



Fast Track Proposed Regulation Agency Background Document

Agency name	Department of Taxation
Virginia Administrative Code (VAC) citation	23 VAC 10 –210-693
Regulation title	Government contractors
Action title	Promulgation of a Permanent Regulation to Replace the Emergency Regulation for 23 VAC 10–210-693 Government Contractors
Date this document prepared	April 11, 2008

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*.

Brief summary

Please provide a brief summary (no more than 2 short paragraphs) of the proposed new regulation, proposed amendments to the existing regulation, or the regulation proposed to be repealed. Alert the reader to all substantive matters or changes.

The 2006 Budget Bill (House Bill 5002, 2006 *Acts of Assembly*, Chapter 3, Special Session I), changed the application of the true object test under the Retail Sales and Use Tax, as it applies to contractors doing business with the federal, state, and local governments. Prior to this change, government contractors applied the “true object test” to the underlying contract between the contractor and the government entity to determine the retail sales and use tax application. The 2006 Budget Bill changed the process by requiring 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 would be 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.

Under the terms of the budget bill, the Department of Taxation (“TAX”) was required to work with the government contracting industry to promulgate an emergency regulation on or before June 30, 2007, to implement this change in tax policy. *Code of Virginia*, § 2.2-4011 authorizes the adoption of emergency regulations in emergency situations, which are defined to include 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. Emergency regulations are limited to 12 months in duration, after which

time, the agency is authorized to promulgate a permanent regulation to replace the emergency regulation. Pursuant to this provision, TAX issued an emergency regulation on July 26, 2007, which will expire on July 25, 2008. The current regulatory action will provide a permanent regulation replacing the emergency regulation.

As mandated by the provisions of the Budget Bill, TAX worked closely with the government contracting industry to develop the emergency regulation. TAX solicited suggestions, comments, and additional information as to industry practices in order to define terms, develop relevant examples and to ensure accuracy of the provisions of the emergency regulation.

TAX has continued to work with the government contracting industry in developing the permanent regulation. TAX made several changes to the emergency regulation text based on additional comments received from the industry subsequent to the promulgation of the emergency regulation. A draft of the permanent regulation was then submitted to the industry, which had no objections to the changes made subsequent to promulgation of the emergency regulation. TAX has made no substantive changes to the proposed regulation following the distribution of the draft to the government contracting industry. As TAX has worked closely with the government contracting industry to develop this regulation, TAX expects this regulatory action to be noncontroversial.

Statement of final agency action

Please provide a statement of the final action taken by the agency including (1) the date the action was taken, (2) the name of the agency taking the action, and (3) the title of the regulation.

The Tax Commissioner approved the replacement of the emergency regulation which is currently in effect, 23VAC10-210-693, with the text contained in this regulatory action on April 11, 2008.

Legal basis

Please identify the state and/or federal legal authority to promulgate this proposed regulation, including (1) the most relevant law and/or regulation, including General Assembly chapter number(s), if applicable, and (2) promulgating entity, i.e., the agency, board, or person. Describe the scope of the legal authority and the extent to which the authority is mandatory or discretionary.

The 2006 Budget Bill (House Bill 5002, Chapter 3, 2006 Acts, Special Session I), changed the application of the true object test under the Retail Sales and Use Tax, as it applies to contractors doing business with the federal, state, and local governments by requiring 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 would be 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. Under the terms of the budget bill, TAX was required to work with the government contracting industry to promulgate an emergency regulation on or before June 30, 2007, to implement this change in tax policy. As emergency regulations are limited to twelve months in duration pursuant to *Code of Virginia* § 2.2-4011, TAX is promulgating this replacement permanent regulation. TAX's authority to promulgate the emergency regulation was mandatory. Although TAX's authority to issue this permanent regulation is discretionary, the permanent regulation is necessary to repeal the former permanent regulation and to reflect the policies set forth in the 2006 Budget Bill and the emergency regulation on a permanent basis.

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.” The authority to replace the emergency regulation with this proposed regulation is discretionary.

Purpose

Please explain the need for the new or amended regulation. Describe the rationale or justification of the proposed regulatory action. Detail the specific reasons the regulation is essential to protect the health, safety or welfare of citizens. Discuss the goals of the proposal and the problems the proposal is intended to solve.

The emergency regulation was promulgated on July 26, 2007, and will expire on July 25, 2008. The language contained in the 2006 Budget Bill, requiring that the true object test be applied at the order level, rather than at the contract level, will remain in effect.

