COUNCIL ON STATE TAXATION

Sales Taxation of Business Inputs

Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services

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About COST

The Council On State Taxation (COST) is the premier state tax organization representing taxpayers. COST is a nonprofit trade association consisting of approximately 575 multistate corporations engaged in interstate and international business. COST's objective is to promote and preserve equitable and nondiscriminatory taxation of multijurisdictional business entities.

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Executive Summary

The Council On State Taxation (COST) requested Ernst & Young LLP to analyze the current sales tax on business purchases, as well as the economic effects of a proposed extension of the sales tax to business services. Our findings include the following:

- The current state and local sales tax differs from a true or ideal retail sales tax. A true retail sales tax would impose a uniform tax only on final consumption—all goods and services sold to households—but would not impose any tax on business purchases of intermediate goods and services. The current sales tax system imposes over $100 billion of taxes on business purchases of business inputs and investments. This type of tax has significant adverse state economic development implications.
- A number of states are considering extending the sales tax to more services. Unless carefully designed, an extension of sales tax to many services would exacerbate the current economic distortions from the sales tax on business inputs.
- The current sales tax on business inputs violates several tax policy principles (economic growth, efficiency, equity, simplicity) and causes a number of economic distortions. The distortions are caused by what economists call “pyramiding”: the tax is imposed at multiple levels, such that the effective tax rate exceeds the retail sales tax rate. Most states make some attempt to reduce the pyramiding of their sales tax, but these efforts are far from complete.
- A sales tax on business inputs is an additional cost of doing business in the state, which companies must either attempt to pass on to their customers or reduce their economic activity in the state. A sales tax on business inputs imposes a particular burden on in-state businesses selling in regional or national markets, since they are less able to pass the added cost on to customers and thus are likely to reduce their activity in the state. As a consequence, these businesses may reduce their in-state investment in equipment and buildings and create fewer jobs for state residents.
- Currently, most states do not tax services principally purchased by business due to the pyramiding and complexity it would create. A recent proposal to impose sales and use tax on certain services in Texas exemplifies the problems that would be caused:
    - 87 percent of the additional static tax revenue would come from business purchases of services;
    - Companies would be encouraged to self-provide these business services to avoid the tax rather than purchasing them from more efficient providers and paying tax;
    - Texas companies selling in international, national and regional markets would be put at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the State;

- The proposal unfairly and inefficiently taxes some products and services more than others by imposing varying degrees of tax on inputs in addition to a general tax rate on final sales;
- The proposal also unfairly hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services.

States that are considering reforms to their sales tax systems need to examine carefully the economic development implications of their current taxation of business purchases. Proposals to extend the sales tax to services could further exacerbate the adverse economic distortions from the current taxation of business purchases.

The Current Sales Tax: Diverging from a True Retail Sales Tax

The current state and local sales tax system is similar to an iceberg. Not only is it a slowly drifting accumulation of many years of legislative actions, but also a large portion is hidden from view. The current sales tax is not grounded in rock-solid tax policy principles of fairness, simplicity, equity, and efficiency. Over 40 percent is submerged by the taxation of business inputs, whose cost is generally hidden and unrecognized in the form of higher consumer prices and/or reduced state economic development. The current system is a clear impediment to state economic development efforts and a drag on companies subject to our complex system of state taxation.

It is important to understand the current system of state and local sales and use taxes and their current taxation of business purchases before analyzing the implications of extending the sales tax to business services.

Current State of the Retail Sales Tax

The retail sales tax, ideally, is a tax on final consumption by households. It is designed to tax final consumption by applying the tax to the final sales in the production and distribution of goods and services. In practice, the retail sales tax falls short of taxing the broad base of household consumption, while falling heavily on many business purchases. The current under-taxation of household consumption and over-taxation of business inputs, relative to a true retail sales tax, creates complexity and economic distortions.

Figure 1 shows the relative magnitude of both the amount of business and consumer purchases and their potential sales tax bases:

- Personal consumption expenditures in the U.S. totaled $6.6 trillion in 2003, of which an estimated 38 percent was subject to sales tax.[1] States exempt large segments of consumer purchases, including most medical, educational, plus numerous other retail goods and services. Over $4 trillion of household purchases are exempt. Sales tax collections from household purchases totaled $133 billion.
- Business purchases totaled $7.3 trillion in 2003, exceeding final household consumption expenditures, due to multiple business-to-business sales between companies involved in the production and distribution process. The current sales tax overtaxes business purchases, falling on approximately 18 percent of business purchases, since most states have incomplete sale-for-resale and limited business purchase exemptions. The $1.3 trillion of business purchases that are currently taxed would not be taxed under an ideal retail sales tax.

[1] This figure excludes expenditures for housing.

Figure 2 shows the level of sales tax on *services* purchased by business and households:

- Personal consumption service expenditures in the U.S. totaled $3.5 trillion in 2003, of which an estimated 11 percent was subject to sales tax. States exempt most services, including most medical and educational services. Taxable services represent 15 percent of the existing personal consumption sales tax base.
- Business purchases of services totaled $3.1 trillion in 2003. The current sales tax overtaxes business purchases of services, falling on approximately 11 percent of business purchases. Taxable services represent 27 percent of the existing business purchases sales tax base.

Figure 1
Level and Taxability of All Business and Household Purchases
(2003; Dollars in Billions)

