



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	05/10/11	Bill No:	<a href="#">Assembly Bill 780</a>
Tax Program:	Sales and Use	Author:	Calderon
Sponsor:	Associated General Contractors	Code Sections:	RTC 7261 & 7262
Related Bills:		Effective Date:	01/01/12

### BILL SUMMARY

This bill would:

- Add a provision in the Public Contract Code that requires fixed price contracts, as defined, between a contractor and a government entity to authorize payment for a change in the contract price that is attributable to an increase or decrease in the state sales and use tax rate, and
- Amend the Transactions and Use Tax Law to specify that, with respect to the sale or lease to a government entity, as defined, tangible personal property shall be deemed obligated pursuant to a contract for any period of time for which the *contractor or lessor* does not have the unconditional right to terminate the contract or lease.

#### Summary of Amendments

Since the previous analysis, this bill was amended to, among other things, specify that with respect to the district tax exemption for tangible personal property obligated pursuant to a fixed price contract or lease, the sale or lease of tangible personal property to a government entity shall be deemed obligated pursuant to a contract or lease for any period of time for which the contractor or lessor does not have the unconditional right to terminate that contract or lease.

### 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. The sales tax is imposed on the retailer, and whether a retailer may add sales tax reimbursement to the sales price of the tangible personal property sold at retail to a purchaser depends solely upon the terms of the agreement of sale. Under Civil Code Section 1656.1, it is presumed that the parties agreed to the addition of sales tax reimbursement if:

- The agreement of sale expressly provides for such addition of sales tax reimbursement;
- Sales tax reimbursement is shown on the sales check or other proof of sale; or
- The retailer posts in his or her premises in a location visible to purchasers, or includes on a price tag or in an advertisement or other printed material directed to purchasers, a notice to the effect that reimbursement for sales tax will be added.

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Under existing law, when a *state* sales and use tax rate increases, a retailer is required to remit tax on all sales made on or after the date of the rate increase at the rate in effect at the time of sale, regardless of whether or not the retailer is locked into a fixed price contract before the rate increase, and regardless of whether or not the retailer may reimburse himself or herself for the tax. Existing state sales and use tax law does not provide an exemption from the increased sales or use tax on sales made after a rate increase pursuant to fixed price contracts entered into prior to a rate increase.

However, a general fixed price contract exemption is 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 (district) 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)). Under these provisions, tangible personal property is *not* deemed obligated pursuant to fixed price contracts (and the sale or purchase is not exempted from the district rate increase) if *either party* to the contract has the unconditional right to terminate the contract. Accordingly, if either a purchaser or a seller may terminate a contract, the contract is not regarded as a qualifying fixed price contract, and the exemption from the increased district tax is not allowable.

The additional district taxes that are levied among various local jurisdictions range from 1/10% to 2.5%. Since 2009, voters in about 30 different local jurisdictions have approved new district taxes within their local areas. Altogether, voters have approved over 100 district taxes that are levied in various cities and counties throughout California.

#### **PROPOSED LAW**

This bill would add Section 7111 to the Public Contract Code and amend Sections 7261 and 7262 of the Transactions and Use Tax Law to do the following:

- In the Public Contract Code, require a fixed price contract, as specified, between a government entity and a contractor to authorize payment for a change in the contract price that is attributable to an increase or decrease in the *state* sales and use tax rate, with the increase or decrease paid in accordance with the contract terms or as agreed to by the parties, as specified.
- In the Transactions and Use Tax Law, specify that, with respect to tangible personal property sold or leased to a government entity, the tangible, personal property shall be deemed obligated pursuant to a contract or lease, if the *contractor or lessor* does not have the unconditional right to terminate the contract or lease.
- Define “government entity” as the State of California, any city, county, community college district, school district, county superintendent of schools, or special district in this state.

The bill would be effective January 1, 2012.

#### **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, neither that measure, nor existing law, provided an

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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 all fixed price contracts. 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.

Last year, AB 2060 (Calderon), which was substantially the same as this measure, was vetoed by Governor Schwarzenegger. The Governor’s veto message stated the following:

“First, I can understand the impact of new taxes on businesses and the frustration that contractors may have when they are not exempted from sales tax increases. This is one of the reasons I have continued to oppose raising additional taxes because it slows our state's economic recovery efforts and dampens job creation. However, this bill seeks an overly broad and permanent exemption which effectively shifts the burden of paying both state and local sales tax increases from the contractor to the government entity and ultimately, on California's taxpayers. In addition, I believe this bill is unnecessary because current law allows an exemption to fixed-price contracts for city and county tax increases, and such exemptions have been allowed on past statewide sales and use tax increases. I believe this process is appropriate and does not affect district tax revenues, as this bill would propose to do. For these reasons, I am unable to sign this bill.”

## 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 with government entities from bearing the cost of a sales and use tax rate increase that cannot be passed on to their government entity customers.
- 2. The May 10, 2011 amendments provide a more narrow approach.** Instead of the previous version that would have deemed any tangible personal property obligated pursuant to a contract or lease for any period for which the *seller or lessor* has the unconditional right to terminate the contract or lease, these amendments specify that this would only apply with respect to sales or leases to government entities. These amendments also make clarifying changes to the Public Contract Code provisions.

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- 3. The proposed changes in the Transactions and Use Tax Law would broaden the scope of the existing exemption.** 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 state or local sales and use tax rates increase, for existing contracts entered into prior to the rate increase, 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 the date of the rate change. 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. The Transactions and Use Tax Law provides a remedy to this, by allowing an exemption from the local district rate increase, certain sales made after the rate increase pursuant to fixed price contracts entered into prior to the rate increase.

The changes proposed in this bill to the Transactions and Use Tax Law were requested by the sponsors, as they indicate that currently, government entities may not enter into contracts for which they do not have the unconditional right to terminate the contract. Consequently, the existing district tax exemption would never apply to contracts with government entities, since the law is specific that neither party may have the unconditional right to terminate the contract in order for the exemption to apply.

Enactment of these changes would assure that a contractor's liability for transactions and use taxes in connection with contracts or leases entered into prior to a local district rate increase with a government entity would be limited to the tax rate in effect at the time the contractor or lessor and the government entity entered into the contract or lease, provided the contractor or lessor does not have an unconditional right to terminate the contract or lease.

- 4. Proposed changes to the Public Contract Code would not affect the BOE's administration of the Sales and Use Tax Law.** With the proposed changes to the Public Contract Code, a seller, contractor, or lessor that enters into a fixed price contract, as defined within that Code, with a government entity prior to any state sales and use tax rate increase would have the ability to reimburse himself or herself for the increase in tax for those taxable sales made pursuant to that contract during the period of the rate increase. It would also ensure that the seller, contractor, or lessor would not be unjustly enriched in situations where a fixed price contract is entered into prior to a rate decrease (since the seller, contractor, or lessor's liability for sales or use tax for sales made subsequent to the rate decrease would be limited to the reduced tax rate).

**COST ESTIMATE**

Some minor costs would be incurred with respect to the bill's changes to the Transactions and Use Tax Law. However, the BOE is reimbursed for its costs in administering district tax ordinances by the district imposing the tax.

**REVENUE ESTIMATE**

This bill would have no affect on existing district tax revenues, since the provisions would only apply to future district tax rate changes.

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