Current section number	Proposed new section number, if applicable	Current requirement	Proposed change and rationale
23VAC10-210-693	23VAC10-210-693(A)	The current regulation does not contain a definitions section.	Section A has been inserted to provide definitions of terms used frequently throughout the regulation.
23VAC10-210-693	23VAC10-210-693(B)	The current regulation does not provide an explanation as to the tax application of contracts solely for the	Section B has been inserted to provide an explanation of the tax application of contracts solely for the provision of services or of tangible personal property. While mixed transactions

		provision of services or of tangible personal property.	require application of the true object test, contracts solely for the provision of services or solely for the provision of tangible personal property do not require application of the true object test.
23VAC10-210-693	23VAC10-210-693(C)	The current regulation recites the true object test as it applies to government contracts.	Section C recites the language used in the original regulation.
23VAC10-210-693	23VAC10-210-693(D)	As the current regulation was written prior to the change in application of the true object test to government contracts, it does not contain a summary of the tax treatment of government contracts executed prior to July 1, 2006.	Section D has been inserted to provide an explanation of the tax treatment of mixed government contracts executed prior to July 1, 2006. The true object test is applied to the overall contract without regard to the individual orders issued prior to July 1, 2006 in furtherance of the overall contract.
23VAC10-210-693	23VAC10-210-693(E)	As the current regulation was written prior to the change in application of the true object test to government contracts, it does not contain a summary of the tax treatment of government contracts executed on and after July 1, 2006.	Section E has been inserted to provide an explanation of the tax treatment of mixed government contracts executed on and after July 1, 2006. The true object test is applied to each individual order, and not the overall contract.
23VAC10-210-693	23VAC10-210-693(F)	As the current regulation was written prior to the change in application of the true object test to government contracts, it does not contain an explanation of transitional provisions for orders entered into prior to July 1, 2006.	Section F has been inserted to explain transitional provisions for orders entered into prior to July 1, 2006. The true object test will be applied to all orders issued under all mixed government contracts if executed on or after July 1, 2006, regardless of the date on which the original contract, add-on, or order was executed.
23VAC10-210-693	23VAC10-210-693(G)	The current regulation does not contain an explanation as to what behavior constitutes taxable interim use and render the transaction taxable.	Section G has been inserted to explain the concept of taxable and exempt interim use. A taxable interim use will occur when a contractor makes an interim use of tangible personal property held for resale to a government entity pursuant to an order for the purchase of tangible personal property provided that the terms of the order in question call for the operation of the tangible personal property by the contractor and that operation is inconsistent with the holding of that property for resale. Exempt interim use will occur when the terms of the order in question call for the operation of the tangible personal property, and that operation is consistent with the holding of that property for resale.
23VAC10-210-693	23VAC10-210-693(H)	As the current regulation was written prior to the change in application of the true object test for government contracts, it does not contain an explanation of the treatment of real property contracts on or after July 1, 2006.	Section H has been inserted to explain the treatment of real property contracts on or after July 1, 2006. For real property construction contracts between a government entity and a contractor, the modified application of the true object test to individual orders will not apply. Real property contracts will apply the same test as before the July 1, 2006 change in policy.
23VAC10-210-693	23VAC10-210-693(I)	The current regulation does not address the application of the true object test to subcontracts with a government entity.	Section I has been inserted to explain the application of the true object test to subcontracts with a government entity. For purposes of this regulation, a subcontractor to a prime contract with a government entity will be granted the same tax treatment as the prime contractor when