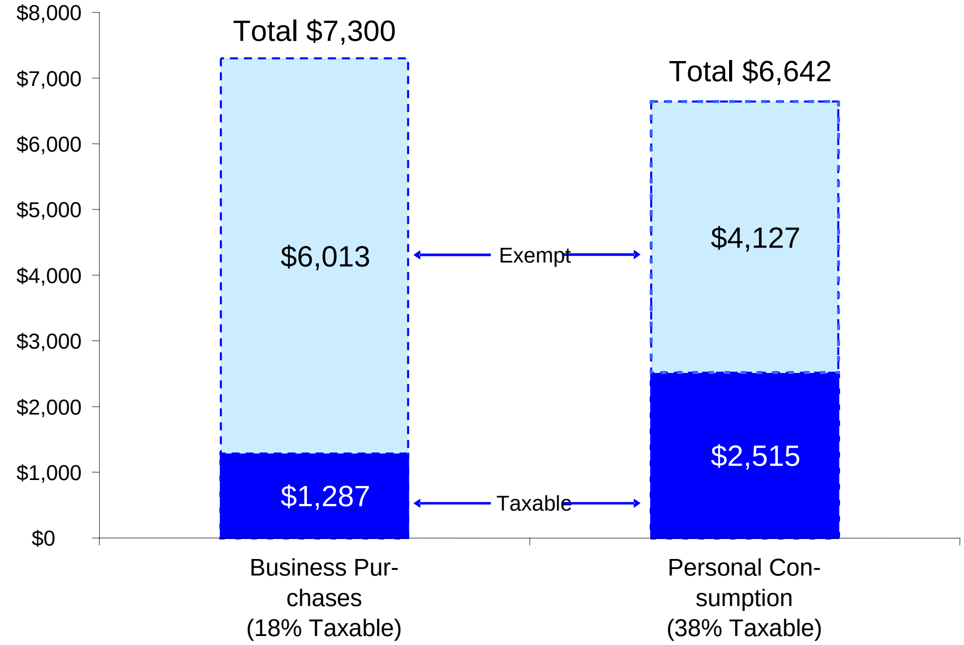
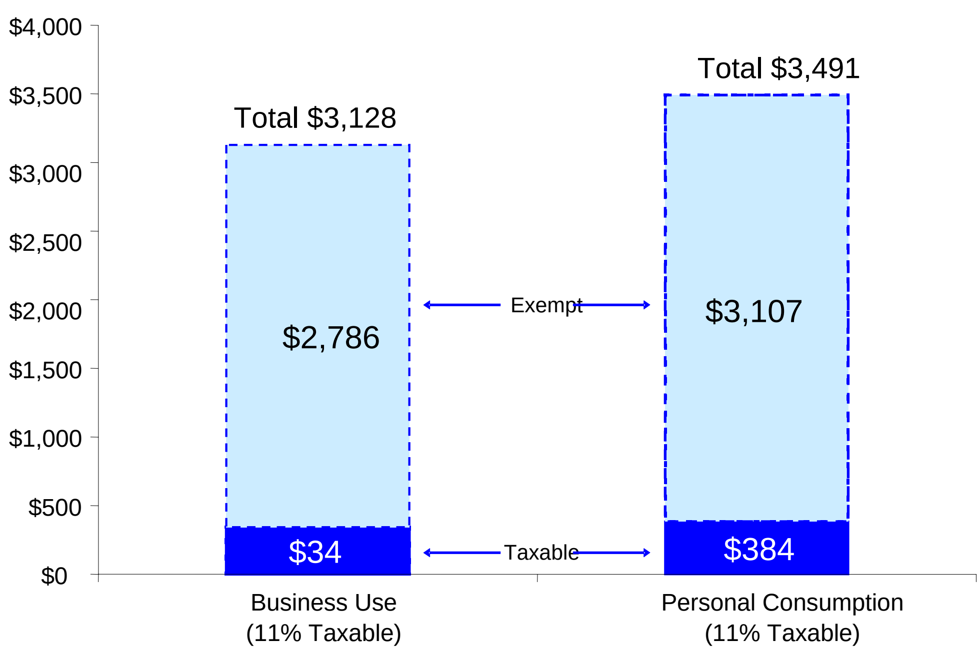


Figure 2
Level and Taxability of Business and Household Purchases of Services
(2003; Dollars in Billions)



The Extent of Sales Taxation of Business Purchases

While a pure retail sales tax would only be imposed on retail purchases by consumers, a significant percentage of retail sales taxes are now imposed on business input purchases. Table 1 provides state-by-state estimates of the percentage of total state and local sales taxes imposed on business purchases.[2] For each state, the table presents estimates of sales taxes paid on business purchases and household consumption. In addition to the dollar amounts, the table includes the business share of total state and local sales taxes.

In fiscal year 2003, state and local sales taxes on business purchases, including intermediate inputs and capital investments, totaled $100.1 billion. The national average business share of all general sales taxes was 43 percent. The business shares varied from 28 percent in Idaho and West Virginia to 67 percent in Louisiana and exceeded 50 percent in eight states.

To put these estimates in perspective, state corporate income tax collections in FY 2003 were an estimated $34.6 billion. Sales tax on business inputs was almost three times larger than state corporate income taxes.[3] State and local retail sales taxes, in practice, impose substantial tax burdens on business purchases, increasing the operating and capital costs of doing business in a state.

The extensive taxation of business inputs creates a number of equity, efficiency, and competitiveness issues that are discussed in detail in this study. The fact that businesses already pay 43 percent of all sales taxes, and those taxes can have significant adverse state economic development effects, must be kept in mind as state legislators consider broadening the sales tax base to include services that are predominantly purchased by business.

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[2] The estimates of sales taxes paid by business on their purchases are derived from the E&Y 50-state sales tax model. The model includes state-specific, industry-by-industry flows of business intermediate input and investment purchases based on national input-output relationships and state output estimates. The model also includes estimates of household purchases by category of spending. A separate sales tax matrix was developed for each state to reflect the current-law sales tax treatment of business and household purchases by detailed categories of commodities and services. Applying the tax matrix to levels of transactions produces estimates of total sales and use taxes on business intermediate inputs, business investment purchases, and consumer expenditures. The general sales tax figures include retail sales taxes and the general gross receipts taxes in several states, including Washington State, New Mexico and Hawaii. In Washington State, the estimates include both the retail sales tax and the B&O tax on gross receipts.

[3] Estimates of business taxes by tax type are from *Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in FY2003*, study prepared by Ernst & Young LLP for the Council on State Taxation. (January 2004).

