



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

Date Amended:	<b>05/18/10</b>	Bill No:	<a href="#"><u>AB 2060</u></a>
Tax:	<b>Sales and Use</b>	Author:	<b>Calderon</b>
Related Bills:	<b>AB 1523 (Calderon)</b>	Position:	

**BILL SUMMARY**

This bill would provide an exemption from the state sales and use tax an amount equal to an amount that is attributable to an increase in the sales and use tax rate for specified fixed price contracts with government entities and qualified contractors, as defined, entered into prior to a sales and use tax rate increase.

**ANALYSIS**

**CURRENT LAW**

Existing law imposes a sales or use tax on the sale or purchase of tangible personal property in this state, unless specifically exempted.

As of April 1, 2009, the statewide sales and use tax rate of 8.25% is imposed on taxable sales and purchases of tangible personal property, and is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
4.75% 0.25% <u>1.00%</u> 6.00%	State (General Fund)	6051, 6201, 6051.3, 6201.3 6051.7, 6201.7
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

**PROPOSED LAW**

This bill would add Section 6376.3 to the Revenue and Taxation Code to provide that during the period of a sales and use tax rate increase, there is an exemption of an amount equal to an amount that is attributable to the increased rate of tax for sales and purchases of the following:

- Tangible personal property, if the seller is obligated to furnish a government entity or the government entity is obligated to purchase the property for a fixed

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price pursuant to a contract entered into prior to the operative date of the increase.

- Materials and fixtures obligated pursuant to an engineering construction contract or a building construction contract entered into for a fixed price prior to the operative date of the rate increase, when a government entity is a party to the contract or where a qualified contractor is obligated to sell or furnish the materials and fixtures. A “qualified contractor” would be defined as a construction contractor with no more than \$1 million in gross receipts from business operations and no more than \$250,000 in taxable income in the prior taxable year.
- A lease of tangible personal property to a government entity that is a continuing sale of the property for any period of time for which the lessor is obligated to lease the property for an amount fixed by the lease prior to the operative date of the rate increase.
- The possession of, or the exercise of, any right or power over tangible personal property pursuant to a lease that is a continuing purchase of the property for any period of time for which the lessee is a government entity and is obligated to lease the property for an amount fixed by a lease entered into prior to the operative date of the rate increase.

The bill would specify that (1) tangible personal property, (2) the sale or lease of tangible personal property, and (3) the storage, use, or other consumption of, or possession of, or exercise of any right or power over, tangible personal property, shall not be deemed obligated pursuant to a contract or lease for any period of time for which any party to the contract or lease has the right to terminate the contract or lease upon notice, whether or not the right is exercised.

The bill would define “fixed price” for purposes of the proposed exemption for sales and purchases of materials and fixtures obligated pursuant to an engineering contract to mean that the prices or price specified in the contract is a lump sum price or a stated unit price or a guaranteed maximum price and the contract does not authorize an increase in price due to an increase in the rate of tax. The bill further defines “guaranteed maximum price” to mean that the price specified in the contract is for actual costs plus a fixed fee, but subject to a maximum price.

The bill would define “government entity” as the United States, the State of California, or any city, county, or city and county, community college district, school district, county superintendent of schools or special district in this state.

The bill would specify that these provisions shall apply only to increases in the sales and use tax rate that occur on or after the effective date of the bill.

The bill would become effective immediately upon enactment.

#### **BACKGROUND**

ABx3 3 (Ch. 18, Stats. 2009, Third Extraordinary Session), a special session measure to deal with the state's fiscal crisis, was signed into law on February 20, 2009. Among other things, that measure increased the State's General Fund sales and use tax rate by one percent. However, that measure, nor existing law, provided an exemption for

sales of tangible personal property obligated pursuant to fixed price contracts entered into prior to the rate increase.

In the past, however, legislation enacting sales and use tax increases has contained provisions that exempted sales of tangible personal property obligated pursuant to fixed price contracts and fixed price leases from the rate increase. For example, California's last state sales and use tax increase occurred in July 1991 with the enactment of AB 2181 (Ch. 85, Stats. 1991) and SB 179 (Ch. 88, Stats. 1991). The rate was increased by 1.25 percent in response to the budget shortfall and the exemption for sales of property obligated pursuant to fixed price contracts entered into prior to the operative date of the increase was part of that enactment.

