

DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: July 12, 2011
POSITION: Oppose
SPONSOR: Associated General Contractors of America

BILL NUMBER: AB 780
AUTHOR: C. Calderon

BILL SUMMARY: Public Contracts: Fixed Price Contracts: Tax Rates

This bill would require a fixed price contract, entered into on January 1, 2012 or later, between a contractor and a government entity to authorize payment for a change in the contract price that is due to an increase or decrease in the sales and use tax rate that occurs subsequent to the signing of the fixed-price contract. This bill would specify, with regard to a sale or lease to a government entity, that tangible personal property shall be deemed obligated pursuant to a fixed price contract if the contractor does not have the unconditional right to terminate the contract.

FISCAL SUMMARY

This bill will have no immediate impact on state or local revenues, since the provisions only apply to future sales and use tax increases. Future revenue effects would likely be minimal as well, since the contractor will be authorized to charge any difference due to an unplanned tax increase. However, there could be additional costs to government entities entering into fixed price contracts in the event that there is an unplanned sales tax increase, as this bill effectively shifts the burden of paying for the unplanned sales tax increase from the contractor to the government entity.

According to the Board of Equalization (BOE), 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.

COMMENTS

The Department of Finance is opposed to this bill for the following reasons:

This bill is meant to address a cost impact to contractors that arises when a contractor enters into a fixed-price contract with a government entity and, before the contract is executed, is subject to an unplanned sales tax increase. The contractor then has no way to pass the sales tax increase on to the customer and must bear the additional costs. However, all tax increases and tax reductions impact various parties in ways they did not plan on. There is no way to insulate all persons and businesses from unexpected changes in the tax code and it is not clear why such firms as are addressed in this bill are deserving of this tax benefit.

The bill shifts the burden of paying for unplanned sales tax increases from the contractor to the government entity so future costs for government entities would increase if there is an unplanned sales tax increase. However, for future sales and use tax rate decreases, the bill would also allow a change to the contract price so that, if the contract so provides, government entities would receive an adjustment in the contract price reflective of that decrease.

Analyst/Principal Date Program Budget Manager Date
(0721) C. White Mark Hill

Department Deputy Director Date

Governor's Office: By: Date: Position Approved
Position Disapproved

BILL ANALYSIS Form DF-43 (Rev 03/95 Buff)

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ANALYSIS

A. Programmatic Analysis

Under existing Transactions and Use Tax Law, the BOE administers a sales and use tax exemption from *any district tax increase* for fixed price contracts. According to the BOE, to qualify as "fixed price," the contract must satisfy the following criteria:

- 1) It must be binding 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.
- 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 the tax.

This bill would change the Transactions and Use Tax Law, *for district tax increases*, to specify that tangible personal property shall be deemed obligated pursuant to a fixed price contract if the contractor does not have the unconditional right to terminate the contract.

Under existing Sales and Use Tax Law, there is no exemption from an increase in the *state sales and use tax rate* that occurs subsequent to the signing of a fixed price contract between any parties.

This bill would amend the Public Contract Code to require a fixed price contract, entered into on January 1, 2012 or later, between a contractor and a government entity to authorize payment for a change in the contract price that is due to an increase or decrease in the *state sales and use tax rate* that occurs subsequent to the signing of the fixed-price contract.

The bill would define "fixed price" for purposes of the Public Contract Code to mean that the amount of all costs or prices is fixed by the contract or lease, the contract or lease does not reserve to the contractor or lessor the right to increase that amount, and the contract or lease does not address the obligations of the parties in the event of any change in taxes or tax rates, including sales and use tax rates.

Discussion

When there have been temporary sales and use tax increases in the past, the legislation has included provisions that exempted sales of tangible personal property under fixed price contracts from the rate increase. This occurred in 1989 when the sales and use tax was increased by 0.25 percent for a 13-month period in response to the October 17, 1989 earthquake and in July 1991, when California's sales and use tax rate was increased by 1.25 percent. No such legislation was included with the temporary 1-percent sales tax increase that went into effect April 1, 2009 and expired June 30, 2011.

The purpose of this bill is to protect the business expectations of the contractors when they enter into a fixed-price contract with a government entity from any unplanned increases in the sales and use tax rate. Finance notes, however, that this bill limits this protection to contracts with government entities and contractors. As a result, parties of fixed-price contracts that fall outside these parameters would receive no protection from this bill. Prior legislation in this regard in 1989 and 1991 was applied to all parties of fixed-price contracts and offered an exemption from the sales tax increase. Further, this bill effectively shifts the burden of paying for the unplanned tax increases from the contractor to the government entity.

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The changes to the Transactions and Use Tax Law are intended to broaden the sales and use tax exemption that exists under current law for fixed price contracts when there is an unplanned district tax increase (these types of increases can happen quite frequently in the various cities and counties). According to the Associated General Contractors of America, the sponsor of this bill, government entities may not enter into contracts for which they do not have an unconditional right to terminate the contract. So under current law, these types of contracts never qualify for the sales and use tax exemption.

Finance notes that, according to the BOE, certain government contracts are "guaranteed maximum price" contracts," which means that the price specified in the construction contract is for actual costs plus a fixed fee, but subject to a maximum price. Such guaranteed maximum price contracts do not qualify as fixed price contracts for purposes of the exemption under the district tax law, since according to the BOE, to be considered a "fixed price contract," the contract must fix the amount of all costs at the outset. Therefore, when contracts entered into with government entities are guaranteed maximum price contracts, contractors would still not receive the benefit of the district tax exemption under this bill.

Last year, AB 2060, which was similar to this measure, was vetoed by Governor Schwarzenegger. The veto message said 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."

B. Fiscal Analysis

This bill will have no immediate impact on state or local revenues, since the provisions only apply to future sales and use tax increases. Future revenue effects would likely be minimal as well, since the contractor will be authorized to charge any difference due to an unplanned tax increase. However, there could be additional costs to government entities entering into fixed price contracts in the event that there is an unplanned sales tax increase, as this bill effectively shifts the burden of paying for the unplanned sales tax increase from the contractor to the government entity.

According to the BOE, 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.

BILL ANALYSIS/ENROLLED BILL REPORT--(CONTINUED)

AUTHOR

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Code/Department Agency or Revenue Type	SO	(Fiscal Impact by Fiscal Year)							Fund Code
	LA	(Dollars in Thousands)							
	CO	PROP							
	RV	98	FC	2010-2011	FC	2011-2012	FC	2012-2013	
1149/Sale Use Tax	RV	No		-----	See Fiscal Analysis	-----		0001	
1151/SalesUseTxFr	RV	No		-----	See Fiscal Analysis	-----		3059	
1148/Realign-Sale	RV	No		-----	See Fiscal Analysis	-----		0331	
L149/Loc Rev Sale	RV	No		-----	See Fiscal Analysis	-----		0994	
0860/Equalization	SO	No		-----	See Fiscal Analysis	-----		0001	

<u>Fund Code</u>	<u>Title</u>
0001	General Fund
0331	Sales Tax Account, Local Revenue Fund
0994	Other Unclassified Funds
3059	Fiscal Recovery Fund