This regulatory action is intended to perpetuate the emergency regulation. As with the emergency regulation, this regulation provides a summary of the law, as applied prior to July 1, 2006, and describes the change in law as a result of the budget language. Definitions for statements of work are included, as are definitions for orders, which encompass task orders, delivery orders, and similar work orders. The regulation also provides an explanation and examples as to the treatment of subcontractors to a governmental contract. In addition, based upon mandates included in the 2006 Budget Bill, this regulation includes 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 in which exempt interim use is made incidental to a resale to the government. The regulation deviates from the emergency regulation only to the extent that it adds a definition for contractor, includes additional examples to provide further clarification, and makes minor style changes, pursuant to the Virginia Style Manual.

Rationale for using fast track process

Please explain the rationale for using the fast track process in promulgating this regulation. Why do you expect this rulemaking to be noncontroversial?

Please note: If an objection to the use of the fast-track process is received within the 60-day public comment period from 10 or more persons, any member of the applicable standing committee of either house of the General Assembly or of the Joint Commission on Administrative Rules, the agency shall (i) file notice of the objection with the Registrar of Regulations for publication in the Virginia Register, and (ii) proceed with the normal promulgation process with the initial publication of the fast-track regulation serving as the Notice of Intended Regulatory Action.

As mandated by the provisions of the Budget Bill, TAX worked closely with the government contracting industry to develop the emergency regulation. TAX solicited suggestions, comments, and additional information as to industry practices in order to define terms, develop relevant examples and to ensure accuracy of the provisions of the emergency regulation.

TAX has continued to work with the government contracting industry in developing the permanent regulation. TAX made several changes to the emergency regulation text based on additional comments received from the industry subsequent to the promulgation of the emergency regulation. A draft of the permanent regulation was then submitted to the industry, which had no objections to the changes made subsequent to promulgation of the emergency regulation. TAX has made no substantive changes to the proposed regulation following the distribution of the draft to the government contracting industry. As TAX

has worked closely with the government contracting industry to develop this regulation, TAX expects this regulatory action to be noncontroversial.

Substance

Please briefly identify and explain the new substantive provisions, the substantive changes to existing sections, or both where appropriate. (Provide more detail about these changes in the "Detail of changes" section.)

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		Prior to promulgation of the emergency regulation, the true object test was applied at the contract level for contracts between contractors and government entities. The emergency regulation changed the application of the true object test to the order level for contracts between contractors and government entities	The concepts set forth in the emergency regulation are retained, but additional examples and definitions are added to provide further clarification as to the new application of the true object test. For additional information, see the Detail of Changes section on this form.

Issues

Please identify the issues associated with the proposed regulatory action, including:

- 1) the primary advantages and disadvantages to the public, such as individual private citizens or businesses, of implementing the new or amended provisions;*
- 2) the primary advantages and disadvantages to the agency or the Commonwealth; and*
- 3) other pertinent matters of interest to the regulated community, government officials, and the public.*

If there are no disadvantages to the public or the Commonwealth, please indicate.

This regulatory action will ease voluntary taxpayer compliance and TAX's administration of the state tax laws by providing clarification as to the treatment of government contracts following the expiration of the emergency regulation on July 25, 2008. The regulation will provide a summary of the law, as applied prior to July 1, 2006, and describe the change in law as a result of the budget language. Definitions for statements of work will be included, as will definitions for orders, which will encompass task orders, delivery orders and similar work orders. The regulation will also provide an explanation and examples as to the treatment of subcontractors to a governmental contract. The regulation will also 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. By clarifying these concepts, TAX ensures uniform application of the tax laws to taxpayers, particularly, businesses contracting with government entities. In addition, businesses will be better equipped to predict the tax consequences of transactions and avoid unanticipated tax assessments as the result of audits.

As this regulation perpetuates an emergency regulation mandated by the 2006 Budget Bill, this regulatory action poses no disadvantages to the public or the Commonwealth.

Requirements more restrictive than federal

Please identify and describe any requirement of the proposal which is more restrictive than applicable federal requirements. Include a rationale for the need for the more restrictive requirements. If there are no applicable federal requirements or no requirements that exceed applicable federal requirements, include a statement to that effect.

The United States Constitution declares itself the supreme law of the land (U.S. Const. Art. VI, Cl. 2). States are generally precluded from taxing the federal government without its consent. *McCulloch v. Maryland*, 17 U.S. 316.

Although the federal government and its agencies have immunity from sales and use taxes, the immunity does not extend to contractors performing contracts for the government, unless the contractor is clearly a government agent, and title to purchases passes directly to the government. Because this regulatory action extends an exemption from the state sales and use tax to contractors contracting with state, federal, and local government entities, provided certain requirements are met, the proposal is not more restrictive than applicable federal requirements.

Localities particularly affected

Please identify any locality particularly affected by the proposed regulation. Locality particularly affected means any locality which bears any identified disproportionate material impact which would not be experienced by other localities.

No localities are particularly affected by this regulatory action.