Table 1
Business Share of Total State and Local General* Sales Tax Collections
(FY 2003; Dollars in Billions)

State	Business Sales Tax	Consumer Sales Tax	Total Sales Tax	Business Share
Alabama	$1,146	$2,039	$3,185	36.0%
Alaska	n/a	n/a	n/a	n/a
Arizona	2,769	3,129	5,898	47.0%
Arkansas	837	1,738	2,575	32.5%
California	14,871	18,113	32,984	45.1%
Colorado	2,092	2,141	4,233	49.4%
Connecticut	1,570	1,603	3,173	49.5%
Delaware	n/a	n/a	n/a	n/a
Florida	5,304	10,353	15,657	33.9%
Georgia	3,666	4,762	8,428	43.5%
Hawaii	542	1,139	1,681	32.2%
Idaho	233	596	829	28.1%
Illinois	3,230	4,492	7,722	41.8%
Indiana	153	1,686	3,959	32.5%
Iowa	789	1,231	2,020	39.1%
Kansas	1,063	1,362	2,425	43.8%
Kentucky	1,104	1,306	2,410	45.8%
Louisiana	3,388	1,682	5,070	66.8%
Maine	323	549	872	37.1%
Maryland	1,151	1,653	2,804	41.0%
Massachusetts	1,544	2,309	3,853	40.1%
Michigan	2,606	5,508	8,114	32.1%
Minnesota	1,727	2,212	3,939	43.8%
Mississippi	915	1,525	2,440	37.5%
Missouri	2,029	2,489	4,518	44.9%
Montana	n/a	n/a	n/a	n/a
Nebraska	686	649	1,335	51.4%
Nevada	945	1,353	2,298	41.1%
New Hampshire	n/a	n/a	n/a	n/a
New Jersey	2,452	3,799	6,251	39.2%
New Mexico	1,008	813	1,821	55.3%
New York	9,166	9,049	18,215	50.3%
North Carolina	1,880	2,807	4,687	40.1%
North Dakota	177	233	410	43.2%
Ohio	3,454	4,573	8,027	43.0%
Oklahoma	1,408	1,310	2,718	51.8%
Oregon	n/a	n/a	n/a	n/a
Pennsylvania	3,057	4,775	7,832	39.0%
Rhode Island	375	388	763	49.2%
South Carolina	837	1,713	2,550	32.8%
South Dakota	366	342	708	51.7%
Tennessee	2,205	4,134	6,339	34.8%
Texas	9,108	9,967	19,075	47.7%
Utah	707	1,345	2,052	34.4%
Vermont	88	136	224	39.5%
Virginia	1,322	2,463	3,785	34.9%
Washington	5,553	4,064	9,617	57.7%
West Virginia	285	719	1,004	28.4%
Wisconsin	1,615	2,458	4,073	39.7%
Wyoming	308	268	576	53.6%
US Total	$100,055	$133,093	$233,148	42.8%

**Does not include specific or selective excise taxes or Alaska's local sales tax.*
Source: E&Y 50-State Sales Tax Model for 2003

Pyramiding of the Sales Tax

In theory, the retail sales tax is designed to tax final consumption of goods and services. In other words, the tax should be imposed only on the purchase of taxable sales by households, while exempting business purchases. In practice, typical state and local sales taxes are imposed on a significant portion of business-to-business sales. This results in a number of problems, including distortions in how firms operate, arbitrary and hidden differences in effective sales tax rates on different goods and services that distort consumer choices, violations of horizontal and vertical equity principles, and detrimental impacts on a state's business competitiveness.

These problems are partially a result of the *pyramiding* of the retail sales tax. As used in this study, sales tax pyramiding refers to the situation where the same goods and services are taxed multiple times as they move from production to final retail sale. This occurs, for example, when the cost of a taxable product or service sold by one business to another is embedded in the price of the purchasing firm's taxable sales.

Tables 2 contrasts sales taxes imposed (at 6 percent) under an ideal sales tax applied only to final retail sales and a typical state sales tax that also taxes a portion of business-to-business sales. The table shows the final stages in the production and distribution of consumer appliances. In the example, a computer manufacturer sells computers to both the manufacturer of appliances and the retailer; the appliance manufacturer sells only to the retailer. A properly designed, ideal retail sales tax would only apply the 6 percent tax rate to the final $700,000 of sales to consumers, yielding $42,000 in tax collections.

The typical sales tax in most states taxes a portion of the inputs purchased by the appliance manufacturer and the retailer, although they generally exempt the purchase of computers used in the manufacturing process and the sales of appliances to the retailer through manufacturing and sale-for-resale exemptions. In this example, $170,000 of computer sales that are not directly related to the manufacturing process are taxed. At 6 percent, the sales tax on these computer purchases generates an additional $10,200 of tax. In effect, the value of the non-manufacturing computers is taxed twice. As shown in the last line of the table, the effective sales tax rate (taxes divided by final retail sales of $700,000) in the typical state example is 7.5 percent. This is 25 percent higher than the ideal retail sales tax rate of 6 percent. This extra tax is a measure of the pyramiding occurring in the sales tax system.[4]

[4] To simplify the example, we have not included the "tax-on-a-tax" that is also part of the pyramiding process. In this case, the 6 percent retail tax on the tax already paid on the purchase of the taxed computers ($36.72) would add to the calculated amount of pyramiding. It should be noted that a value-added tax is a form of a retail sales tax that avoids pyramiding by eliminating the tax on business inputs.

Table 2
Example of Pyramiding Under a Retail Sales Tax

	Sales By:			Sales Tax at 6%	
Sales To:	Computer Manufac-turer	Appliance Manufac-turer	Retailer	Typical State	Ideal Tax
Appliance Manufacturer:					
Computers used in manufacturing	$30,000			$0*	$0
Office computers	$150,000			$9,000	$0
Retailer:					
Office computers	$20,000			$1,200	$0
Appliances		$600,000		$0†	$0
Final Consumers:			$700,000	$42,000	$42,000
Total Sales Tax				$52,200‡	$42,000
Effective Tax Rate on Retail Sales				7.5%	6.0%

* Exemption provided for computers used in manufacturing process.
† Exemption provided for purchases of appliances for resale.
‡ Does not include tax on tax.

Economic Distortions and Impacts on Competitiveness from Pyramiding

Pyramiding from taxes on business inputs impacts interstate business tax competitiveness, economic efficiency, and tax equity.

- Different final products are subject to varying effective tax rates. This distorts consumer choices, penalizing the purchase of goods and services subject to higher effective tax rates.
- The sales tax imposed on business-to-business sales can encourage businesses to vertically integrate to avoid taxable transactions, even if it involves additional costs that reduce the value of a state's economic output.
- To the extent a state taxes a greater percentage of business purchases and imposes a higher sales tax rate on these purchases, in-state businesses face higher costs of production that cannot, most likely, be passed along in higher prices to out-of-state buyers. This puts in-state businesses at a competitive disadvantage and reduces economic growth.

It should be noted that the problems associated with pyramiding of the retail sales tax affect firms producing services as well as goods. Although states have been more cautious in extending the sales tax to the purchase of business and household services, they have also denied sale-for-resale and other exemptions that would reduce the sales taxes paid by service firms on their taxable input purchases. Issues involved in taxing services purchased by business are discussed in Chapter 2.