Prior to that increase, for a 13-month period beginning December 1, 1989 and ending December 31, 1990, a 0.25 percent state sales and use tax increase was enacted in response to the October 17, 1989 earthquake (commonly referred to as the Loma Prieta earthquake) in the San Francisco Bay Area (SBx1 33, Ch. 14, Stats. 1990, First Extraordinary Session). That measure also contained an exemption for sales of property obligated pursuant to fixed price contracts entered into prior to the date of the rate increase.

A general fixed price contract exemption is also contained in the Transactions and Use Tax Law (and has been since 1979) for purposes of exempting all sales of property obligated pursuant to fixed price contracts from the various city and county tax rate increases when those contracts are entered into prior to the operative date of those rate increases (see Revenue and Taxation Code Sections 7261(g) and 7262(f)).

## COMMENTS

- 1. Sponsor and Purpose.** The sponsor of this bill is the Associated General Contractors of California. According to the author's office, its purpose is to protect contractors with fixed price contracts from bearing the cost of a sales and use tax rate increase that cannot be passed onto their customers.
- 2. This bill is intended to address an issue of equity – but only for some.** A fixed price contract exemption is designed to protect the business expectations of the parties when they entered into the contract and protect them from an unplanned increase in tax rate. Under a fixed price contract, the contractor assumes all of the cost variation risk and reward. If the cost exceeds the contract price, the difference comes out of the contractor's pocket. Absent an exemption for fixed price contracts, when the sales and use tax rate increased on April 1, 2009, for existing contracts entered into prior to that date, the contractors are liable for the increase in the sales and use tax rate on any purchases and sales made pursuant to the contract on or after April 1, 2009. However, due to the nature of a fixed price contract, the contractor may not pass that increase on to the customer or recoup his or her costs in any other manner. Consequently, the contractor alone must bear the out-of-pocket cost of the rate increase. Enactment of this bill would assure that, within the limitations of the bill, a contractor's liability for sales or use tax in connection with purchases made subsequent to enactment of this bill pursuant to fixed price contracts and fixed price lease agreements entered into prior to a rate increase, would be limited to the sales and use tax rate in effect at the time the contractor and his or her customer entered into the contract. This change would also eliminate any issues between a contractor and his or her

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customer in cases where a contractor inappropriately attempts to collect the additional tax from the customer on a qualifying fixed price contract. However, since the bill is intended to fix an inequity, is it fair to limit its provisions to contracts entered into with a government entity or by certain contractors that fall within the income thresholds? Shouldn't all affected taxpayers be considered?

- 3. Proposed definition of "fixed price" is broader than the Board's current rulings.** The Board currently administers an exemption for fixed price contracts under the Transactions and Use Tax Law (since each new district tax levied raises similar concerns), and has administered fixed price contract exemptions on past statewide sales and use tax increases. As a result, the Board has a substantial body of annotations that summarize the conclusions reached in selected rulings of the Board's Legal staff that clarify what constitutes a "fixed-price" contract for purposes of these exemptions.

These conclusions consistently provide that, in order to qualify as "fixed price," the contract must satisfy the following criteria:

- (1) It must be binding prior to the rate increase;
- (2) Neither party may have an unconditional right to terminate the contract;
- (3) The agreement must fix the amount of all costs at the outset; and
- (4) The agreement must include a provision that fixes the tax obligation on a tax-included basis or sets forth either the amount or the rate of tax and does not provide for an increase in the amount of tax. (Note, a contract that contains no provisions at all regarding California sales or use taxes, still qualifies as fixed price if the other criteria are satisfied).

It appears the difference between these criteria with the criteria in this bill hinges primarily on criteria (3) above. The bill does not require that the contract fix the amount of all costs at the outset. Instead, the bill would simply require that the contract contain a "guaranteed maximum price," which, by definition, would enable a contractor to be paid for his or her "actual costs." By enabling a contractor to be reimbursed for his or her actual costs, which could include the sales tax at the higher rate, such a contract would not qualify as "fixed price" under current legal rulings. Therefore, it appears more types of contracts would qualify as "fixed price" than have in the past (although overall, less contracts would qualify since the bill would limit the exemption in other ways).