			fulfilling its contractual obligations to the prime contractor. The subcontractor will be required to maintain suitable records and documentation in order to accurately determine the true object of an order entered into in furtherance of a contract between a prime contractor and a government entity.
23VAC10-210-693	23VAC10-210-693(J)	As the current regulation was written prior to the change in application of the true object test for government contracts, it does not contain an explanation as to how to treat mixed invoices for orders executed on or after July 1, 2006.	Section J has been inserted to explain the treatment of mixed invoices for orders executed on or after July 1, 2006. Where a single vendor order for tangible personal property purchased by a government contractor includes items used in fulfilling two or more separate orders issued under a government contract, the government contractor will determine the sales and use tax application based upon the true object of each of the two or more separate orders.
23VAC10-210-693	23VAC10-210-693(K)	The current regulation does not address how TAX will treat classified contracts, when the true object of an order requires the review of such contract.	Section K has been inserted to address classified contracts. In cases where the true object of an order requires the review of a classified government contract, TAX's authorized Classified Contract Agent will review the order to determine if the order is for the sale of tangible personal property or for the provision of services. The new regulation allows the Department to review other sources of information in cases where it is impossible or infeasible to obtain a classified contract.
23VAC10-210-693	23VAC10-210-693(L)	The current regulation does not address how consumable goods, such as office and cleaning supplies, will be treated.	Section L has been inserted to address the treatment of consumable goods. A contractor will be taxed on the cost price of all office, cleaning, clothing, and other supplies used or consumed by the contractor in the performance of any type of government contract.
23VAC10-210-693	23VAC10-210-693(M)	The current regulation does not address the government contractor's record-keeping requirements.	Section M has been inserted to address a government contractor's record-keeping requirements. It is the contractor's duty to retain suitable records and documentation in order to accurately determine the true object of an order entered into with government entities.
23VAC10-210-693	23VAC10-210-693(N)	The current regulation does not address audit methodology for government contracts.	Section N has been inserted to explain that all government contractor audits will be conducted in accordance with audit procedures as established by the Department, including but not limited to those procedures outlined in the Department's Field Audit Procedure Manual.

Alternatives

Please describe all viable alternatives to the proposed regulatory action that have been or will be considered to meet the essential purpose of the action. Also describe the process by which the agency has considered or will consider, other alternatives for achieving the need in the most cost-effective manner.

Any alternative other than the issuance of an emergency regulation would place TAX in violation of Item 268 of the 2006 Appropriations Act (House Bill 5002, Chapter 3, 2006 Acts of Assembly, Special Session I), which required that TAX work with the government contracting industry to develop an emergency regulation providing an explanation of the new application of the true object test.

Public participation

Please indicate the agency is seeking comments on the intended regulatory action, to include ideas to assist the agency in the development of the proposal and the costs and benefits of the alternatives stated in this notice or other alternatives. Also, indicate whether a public meeting is to be held to receive comments on this notice.

TAX is seeking comments on the intended regulatory action, including but not limited to 1) ideas to assist in the development of a proposal, 2) the costs and benefits of the alternatives stated in this background document or other alternatives and 3) potential impacts of the regulation. TAX is also seeking information on impacts on small businesses as defined in § 2.2-4007.1 of the Code of Virginia. Information may include 1) projected reporting, recordkeeping and other administrative costs, 2) probable effect of the regulation on affected small businesses, and 3) description of less intrusive or costly alternative methods of achieving the purpose of the regulation.

Anyone wishing to submit written comments for the public comment file may do so **at the public meeting that will be held in 2008 during the proposed regulation stage of this action** or by mail, email or fax to

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Written comments must include the name and address of the commenter. In order to be considered comments must be received by the last day of the public comment period.

A public meeting will be held during the proposed regulation stage of this action and notice of the meeting can be found in the Calendar of Events section of the Virginia Register of Regulations. Both oral and written comments may be submitted at that time.

Participatory approach

Please indicate the extent to which an ad hoc advisory group will be used in the development of the proposed regulation. Indicate that 1) the agency is not using the participatory approach in the development of the proposal because the agency has authorized proceeding without using the participatory approach; 2) the agency is using the participatory approach in the development of the proposal; or 3) the agency is inviting comment on whether to use the participatory approach to assist the agency in the development of a proposal.

TAX formed a Technical Advisory Group consisting of representatives of the government contracting industry and tax practitioners to assist in the drafting of the emergency regulation. TAX anticipates using the same group of representatives to develop the proposed regulation.

Family impact

Assess the potential impact of the proposed regulatory action on the institution of the family and family stability including to what extent the regulatory action will: 1) strengthen or erode the authority and rights of parents in the education, nurturing, and supervision of their children; 2) encourage or discourage economic self-sufficiency, self-pride, and the assumption of responsibility for oneself, one's spouse, and one's children and/or elderly parents; 3) strengthen or erode the marital commitment; and 4) increase or decrease disposable family income.

This regulatory action is not expected to have an impact on family formation, stability and autonomy.