Magnitude of Pyramiding

The hidden tax on business purchases, or pyramiding, results in an additional tax on final consumer goods. For example, a recent study by the Washington State Tax Structure Study Committee found that the Washington State Business and Occupation Tax, which is a gross receipts tax, pyramids an average of 2.5 times.[5] In other words, $1.00 of initial tax on an industry's sales results, on average, in $1.50 in additional taxes from pyramiding.

While states have reduced pyramiding of the retail sales tax with sale-for-resale and manufacturing exemptions, significant pyramiding still occurs in the sales tax system. Nationally, the current sales tax system imposes an effective tax rate of 1.27 percent on final retail sales, both taxable and non-taxable, due to the numerous exemptions of final retail sales. However, the total effective tax rate, including the sales tax on business purchases, is 2.19 percent, or 1.72 times the average nominal sales tax rate. This occurs because 43 percent of the sales tax falls on business purchases.

The extent of pyramiding varies by industry and by type of goods and services purchased, and will also vary by state. Table 3 shows the extent of pyramiding for selected consumer goods and services on a national basis. Pyramiding results in total effective tax rates far in excess of the nominal sales tax rate on certain goods. For example, sales of motor vehicles have an average sales tax rate of 3.4 percent; however, sales tax on business purchases results in another 0.9 percent sales tax embedded in motor vehicle prices. As a result, the total effective tax rate is 4.3 percent. The pyramiding rate is 1.3.

Hidden taxes on input purchases also result in indirect sales taxes on goods and services that are nominally "exempt" from the retail sales tax. For example, while educational and health services are generally exempt from sales taxes, an estimated $4 billion of state and local sales taxes are imposed on inputs used in these industries.

Finally, state-by-state variations in the extent of sales taxation of business inputs are important for evaluating the potential economic competitiveness effects of the current sales tax. The sales tax paid on business purchases is an origin-based tax paid at the location of the producer. The sales tax paid by the consumer on the price of the final retail purchase is a destination tax; it is imposed on the good or service regardless of where the good or service was produced. Thus, a sales tax imposed on the production of paper products in Wisconsin will increase the cost of a Wisconsin producer, who may not be able to pass along that Wisconsin-specific tax to customers in Minnesota, Florida, or Germany. Even if the Wisconsin producer can pass the tax forward in a higher price, that could reduce the total amount of sales the producer could make. If they cannot pass the tax forward, the company and its workers will receive less than they would in certain other states.

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[5]Washington State Tax Structure Study Commission, *Tax Alternatives for Washington State: A Report to the Legislature,* November 2002, p. 110-112. The gross receipts tax applies to all business sales, not just retail sales to final consumers.

Table 3
Estimated National Pyramiding and Resulting Sales Tax Rate Non-Uniformity

Commodity	Embedded Tax	Tax on Final Sales	Total Tax Rate	Pyramiding Index
Extraction and Utilities				
Agricultural Products	1.7%	1.5%	3.3%	2.1
Oil and Gas Extraction	6.7%	4.9%	11.6%	2.4
Electric, Water, Gas	1.2%	2.9%*	4.0%	1.4
Non-Durable				
Food and Beverage	0.5%	1.4%*	1.9%	1.3
Textiles and Apparel	1.5%	2.4%	3.8%	1.6
Paper Products	3.8%	2.6%	6.4%	2.5
Petroleum and Chemical Products	2.3%	3.0%	5.2%	1.8
Durable				
Primary and Fabricated Metals	3.1%	0.2%	3.3%	14.9
Machinery	0.8%	3.5%	4.2%	1.2
Computer Equipment	0.9%	2.6%	3.5%	1.3
Electrical Equipment	1.7%	2.9%	4.5%	1.6
Motor Vehicles and Parts	0.9%	3.4%	4.3%	1.3
Furniture and Miscellaneous	1.2%	3.6%	4.8%	1.3
Services				
Information and Telecommunications	2.3%	1.4%*	3.7%	2.7
Financial Services	0.8%	0.1%	0.9%	9.9
Professional and Business Services	3.1%	0.2%	3.3%	14.9
Entertainment, Meals, and Lodging	0.9%	4.4%	5.4%	1.2
Repair, Maintenance, and Cleaning	0.1%	0.3%	0.4%	1.2
All Commodities and Services	0.9%	1.3%	2.2%	1.7
Note: Exempt at Final Sale				
Educational and Health Services	0.2%	0.0%	0.2%	--
Construction	1.6%	0.0%	1.6%	--

Source: E&Y calculations based on Bureau of Economic Analysis input-output data and 2003 sales tax rates researched by E&Y.

*Certain commodities, such as electricity, alcoholic beverages, and telecommunications are subject to additional, commodity-specific, and substantially higher, taxes than the general sales tax. For example, please see the Council On State Taxation, 2001 State Study and Report on Telecommunications.

The Economic Effects and Administrative Complexities of Taxing Business Services

The problems inherent in the current sales tax systems will be magnified if the retail sales tax is extended to services that are predominantly consumed by business. This chapter discusses the issues related to applying state and local sales taxes to business services.

States have been reluctant to extend the sales tax to business services, including professional services provided by lawyers, accountants, technology consultants, and engineers. South Dakota and Connecticut appear to be the only states that tax a significant number of professional services (excluding advertising and medical care) under a retail sales tax. Hawaii and New Mexico impose gross receipts taxes that in practice are similar to a retail sales tax on most professional services.

There are important reasons why almost all states have chosen not to impose a retail sales tax on business services, including: 1) the challenge of determining where the use of services occurs and the potential for multiple taxation, 2) the economic distortions and inefficiencies that are created by pyramiding of the sales tax on business services, and 3) the detrimental impact of taxing business services on a state's economy. The following sections discuss the problems and issues in imposing sales taxes on business purchases in more detail.

Arbitrary Determination of Where Services Are Used

A key issue in extending the retail sales tax to services, whether purchased by business or consumers, is how to determine where a service is "used" or consumed.[6] This determination is much more complicated for services than for sales of tangible personal property. For goods, retail sales tax systems are generally structured as destination-based taxes. In other words, the tax is imposed in the state where goods are used or consumption occurs. If goods are purchased from an out-of-state vendor, a "use" tax is imposed on the consumer if the vendor has not collected a state's retail sales tax. The location of consumption is generally where the product is delivered. Therefore, consistent with the destination approach, states generally exempt sales to out-of-state customers. These customers are instead generally liable for tax in the state in which the good is ultimately used.

