Fiscal Note

BILL # HB 2749

TITLE: TPT; prime contracting; exemption; alterations

SPONSOR: Cobb

STATUS: As Introduced

PREPARED BY: Hans Olofsson

Description

HB 2749 would change the definition of "alteration" for the purpose of taxing contracting activities. Under current law, alteration is defined as any "activity or action that causes a direct physical change to existing property." Activities are considered alteration if the contract amount for existing residential properties is 25% or less of the property's full cash value. The bill would modify the definition of "alteration" such that an activity is considered alteration so long as it does not increase the square footage of existing residential property irrespective of the contract amount. HB 2749 would retain the current definition of alteration for commercial and other non-residential property.

The bill would become effective on January 1, 2023.

Estimated Impact

Due to a lack of detailed contracting data, we are not able to determine the fiscal impact of the bill. While we have provided examples below of how the bill could either increase or decrease General Fund revenue depending on the particular circumstances of the contracting activity, we cannot determine in advance whether the aggregate net impact to the General Fund would be positive or negative.

Analysis

Under current law, gross proceeds from activities that are limited to contracts for the "maintenance, repair, replacement or alteration" (MRRA) of existing property with the owners of real property are exempt from the prime contracting tax. Materials purchased to be incorporated into MRRA contracts are taxed under the retail classification of the Transaction Privilege Tax (TPT).

Gross proceeds from activities that are deemed "modifications" of real property are subject to the prime contracting tax. Modification includes activities such as "ground up" construction, grading, wreckage, or demolition. While the gross proceeds from modification contracts are subject to the prime contracting tax, the materials incorporated into these contracts are exempt from retail TPT.

As noted above, alteration refers to any "activity or action that causes a direct physical change to existing property." Whether an activity is nontaxable alteration or taxable modification depends on the property type and scope of the contract. Under current law, activities are considered nontaxable alteration if the contract amount for existing residential properties is 25% or less of the property's full cash value. Therefore, activities that exceed the 25% full cash value threshold are considered "modification" projects and they are taxed under the prime contracting classification. Under the bill, an activity is considered alteration so long as it does not increase the square footage of existing residential property.

(Continued)

As a result of the changes under the bill, some activities that currently fall under "alteration" would become "modification" projects or the other way around. Depending on the specifics of a contract, the bill could result in either a General Fund revenue gain or loss. To illustrate this point, we have constructed 2 hypothetical examples.

Example 1 - $78,000 Kitchen and Bathroom Remodeling of Home
In the first example, a home with a full cash value of $260,000 (statewide average full cash value for residential property) has both its kitchen and 2 bathrooms remodeled at a total cost of $78,000. We have further assumed that 40% of the contract cost is for materials [= $31,200] and the remaining 60% for labor [= $46,800]. The remodeling project does not result in any increase of the home's square footage.

Under current law, this remodeling project would be considered "modification" since the contract amount of $78,000 is 30% of the home's full cash value. For this reason, this amount would be subject to the prime contracting tax.

Current law provides a 35% deduction on the contract amount, which means that the tax base is reduced by $(27,300) to $50,700. At the state tax rate of 5%, this contract would generate prime contracting tax revenue of $2,535, of which $2,203 would be distributed to the General Fund.

Since the remodeling project would not result in any increase of the home's square footage, this activity would be considered "alteration" under the bill. For this reason, only the materials used in the remodeling of the home would be subject to tax under the retail classification of TPT. At the state tax rate of 5%, this would generate retail tax revenue of $1,560 [= $31,200 x 5%] of which $,1,151 would be distributed to the General Fund. (Note that the General Fund retains 86.9% of state contracting TPT compared to 73.8% of state retail TPT.)

In this first example, the General Fund would incur a revenue loss of $(1,052) [=$1,151 - $2,203] under the bill.

Example 2 - $78,000 Room Added to Home
In the second example, a home with a full cash value of $390,000 has a small room added to its structure at a total cost of $78,000. As in the prior example, we have assumed that 40% of the contract cost is for materials [= $31,200] and the remaining 60% for labor [= $46,800]. This project results in an increase of the home's square footage.

Under current law, the project in this example would be considered "alteration" since the contract amount of $78,000 is 20% of the home's full cash value. For this reason, only the materials used in this building project would be subject to tax under the retail classification of TPT. At the state tax rate of 5%, this would generate retail tax revenue of $1,560 [= $31,200 x 5%] of which $1,151 would be distributed to the General Fund.

Since the project would result in an increase of the home's square footage, this activity would be considered "modification" under the bill. For this reason, the $78,000 contract amount would be subject to the prime contracting tax. The amount of taxable gross proceeds after the 35% deduction is $50,700 [= $78,000 - $27,300]. At the state tax rate of 5%, this contract would generate prime contracting tax revenue of $2,535, of which $2,203 would be distributed to the General Fund.

In this second example, the General Fund would have a revenue gain of $1,052 [=$2,203 - $1,151] under the bill.

The two examples above demonstrate that the fiscal impact cannot be determined without examining each contract affected by the proposed legislation. However, as noted earlier, since such detailed data is not available, we are not able to determine aggregate impact of the bill.

Local Government Impact

For the same reason as outlined above, we cannot determine the local government impact of the bill.

2/18/22