Regulatory flexibility analysis

Please describe the agency's analysis of alternative regulatory methods, consistent with health, safety, environmental, and economic welfare, that will accomplish the objectives of applicable law while minimizing the adverse impact on small business. Alternative regulatory methods include, at a minimum: 1) the establishment of less stringent compliance or reporting requirements; 2) the establishment of less stringent schedules or deadlines for compliance or reporting requirements; 3) the consolidation or simplification of compliance or reporting requirements; 4) the establishment of performance standards for small businesses to replace design or operational standards required in the proposed regulation; and 5) the exemption of small businesses from all or any part of the requirements contained in the proposed regulation.

TAX has considered modifying the regulatory methods for small businesses. The regulatory methods follow the least intrusive and burdensome method consistent with statutory language, and could not be made less burdensome for small businesses without jeopardizing the enforcement of the tax laws.

Economic impact

Please identify the anticipated economic impact of the proposed regulation.

Projected cost to the state to implement and enforce the proposed regulation, including (a) fund source / fund detail, and (b) a delineation of one-time versus on-going expenditures	As the proposed regulation is declarative of current law as set forth in the 2006 Budget Bill and of current sales tax policy, the projected cost to the state to implement and enforce the proposed regulation is expected to be <i>de minimis</i> .
Projected cost of the regulation on localities	As the proposed regulation is declarative of current law and sales tax policy, the projected cost of the regulation on localities is <i>de minimis</i> .
Description of the individuals, businesses or other entities likely to be affected by the regulation	As the proposed regulation is declarative of current law and sales tax policy, this regulation will not impact individuals, businesses or other entities beyond the impact of current law.
Agency’s best estimate of the number of such entities that will be affected. Please include an estimate of the number of small businesses affected. Small business means a business entity, including its affiliates, that (i) is independently owned and operated and (ii) employs fewer than 500 full-time employees or has gross annual sales of less than \$6 million.	As the proposed regulation is declarative of current law and sales tax policy, it will affect no individuals, businesses or other entities not affected by current law.
All projected costs of the regulation for affected individuals, businesses, or other entities. Please be specific. Be sure to include the projected reporting, recordkeeping, and other administrative costs required for compliance by small businesses.	As the proposed regulation is declarative of current law and sales tax policy, it will result in no costs for individuals, businesses or other entities beyond those costs already imposed as a result of current law.

Alternatives

Please describe any viable alternatives to the proposal considered and the rationale used by the agency to select the least burdensome or intrusive alternative that meets the essential purpose of the action. Also, include discussion of less intrusive or less costly alternatives for small businesses, as defined in §2.2-4007.1 of the Code of Virginia, of achieving the purpose of the regulation.

TAX considered alternatives to the proposed regulatory action. Allowing the emergency regulation to expire without providing a replacement regulation would bring the regulation back into effect as it existed prior to promulgation of the emergency regulation, thereby creating inconsistency between the 2006 Budget Bill and the regulation. This would result in confusion in the government contracting industry and would reduce the level of customer service and, as a result, tend to reduce the level of voluntary compliance with the tax laws. TAX could also allow the emergency regulation to expire, and subsequently repeal the regulation that existed prior to the emergency regulation’s promulgation. Although this would eliminate the potential for a regulation that is inconsistent with the 2006 Budget Bill, taxpayers would have limited guidance as to how to treat mixed government contracts and orders, beyond the guidance provided in the budget bill. This, too, would cause confusion in the government

contracting industry and likely reduce the level of voluntary compliance. Audit and compliance activity would produce less uniform results and would be much less effective in enforcing the tax laws.

Since 1980, administrative interpretations of the tax laws that are not in the form of published rulings or a regulation have not been admissible as evidence in court. Code of Virginia, § 58.1-205. Even published “rulings and policies themselves are not entitled to great weight, unless expressed in regulations.” *Chesapeake Hospital Authority v. Commonwealth*, 262 Va. 551, 5554 S.E. 2d 55 (2001). Therefore, to ensure enforcement, it is necessary to promulgate regulations containing the Tax Commissioner’s interpretations of the tax laws.

Family impact

Please assess the 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.

Detail of changes

Please detail all changes that are being proposed and the consequences of the proposed changes. Detail all new provisions and/or all changes to existing sections.

If the proposed regulation is intended to replace an emergency regulation, please list separately (1) all changes between the pre-emergency regulation and the proposed regulation, and (2) only changes made since the publication of the emergency regulation.

Changes between pre-emergency regulation and emergency regulation: Strike all language in original 23VAC10-210-693 and replace with new “emergency regulation” language. The true object test will be applied at the order level for contracts between contractors and government entities.

Changes between emergency regulation and current regulatory action: Additional definitions and examples added for clarification of policy that was set forth in the emergency regulation.