In the case of business services, it is much more difficult to determine the location or *situs* of the consumption. In many cases, such as legal services, computer processing or consulting services, the services can be 1) contracted for in one state, 2) performed in a second state, 3) delivered to a client in a third state, and then 4) dis-

[6] The following discussion assumes that states have defined what a service is and can distinguish between tangible personal property (goods) and services. States continue to struggle with these distinctions. For example, the Streamlined Sales Tax Project appears to have reached an impasse in their efforts to distinguish between tangible and intangible computer products and computer services. For another example, states have not been able to reach agreement on whether electricity is a tangible product or a service. These differences add to complexities and compliance costs in the sales tax system.

tributed by the client to business locations in additional states. The delivery will often take the form of electronic transfers of information and documents. The fundamental question in this situation is: Where is the service used and where does the taxable sale(s) occur?

South Dakota's approach to taxing legal services illustrates the challenges in imposing a state transaction tax on mobile, professional services[7]. Here is a description of how it works: An out-of-state law firm must charge and collect the South Dakota sales tax on their entire legal fees if: 1) the client resides or has nexus in South Dakota, and 2) the legal matter involves in-state property, events or in-state transactions, and 3) the attorney enters South Dakota or makes an appearance in the state, but physical entry is not necessarily required. If all three conditions are not met, the tax is determined by actual work and time in South Dakota. If an in-state company purchases legal services from outside the state, a use tax is due from the purchaser (if the provider does not collect and remit the sales tax.). If an in-state lawyer sells services that are used entirely outside of South Dakota, no sales tax is due in South Dakota. In addition, there are extensive rules to determine when a sale of services is exempt as a purchase for resale.

Florida's brief experiment for six months in 1987 with applying the general sales tax to services further illustrates the difficulty in determining where services are consumed and how to impose a use tax effectively on out-of-state purchases. Because an estimated 70 percent of the anticipated revenue from expanding the sales tax to services was from business services, this became the key focal point for opponents of the tax.[8] In reality, the heated Florida debate was a debate about business taxation.

Florida adopted an entirely new method of determining the location of the use of business services for purposes of imposing the retail sales tax. For services directly related to property, such as construction and maintenance services, the location of the property determined where use occurred. But for general business services purchased by multistate businesses, Florida's unique approach borrowed the concept of formula apportionment from the state's corporate income tax.

Under the Florida approach, business services were "presumed" to be used in Florida in proportion to the profits earned in the state and Florida's three-factor formula for apportioning corporate income was adopted to determine where this use took place.[9] The apportioned services included general legal, accounting, data processing, and management services. In effect, Florida argued that, just as net income of a multistate company earned in a specific state cannot be known but only apportioned by arbitrary factors, use of business services, other than services directly related to

[7] See Commerce Clearing House, *South Dakota State Tax Reporter.*

[8] James Francis, "The Florida Sales Tax on Services: What Really Went Wrong?" in Steven D. Gold, *The Unfinished Agenda for State Tax Reform* (November 1988), p. 136.

[9] The weighted apportionment percentage was applied to the sales price of services to determine the taxable sale in Florida. For example, if 10 percent of a company's profits were apportioned to Florida (based on the 3-factor apportionment percentage), then 10 percent of business purchases of services were assumed to be in Florida.

real and personal property, cannot be known for a specific state, but can only be apportioned by arbitrary factors.[10]

Florida's adoption of the net income formulary apportionment to divide the use of business services among the states is a testimony to the arbitrariness and lack of theoretical justification for including business services in a retail sales tax system. The business service tax adopted a broad use tax levied on purchasers of business services instead of the traditional retail sales tax collected and remitted by sellers of services. In effect, Florida created another general business tax, based on apportioned business service expenses, within the state retail sales tax structure.

The resulting hybrid tax system was strongly criticized by business as creating very high compliance costs relative to the taxes collected. Firms had to segregate purchases of business services into those assigned to Florida and those apportioned to Florida and other states. Compliance required accounting and tax compliance systems that looked more like a corporate income tax than a retail sales tax.[11] While it is not clear what type of tax this was, it was anything but a retail sales tax collected by the seller on final sales to household consumers.

A former Minnesota Commissioner of Revenue succinctly commented on the advisability of this novel approach to sales taxation of business services:

> Expecting the buyer of services to keep records apportioning their benefit among multiple states and to pay tax on each purchased service would be absurd – absurd in effort and cost for the taxpayer relative to the benefit to the states and absurd in expectably low compliance, which would foment wider disrespect for the law.
>
> The conclusion is simple: if you believe that you are in a situation in which apportionment of sales tax among jurisdictions is in order, it is time to start thinking about a different mode of taxation. Apportionment of a transaction-based tax like the sales tax is grossly inappropriate.[12]

An important tax policy issue directly related to the difficulty in determining where business services are used is the very real possibility of multiple taxation of basically the same transaction by different states. This outcome can be illustrated by using the earlier example of determining the *situs* of business services. A legal firm with offices in state A may sign a contract in state B to provide and deliver services to a multistate manufacturer with headquarters in state C. The headquarters may

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[10]The Florida apportioned use tax provisions borrowed other concepts from the state corporate income tax including the sourcing of services (where the greater proportion of services occurs).

[11] See James Francis, "The Florida Sales Tax on Services," for a detailed discussion of the structure of the business services tax. Special formulas were adopted to apportion advertising and transportation services to Florida. For individual consumption of services, the new system assigned the sales to the state where the greatest proportion of the cost of providing services occurred. Again, a concept used in sourcing sales in the corporate profits tax apportionment formula. It should also be noted that the Florida legislation imposing the sales tax on services did not define the term "taxable services." Definitional challenges included whether interest paid to financial institutions is a payment for the service of lending money (and taxable as a service) or a payment for leasing property (and not taxable).

[12] John P. James, "Sales Tax on Services: A Tax Administrator's Perspective," in William F. Fox, editor, *Sales Taxation: Critical Issues in Policy and Administration* (1992), p. 73.

then distribute the results of the legal analysis electronically to two affiliates located in state D and state E.

