STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE ENROLLED BILL ANALYSIS

Date Amended:	Vetoed	Bill No:	AB 2060
Tax:	**Sales and Use**	Author:	**Calderon**
Related Bills:	**AB 1523 (Calderon)**	Position:	

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 a fixed price contract, tangible personal property shall not be deemed obligated pursuant to a contract for any period of time for which the *contractor or lessor* has the right to terminate the contract.

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.

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, about 20 different local jurisdictions imposed new district taxes. Altogether, there are over 100 district taxes levied in various cities and counties in 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 tangible personal property shall *not* be deemed obligated pursuant to a fixed price contract, if the *seller or lessor* has the unconditional right to terminate the contract.

The bill would become effective January 1, 2011.

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 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 (not just those with which a government entity was a party). 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.

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 August 20 and August 18, 2010 amendments** deleted the proposed fixed price contract exemption for government entities in the Sales and Use Tax Law, and instead, added a provision to the Public Contract Code that requires fixed price contracts with government entities to authorize payment for a change in the contract price that is attributable to an increase or decrease in the sales and use tax rate. The amendments also included changes to broaden the existing fixed price contract exemption in the Transactions and Use Tax Law. The **July 15, 2010 amendments** deleted the fixed price contract exemption that would have applied to certain smaller contractors, and instead, limited the fixed price contract exemption solely to contracts and leases with government entities. **The May 18, 2010 amendments** limited the proposed fixed price contract exemption to contracts and leases with government entities and smaller contractors.

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 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 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 fixed price contracts or leases entered into prior to a local district rate increase would be limited to the tax rate in effect at the time the contractor and his or her customer entered into the contract.

4. **Proposed changes to the Public Contract Code would not affect the Board'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 with a government entity prior to a 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).

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

COST ESTIMATE

Since this bill would apply only to prospective tax increases, the bill would not significantly increase the Board's costs. Some absorbable costs would be incurred related to revising publications and preparing directives to staff.

REVENUE ESTIMATE

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

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