- 4. Bill would broaden the fixed price contract exemption for construction contracts entered into before district tax increases.** Local ordinances to adopt additional local district taxes or to increase existing local district taxes (Parts 1.6 and 1.7 of the Revenue and Taxation Code) are required to contain provisions identical to those contained in Part 1 of the Revenue and Taxation Code (the Sales and Use Tax Law). Also, Revenue and Taxation Code Sections 7261(g) and 7262(f) under Part 1.6 requires ordinances proposing new local district taxes contain fixed price contract provisions for all sales and purchases of tangible personal property obligated pursuant to a fixed price contract, and fixed price leases of property entered into prior to any district tax rate increase. Accordingly, since this bill would change the definition of a "fixed price" to include additional types of contracts (i.e., guaranteed maximum price contracts) under Part 1 for

purposes of materials and fixtures obligated pursuant to a guaranteed maximum price construction contract, it appears that change would apply to construction contracts entered into prior to the date new district taxes are imposed under Part 1.6 and Part 1.7. Accordingly, this bill would not only have an impact on future state sales and use taxes, it could also affect future district tax revenues with respect to materials and fixtures obligated pursuant to guaranteed maximum price construction contracts entered into prior to any new local district taxes and acquired after the rate increase and after enactment of this bill. Since 2009, voters in about 16 different local jurisdictions have approved district tax increases.

**5. Different set of standards for state taxes than district taxes.** Under this bill, for state tax rate increases, only certain fixed price contracts and leases would qualify for the exemption – those with government entities, and those construction contracts entered into with smaller contractors. However, for district tax increases, all fixed price contracts entered into with any purchaser or any contractor, or fixed price lease entered into with any lessor or lessee, would qualify for the district tax fixed price contract exemption if entered into prior to a district tax increase. This different set of standards could cause confusion.

**6. Bill should clarify whether an extension of the one percent sales and use tax rate would be regarded as a tax increase.** For fixed price contracts entered into after the April 1, 2009 one percent sales and use tax rate increase that contemplated the expiration of the increase effective July 1, 2011, it is recommended that the bill clarify that any extension of that rate increase would be regarded as an increase in the sales and use tax for purposes of the proposed fixed price contract exemption. Otherwise, the strict wording of the language of the bill could be interpreted to mean that any extension of the rate on July 1, 2011 is not an “increase in the sales and use tax rate” and that contractors and lessors would be liable for the tax, yet not be able to reimburse themselves for the additional tax during the period of the extension. The following language is recommended to be added as a new subdivision (d):

(d) If, on or before July 1, 2011, the sales and use tax rate imposed pursuant to Sections 6051.7 and 6201.7 as added by Chapter 18, Statutes of 2009, Third Extraordinary Session, or any portion thereof, is extended for a period or periods on and after July 1, 2011, the sales and use tax rate during the extended period or periods shall be regarded as “an increase in the sales and use tax rate” for purposes of subdivision (a).

**7. Related legislation.** Last year, AB 1523 (Calderon) would have provided an exemption for fixed price contracts entered into prior to the April 1, 2009 sales and use tax increase. That bill died in the Assembly Appropriations Committee.

## **COST ESTIMATE**

Some costs would be incurred in immediately notifying retailers and contractors, revising publications and the Board’s website, and providing directives to staff. An estimate of these costs is pending.

**REVENUE ESTIMATE**

**BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

This bill would have no affect on state or local revenues, since the provisions would only apply to future sales and use tax increases.

To determine the annual revenue impact on future sales and use tax increases, we would have to determine the value of fixed price continuing leases of tangible personal property with government entities and the dollar amount of fixed price construction contracts with government entities and small contractors. We do not have data that indicates the volume of qualifying fixed price continuing leases or fixed price contracts with small contractors. However, using construction contract information from the Division of Engineering Services of the California Department of Transportation (Caltrans) alone, we found that approximately 50 fixed price contracts had been awarded in 2008 valuing over \$382 million. If we assume that the dollar amount of contracts entered into in 2008 is representative of the dollar amount of fixed price contracts in the future, and that at least half of the value of these contracts represents materials and fixtures, then at least \$191 million ( $\$382 \text{ million} / 2$ ) would be attributable to purchases of tangible personal property obligated pursuant to fixed price contracts for Caltrans alone.

**REVENUE SUMMARY**

We cannot determine with any degree of certainty the total revenue associated with this bill's proposed fixed price contract exemption that would be foregone with future sales and use tax increases. However, based on Caltrans contracts alone, we estimate that a fixed price contract exemption could result foregone revenues of at least \$1.91 million ( $\$191 \text{ million} \times 1\%$ ) for a one percent sales and use tax increase.

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