Based on the different approaches that states have taken to determine where taxable sales of services occur, the same legal services in this example may be taxed simultaneously in five different states as follows: 1) state A may tax the transaction based on where the services are performed, 2) state B may tax it based on where a contract is signed, 3) state C may tax it based on the point of delivery of the services, and 4) states D and E may both tax the transaction based on where the services are used. Combined with the fact that states may not provide credits for sales taxes paid in other states on services, the legal services could be taxed multiple times.

The key point here is that it is extremely difficult to determine where business services are consumed and, therefore, how to determine which states impose sales and use taxes on service transactions and which states provide offsetting tax credits to avoid multiple taxation. Ad hoc approaches to deal with these problems quickly lead away from the retail sales tax to a new, additional system of business taxation.

As discussed below, before extending the sales tax to business services, states should carefully consider the potentially significant negative impacts on a state's economic competitiveness, in addition to the complexity and administrative and compliance burdens involved

Tax Pyramiding or Cascading

The second major problem with taxing business services is the pyramiding of the tax. As illustrated in Chapter 1, pyramiding (sometimes referred to as cascading) results in the sales tax being imposed multiple times on the same goods and services as inputs move through the production and distribution chain. Pyramiding results in final sales of different products and services bearing different amounts of sales tax per dollar of sales. The resulting variation in effective tax rates distorts consumption choices, encourages vertical integration by businesses to avoid taxable transactions, and produces unintended and unknown distributional effects.

Public finance economists and state tax administrators understand that a properly designed retail sales tax should only be applied to final consumer purchases, not intermediate input purchases by businesses. The objective is to tax final consumers, not businesses. Over time, states have adopted a number of sales tax features to reduce the level of taxation of business purchases of tangible personal property. These include exemptions for sale for resale, for materials consumed in production and for materials that become an integral part of a product.

While these limited provisions are consistent with the guiding principle of taxing only final sales, states have not adopted general sales tax exclusions for business input purchases, primarily due to the significant reduction in taxes that would result from these exclusions. In some cases, legislators have chosen to tax inputs purchased by firms, such as health care providers, as an indirect way to tax services (health care, for example) that are intentionally exempted from direct sales taxation for public policy ("equity") reasons.

These exemptions are a fundamental feature of the retail sales tax, but are much more difficult to administer in the case of business services.[13] If exemptions are not provided for business purchases of services, the problems associated with pyramiding will be magnified. For example, larger companies could hire in-house lawyers, accountants and other professionals and avoid paying the sales tax, leaving small or medium-size firms subject to paying the sales tax on their service purchases from other firms.[14]

Table 4 clearly illustrates why pyramiding of the retail tax is a significant problem in taxing business services. The table presents national estimates of the percentage of different service categories purchased by business. The top four service categories (advertising; architecture and engineering; employment; and management and technical services) all have business shares that are 88 percent or higher. Retail sales taxes imposed on these services are almost exclusively taxes on business inputs and are likely to be passed along in higher prices to the purchasers of the services. If the sales of the firms buying the services are also taxable, the cost of the business service will be built into the price of other goods and services and the value of the services may be taxed multiple times.

Additional services, including data processing, accounting and legal, and securities and investment services have business shares in excess of 65 percent. The business purchases of these services will exacerbate the current pyramiding problem. In contrast, the table shows a number of service categories that are predominantly purchased by households. These are the types of services that states have been slowly adding to retail sales tax bases consistent with the tax policy objective of extending the retail sales tax to more *household* services. So far, state legislators appear to understand that a sales tax on services primarily consumed by businesses is a distinctly different tax from the retail sales tax imposed on services primarily consumed by households.

[13] See South Dakota Department of Revenue, *A Guide to Sales and Use Tax (2002)*, Sales for Resale Chapter examples, p. 24.

[14] South Dakota subjects a comprehensive list of business services to the retail sales tax, but provides limited sale for resale exemptions to reduce pyramiding. For example, if a law firm purchases professional services on behalf of a client, the purchase qualifies for a resale exemption, if the service is delivered without any alteration or change. However, the services provided by the law firm to other businesses within South Dakota are taxable and can result in additional pyramiding. See South Dakota Department of Revenue, *A Guide to Sales and Use Tax (2002)*, sales for resale examples.

Table 4
Business Share of Purchases of Services, 2003

Industry	Business Share of Purchases of Ser-	Total Purchases of Services ($billions)
Principally Business Purchases		
Advertising	98%	$175.3
Architecture & Engineering Ser-	96%	125.2
Employment Services	94%	88.6
Management & Technical Ser-	88%	89.8
Data Processing Services	84%	38.4
Accounting & Legal Services	71%	196.1
Securities & Investment Services	66%	194.9
Principally Household Purchases		
Automobile Repairs	26%	145.6
Personal Services	11%	96.5
Education Services	7%	131.4
Amusements and Recreation	5%	81.0
Medical Services	1%	889.5

Note: Calculated by E&Y from U.S. Bureau of Economic Analysis, U.S. Benchmark Input-Output Matrix, adjusted to 2003 levels. Business percent equals business purchases divided by total supply of the service.

The states' experience with gross receipts taxes provides an important lesson concerning the adverse impacts of extending the retail sales tax to business services. As discussed earlier, four of the five states that tax business services extensively do so under a gross receipts tax. In the case of Washington State, the gross receipts (B&O) tax applies to most industries. Based on a comprehensive state tax study, the Washington State Tax Structure Study Committee recently recommended that the gross receipts tax be replaced. In their final report, the committee stated: "Our B&O tax is a dramatic violator of the principle of neutrality among like businesses. The pyramiding of this tax on goods as they move through the production chain is a fundamental problem that requires correction."[15]

Taxing business services under a retail sales tax without exempting purchases by business will create similar problems of pyramiding because of the high business shares of purchases. While states could adopt a complex system of exemptions for business purchases of services to avoid pyramiding, the resulting business service tax base would be substantially reduced by the exemptions. The tax policy question is whether the additional sales tax revenues justify the additional complexity and compliance and administrative costs of the expanded sales tax system. Without these exemptions, states could collect more revenue but at the cost of significant economic distortions and negative impacts on a state's business tax competitiveness.

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[15]Washington State Tax Structure Study Committee, *Tax Alternatives for Washington State: A Report to the Legislature*, November 2002, p. 30. Alternatives considered by the Committee were a value-added tax and a goods and services tax with a credit for all intermediate business purchases. Either alternative would eliminate pyramiding and approximate a pure retail sales tax on final consumption with no tax on business purchases.

