



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

Date Introduced: **02/18/10**

Bill No: **[AB 2060](#)**

Tax: **Sales and Use**

Author: **Calderon**

Related Bills: **AB 1523 (Calderon)**

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 fixed price contracts entered into prior to a sales and use tax rate increase, as specified.

**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):

<b>Rate</b>	<b>Jurisdiction</b>	<b>R &amp; T Code</b>
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:

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- Tangible personal property, if the seller is obligated to furnish or the purchaser is obligated to purchase the property for a fixed 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.
- A lease of tangible personal property 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 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 become effective immediately upon enactment.

#### **BACKGROUND**

AB 3xxx (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.

In the past, legislation enacting sales and use tax increases has historically contained provisions that exempt fixed price contracts from the rate increase – provisions that are substantially the same as the language in this bill. 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 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 (SB 33x, Ch. 14, Stats. 1990, First Extraordinary Session). That measure also contained an exemption for 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 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. The author's office notes that this bill is intended to provide prospective relief only.
- 2. This bill is intended to address an issue of equity.** 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 a contractor's liability for sales or use tax in connection with any 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 customer in cases where a contractor inappropriately attempts to collect the additional tax from the customer on a fixed price contract.
- 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 contracts would qualify as "fixed price" than have in the past.

- 4. Bill could also affect 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). Accordingly, since this bill would change the definition of a "fixed price" contract under Part 1 for purposes of materials and fixtures obligated pursuant to a construction contract, 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 state sales and use taxes, it could also affect district tax revenues with respect to materials and fixtures obligated pursuant to 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. For purposes of clarity, the bill should be more specific of its prospective application.** The author's office has indicated that this bill is intended to only have prospective application. Accordingly, the proposed exemption that would be applicable to materials and fixtures obligated pursuant to construction contracts entered into prior to the April 1, 2009 state sales and use tax increase, is intended to only apply to purchases or leases made on or after the effective date of this bill. In order to ensure a prospective application, however, it is suggested that a new subdivision (d) be added to clarify:  
(d) This section shall apply to sales, leases or purchases made on or after the effective date of the act adding this subdivision.
- 6. 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**

We have no information that would indicate the value of continuing leases of tangible personal property entered into prior to the April 1, 2009 sales and use tax increase. However, using construction contract information from the Division of Engineering Services of the California Department of Transportation (Caltrans), we found that approximately 50 contracts had been awarded prior to effective date of the one-percent sales and use tax increase that could be affected by this bill. These contracts date back to February 2008. The value of the contracts amounted to over \$382 million. If we assume that at least half of the value of these contracts are for 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 as defined in this bill.

However, in order for the proposed exemption to apply to purchases of the materials and fixtures that are obligated pursuant to these contracts, the purchases will have to occur after the effective date of the bill (which could be as late as September 2010). Accordingly, in order to determine the amount of revenue loss associated with this bill, the value of purchases made after the effective date of the bill pursuant to those 50 Caltrans contracts would have to be determined. We do not know what portion of these 50 contracts would still be open at the time this bill is enacted, and to what extent the contractor is still acquiring materials and fixtures pursuant to those contracts. As an order of magnitude, we assume that at least 1/3 of the expenditures for materials and fixtures will be incurred subsequent to the effective date of this bill. Therefore, we estimate that at least \$63.7 million ( $\$191 \text{ million} \times 1/3$ ) of material and fixture purchases would qualify for the proposed exemption from the 1-percent increase in the State sales and use tax.

**REVENUE SUMMARY**

We cannot determine with any degree of certainty the total revenue loss related to this measure. However, based on Caltrans contracts alone, we estimate that this bill could result in a revenue loss of \$637,000 to the State General Fund ( $\$63.7 \text{ million} \times 1\%$ ). Additional district tax losses could also occur to the extent purchases of materials and fixtures obligated pursuant to fixed price contracts entered into prior to their rate increases will still be occurring after the effective date of this measure.

Analysis prepared by:	Sheila T. Waters	916-445-6579	04/05/10
Revenue estimate by:	Bill Benson	916-445-0840	
Contact:	Margaret S. Shedd	916-322-2376	
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