Current Section Number	Proposed Section Number for Emergency Regulation	Changes between Pre-emergency Regulation and Emergency Regulation	Changes between Emergency Regulation and Current Regulatory Action
N/A	Section A— Definitions	Adds a “definitions” section which defines terms such as mixed contract, order, purchase for resale, statement of work, subcontractor, and true object test.	<ul style="list-style-type: none"> • Adds a definition for “contractor,” and includes under the definition a prime contractor, contractor, subcontractor, and other terms intended to convey that obligation. • Under the definition of subcontractor, adds the provision that other references conveying the relationship at any tier between the contractor and the entity

			<p>performing the work under the subcontract will be considered a subcontractor.</p> <ul style="list-style-type: none"> • Adds a definition for “vendor,” as a person who is not a contractor or subcontractor, and who transfers tangible personal property by sale. • Alters the definition of vendor order to reference subsection E, in which vendor orders are described in greater detail.
N/A	Section B— Treatment of mixed government contracts...	Sets forth the policy with respect to mixed government contracts, which require application of the true object test, and contracts solely for the provision of services or tangible personal property, or real property contracts, which do not require application of the true object test.	Alters example 2 to describe a mixed contract that more clearly would be deemed a contract for the provision of tangible personal property. Rather than having the terms of the contract require that the contractor provide a computer system and operate that system, the contract calls for the provision of the computer system and for the contractor to develop and oversee training to use the system.
N/A	Section C— True object test; generally.	Sets forth the true object test, as articulated in 23VAC10-210-4040.	No substantive changes.
N/A	Section D—Tax treatment of government contracts executed prior to July 1, 2006.	Restates the policy that prior to July 1, 2006, the true object test is to be applied to the underlying mixed contract, without regard to the individual orders issued prior to July 1, 2006 in furtherance of those contracts.	No substantive changes.
	Section E—Tax treatment of orders executed on and after July 1, 2006.	Sets forth the policy for mixed contracts and orders issued pursuant to such contracts on and after July 1, 2006. The true object test is to be applied to the order issued in furtherance of the contract, and not the underlying contract.	Adds language that clarifies that the amended treatment of orders executed on and after July 1, 2006 does not apply to vendor orders and adds two examples in addition to the existing examples to clarify this policy.
	Section F— Transitional provisions for orders entered into prior to July 1, 2006.	Sets forth the policy for orders executed on or after July 1, 2006, when contracts were entered into prior to that date. The true object test is to be applied to each of these orders, regardless of the date on which the contract was executed.	No substantive changes.
	Section G— Interim use.	Sets forth the policy that when a contractor makes an interim use of tangible personal property that is held for use in the government contract, this will constitute a taxable use. The section provides examples of taxable interim use, as mandated by the 2006 Budget Bill.	No substantive changes.
	Section H— Real property contracts with government entities.	Sets forth the policy that the revised application of the true object test does not apply when the contract at issue is a real property contract.	No substantive changes.

	Section I— Subcontractor activities.	Sets forth the policy that, for purposes of this regulation, a subcontractor to a government contract will receive the same tax treatment as the prime contractor, regardless of how far removed the subcontractor is from the original contract. Additionally, sets forth subcontractor record keeping requirements.	Alters the requirement set forth in the emergency regulation <u>permitting</u> prime contractors that issue orders to subcontractors in furtherance of a government contract to provide documentation so that the subcontractor can prove the order was in furtherance of a government contractor, and makes the provision of such documentation by the prime contractor mandatory.
	Section J— Mixed invoices.	Sets forth the policy with respect to a single invoice for tangible personal property that includes items used in fulfilling two or more separate orders issued under a government contract. The items used to fulfill the order for tangible personal property can be purchased exempt of the sales tax, and those used to fulfill the order for the provision of services are subject to the tax.	No substantive changes.
	Section K— Classified contracts.	Sets forth the policy that requires the Department's Classified Contract Agent to review classified government contracts to determine whether the order is for the sale of tangible personal property or services.	No substantive changes.
	Section L— Consumable goods.	Sets forth the policy that contractors are subject to sales tax on purchases of office, cleaning and other consumable goods used in the performance of any government contract.	No substantive changes.
	Section M— Record keeping requirements of the contractor	Sets forth the Department's policy with respect to review of government contracts, stating that TAX will generally rely on the language used in each individual order, but may consider other source documents, and will rely on the normal books and records kept by the contractor in its ordinary course of business to determine whether a particular purchase was made to fulfill a particular order.	Adds language requiring that the contractor continue to abide by the recordkeeping requirements imposed upon every taxpayer, and set forth at 23VAC10-210-470.
	Section N— Audit methodology	Sets forth the policy that government contractor audits will be conducted in accordance with procedures established by TAX, including those outlined in the TAX's Field Audit Procedure Manual.	No substantive changes.