Negative Impacts on Interstate Business Tax Competitiveness

Due to intensifying interstate (and international) competition for new business investments and additional jobs, states are increasingly concerned about the adverse impact of out-of-line state and local taxes on economic development. Extending the sales tax to business services could have a significant negative impact on a state's business tax competitiveness by increasing business costs due to the sales tax on input purchases (including the pyramiding effect) and by putting in-state businesses at a competitive disadvantage compared to out-of-state firms selling into the state.

How Sales Taxes on Business Inputs Affect Competitiveness

The taxation of business purchases of products and services' effect on a state's economic competitiveness was recently described:

> Businesses will be at [an] economic disadvantage in competition with states providing broader producer input exemptions and, of increasing significance, in competition on world markets with entities producing in VAT [value-added tax] countries that afford more complete exclusion of producer purchases. Embedded tax paid on production inputs will make the product relatively more costly in these comparisons.[16]

If a state extends the retail sales tax to business services, the competitive disadvantage will be magnified, particularly given the reluctance of states to extend even the limited current business input exemptions for the purchase of goods to the purchase of services. If other states do not impose retail sales taxes on services purchased primarily by business, companies selling into competitive regional, national or international markets will not be able to pass this tax forward in higher prices to customers.

If these companies try to increase prices, they will lose significant sales to competitors in other states (or possibly other countries). The only option for a company in this situation to remain competitive is to reduce investment and jobs in the state imposing the taxes on business services. This will eventually shift the burden of the tax backwards to labor in the state through lower wages and employment.[17] If this happens, "business" will not bear the burden of the tax on business services, but the state's residents will.

Note that this will adversely affect a state's competitiveness even if the state exempts exports of business services from the sales tax, as is normally the case for sales of tangible personal property. Out-of-state sales by companies selling any goods and services that require significant inputs of business services will be burdened by the cumulative amount of sales taxes on business services used throughout the production process.

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[16] John L. Mikesell, "Sales Tax Incentives for Economic Development: Why Shouldn't Production Exemptions be General?," *National Tax Journal*, Vol. LIV, No. 3, p. 558.

[17] Assuming that capital investment is quite mobile among the states, these businesses cannot pass the tax backward to investors in the form of lower rates of return on capital.

For in-state companies selling to customers in the state imposing the sales tax on business services, the negative impact on competitiveness will occur through a different mechanism. As explained above, it is very difficult to impose an effective use tax on services produced in another state. Therefore, in-state providers of business services will not be able to increase in-state prices sufficiently to cover the sales tax liability on their sales. In effect, these in-state companies will be put at the same competitive disadvantage that many in-state retailers currently face because in-state customers do not pay sales or use tax on purchases of tangible personal property from remote sellers. This disadvantage could average 6 percent of gross sales. Once again, firms will have to reduce their employment in the state and/or lower employee wages (pass the tax backwards) to remain competitive.

The in-state vs. out-of-state competitiveness issue was one of the key factors that caused Florida's legislature to repeal their sales tax on services, only six months after it went into effect. The business community's opposition to the extension of the tax to services that fell primarily on business inputs was swift, loud and, ultimately, successful. After repeal of the service tax, Florida replaced the lost revenue with an increase in the sales tax rate on the previous tax base.

In terms of competitiveness, a major criticism of the Florida tax on services was that the resale provisions of the Florida law were too narrow, resulting in substantial pyramiding that put Florida companies at a competitive disadvantage. The Florida law used a narrow definition of final sale, considering a purchase to be non-taxable only if the item was specifically purchased for the consumption of some subsequent consumer.[18] Purchases of services consumed by a business in the general running of the business were considered taxable.

New Mexico is also confronted with the same competitiveness issues in taxing business services under their state's gross receipts tax. In effect, the gross receipts tax does not impose a use tax on the purchaser of taxable services from out-of-state suppliers. For most services, the out-of-state supplier only pays the tax on the portion of services actually provided within the state. This treatment puts in-state service providers at a competitive disadvantage. In addition, New Mexico has only a limited sale-for-resale exemption for service providers.

Adverse Impacts on New Investment

To understand better the negative impact of taxing business inputs under the retail sales tax, we have modeled the reduction in the after-tax rate of return on new investments in a state for representative firms in selected states and industries.[19] This approach applies the current-law sales tax provisions in the selected states to the

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[18] For example, the fees charged by a court reporter would only be nontaxable if expressly requested by a lawyer's client. If the client merely sought legal counsel, the fees charged by the court reporter to the law firm would be taxable.

[19] The representative taxpayer approach to business tax analysis is being used in a number of states. For example, see Wisconsin Department of Revenue, Division of Research and Policy, *Corporate Tax Burden Comparison: Paper Industry* (August 23, 2004). As pointed out in this analysis, the results of these studies are sensitive to the assumptions about the characteristics of the representative firms.

balance sheet and income statement information of firms in specific industries.[20] By holding the financial and economic characteristics of the representative firms constant across the states, this approach makes it possible to isolate the impact of sales taxes on business purchases on the profitability of a new investment or business expansion in a state, a measure that can be easily understood and compared across states and tax types.

For the states and industries included in this comparison, the sales tax on business inputs averaged 31 percent of the total state and local tax burden on new investments for the included states and industries. In other words, the direct sales tax, assuming it is passed forward in higher input prices, accounts for almost one-third of the total state and local tax burden imposed on these representative taxpayers' new investment. The share of total taxes accounted for by the sales tax was highest in the service industries because they received relatively smaller resale and production sales tax exemptions, and, in some cases, were paying sales taxes on the purchase of services, such as computer services. Taxing business services more broadly would add to the sales tax effective tax rate.

As discussed earlier, a business taxpayer competing with out-of-state sellers in competitive markets is unlikely to be able to pass above-average sales tax burdens forward to consumers in higher prices. As a result in-state firms put at a competitive disadvantage will have an incentive to invest in lower-tax states. As capital investment responds to the higher sales tax burdens, the tax burdens are shifted backwards to in-state labor and state economic growth is reduced.

[20] The analysis looks at seven types of industries, representing durable manufacturers, non-durable manufacturers, and service firms located in eleven different states. The methodology measures the impact of sales taxes over time for business investments. While the results cannot be extended to all industries and all states, they do provide insight into the relative size of sales taxes imposed on business inputs.

Evaluating a Proposal to Extend the Sales Tax to Business Services

Many states faced with fiscal stress over the previous decade have re-evaluated traditional sales tax base definitions and extended the sales tax to sales of selected services. Forced to choose between politically unpopular general sales tax rate increases and base broadening options, most states have chosen base broadening.

Given the potential high percentage of sales taxes on professional services that would be paid by in-state businesses, state policymakers should be concerned about the negative impact of these taxes on in-state businesses. If states cannot effectively enforce sales tax collection on out-of-state professional service providers, a tax on professional services could put in-state service providers at a competitive disadvantage that could be as high as six percent of gross sales. The sales tax on professional services is almost exclusively a tax on business inputs. Whether these taxes are paid by the businesses providing professional services or passed along in higher prices to other businesses, the sales tax on professional services should be considered principally a state business tax.

Example: Texas Proposed Expansion of Taxable Services

A 2004 legislative proposal in Texas, S.B. 1031, is used to illustrate the state-by-state effects of an expansion in the sales tax base to more services, and its implications for taxation of business inputs. Texas S.B. 1031 adds eleven enumerated services to the sales tax base: accounting and audit services; advertising media services; architectural services; expanded computer programs; commercial research, development or testing services; employment agency services; engineering services; financial services; legal services; management, consulting or public relations services; real estate brokerage and agency services; temporary labor supply services; transportation services; and veterinary services.

The Texas proposal lacked a simple and comprehensive mechanism for identifying sales for resale exemptions, which causes a major portion of the economic distortions associated with taxing services. The proposed legislation provided minimal sale-for-resale exemptions, including:

- A taxable service, other than a transportation service, performed on tangible personal property that is held for sale by the purchaser of the taxable service; or
- The provision of temporary labor supply services if the employee provided is directly engaged in providing a taxable service.

Table 5 presents the estimated current business sales tax on inputs in each state, the proposed change in business liability from taxing the bundle of business services, the total business sales tax on inputs under the proposed Texas law, and the percent of the revenue increase borne by business (assuming the Texas proposal were law in all states).

Table 5
Estimated Impact of Extending Sales Tax to Business Services
(Texas S.B. 1031, 2003; Dollars in Millions)

State	Current Law Business Sales Tax on Inputs	Change in Business Sales Tax	Total Proposed Business Sales Tax	% of Revenue Change Falling on Business Inputs
Alabama	$1,092	64%	$1,797	90%
Alaska	n/a	n/a	n/a	n/a
Arizona	2,175	36%	2,178	89%
Arkansas	847	51%	1,019	94%
California	14,868	42%	18,741	86%
Colorado	2,092	24%	2,132	86%
Connecticut	1,569	21%	1,674	76%
Delaware	n/a	n/a	n/a	n/a
Florida	5,374	41%	6,187	87%
Georgia	3,750	33%	4,285	88%
Hawaii	548	13%	415	81%
Idaho	234	61%	327	90%
Illinois	3,295	84%	5,936	89%
Indiana	1,285	69%	2,181	93%
Iowa	784	58%	1,090	93%
Kansas	1,089	39%	1,379	91%
Kentucky	1,116	56%	1,445	92%
Louisiana	3,431	35%	4,455	92%
Maine	322	28%	345	85%
Maryland	1,146	35%	1,640	81%
Massachusetts	1,523	66%	2,240	86%
Michigan	2,631	62%	3,871	91%
Minnesota	1,628	54%	2,396	91%
Mississippi	912	35%	1,053	90%
Missouri	2,088	33%	2,374	88%
Montana	n/a	n/a	n/a	n/a
Nebraska	692	20%	889	85%
Nevada	954	40%	1,210	92%
New Hampshire	n/a	n/a	n/a	n/a
New Jersey	2,450	64%	3,627	87%
New Mexico*	1,015	0%	1,015	n/a
New York	9,737	41%	12,731	82%
North Carolina	1,828	62%	3,048	91%
North Dakota	176	49%	215	95%
Ohio	3,458	50%	5,597	90%
Oklahoma	1,444	20%	1,645	83%
Oregon	n/a	n/a	n/a	n/a
Pennsylvania	3,079	62%	4,488	88%
Rhode Island	355	34%	402	85%
South Carolina	846	63%	1,171	86%
South Dakota	374	15%	333	91%
Tennessee	2,238	63%	3,160	93%
Texas	10,003	57%	15,405	91%
Utah	696	48%	854	93%
Vermont	89	90%	191	91%
Virginia	1,372	64%	1,857	89%
Washington	3,447	34%	2,773	89%
West Virginia	288	78%	543	89%
Wisconsin	1,631	50%	1,992	93%
Wyoming	308	62%	382	54%
US TOTAL	$100,279	33%	$133,556	87%

Source: Calculated by E&Y based on the E&Y 50-State Sales Tax Model for 2003.

Note: The Texas legislation imposes tax on specific types of revenue for each industry. The percentage of taxed revenue varies from approximately 4% percent of financial services revenue to roughly 75 percent of legal services. New Mexico currently imposes tax on an equal or greater percentage of these services and would not be significantly affected by the proposed tax law change.

Nationally, over 87 percent of the increase in tax revenue would result from increased taxes on business purchases. While the Texas sales tax on services proposal appears to be a logical extension of the sales tax, in fact it is targeted at services that are predominantly purchased by businesses, and thus has the detrimental effect of increasing the taxation of business inputs without providing the possibility of clear exemptions for resale or production.

Conclusion

The current state and local sales tax differs from a true or ideal retail sales tax, and violates fundamental tax policy principles of competitiveness, fairness, simplicity, equity, and efficiency.

A true retail sales tax would impose a uniform tax only on final consumption—all goods and services sold to households—but would not impose any tax on business purchases of intermediate goods and services. All consumption by households would be taxed uniformly to avoid distorting consumption decisions. No sales tax would apply to business purchases to avoid tax pyramiding and differential tax rates across different goods and services and different forms of business operations.

The current state and local sales and use tax system exempts a majority of consumer goods and services, while imposing over $100 billion of sales taxes on business purchases. It is far from a true retail sales tax. The current system has significant pyramiding, or multiple taxation, of many goods and services, taxing some goods at rates significantly higher than the nominal sales tax rate and also imposing tax on goods and services that are nominally “exempt.”

It is important in any consideration of sales taxation of services to distinguish between services consumed predominantly by households and services purchased by businesses for use in the production of other goods and services. Expansion of the sales tax on additional business purchases will exacerbate the existing tax distortions and be adverse to states’ economic development efforts.