The Impact of Imposing Sales Taxes on Business Inputs

NCSL Executive Committee Task Force on State and Local Taxation
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Agenda

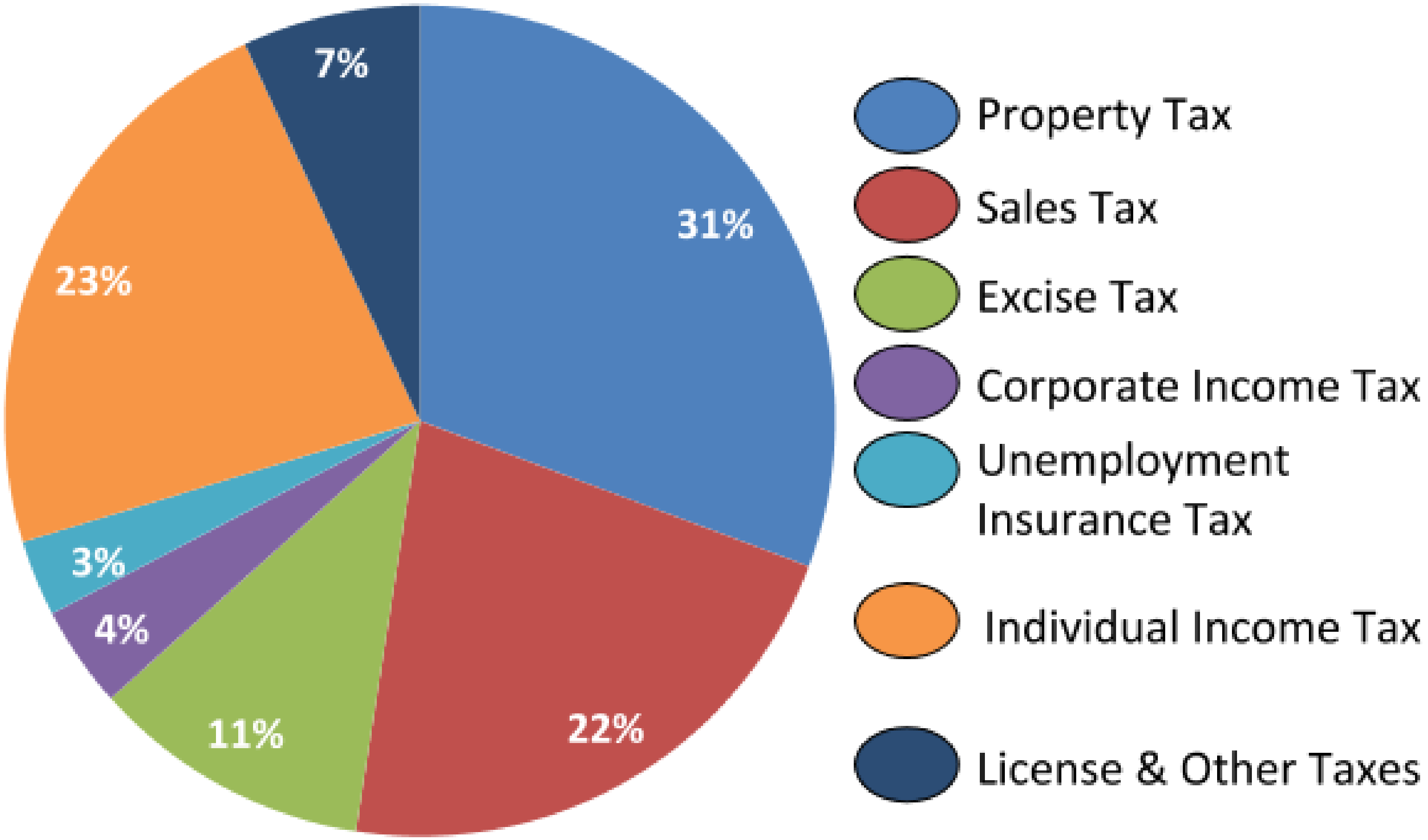
- The Principles of a Good Consumption Tax
- Sales Taxes on Business Inputs
- Convergence of the Sales Tax Base and the Income Tax Base
- The Narrow Breadth of Sales Taxes on Household Consumption
- Expanding the Sales Tax Base Would Be Less Complex if the States had More Uniformity
- An International Perspective on the U.S. Sales Tax System
- The Difficulty with Sweeping Sales Tax Base Broadening Legislation

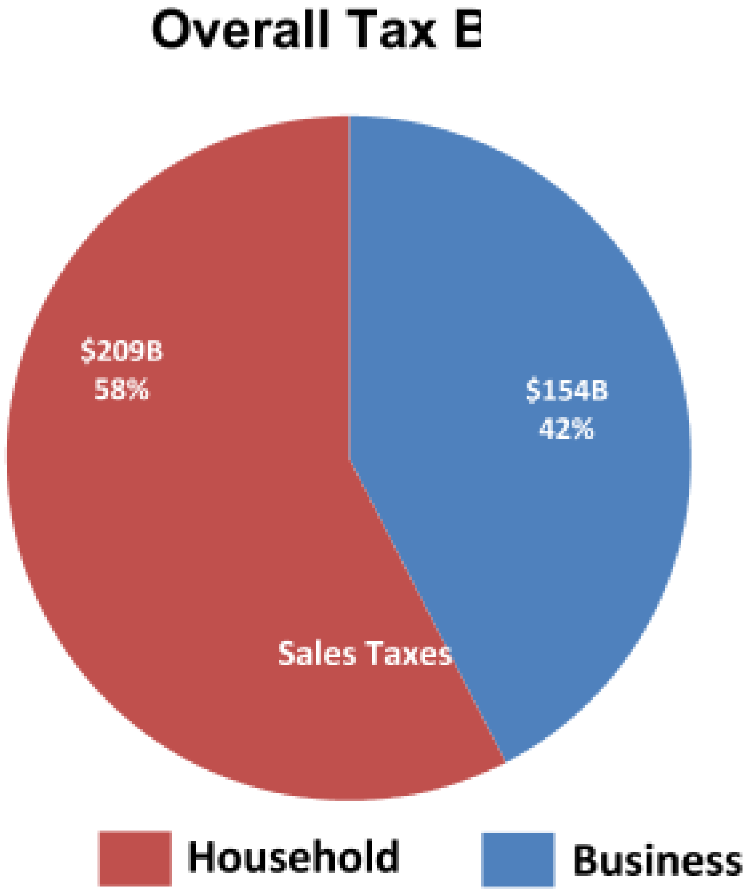
THE PRINCIPLES OF A GOOD CONSUMPTION TAX

The Principles of a Good Consumption Tax

- Primarily applies to final household consumption
- Exempts business inputs
- Uniform (harmonized) tax base
- Centralized tax administration w/limited local jurisdictions

Sales Tax and Overall State & Local Revenue





SALES TAXES ON BUSINESS INPUTS

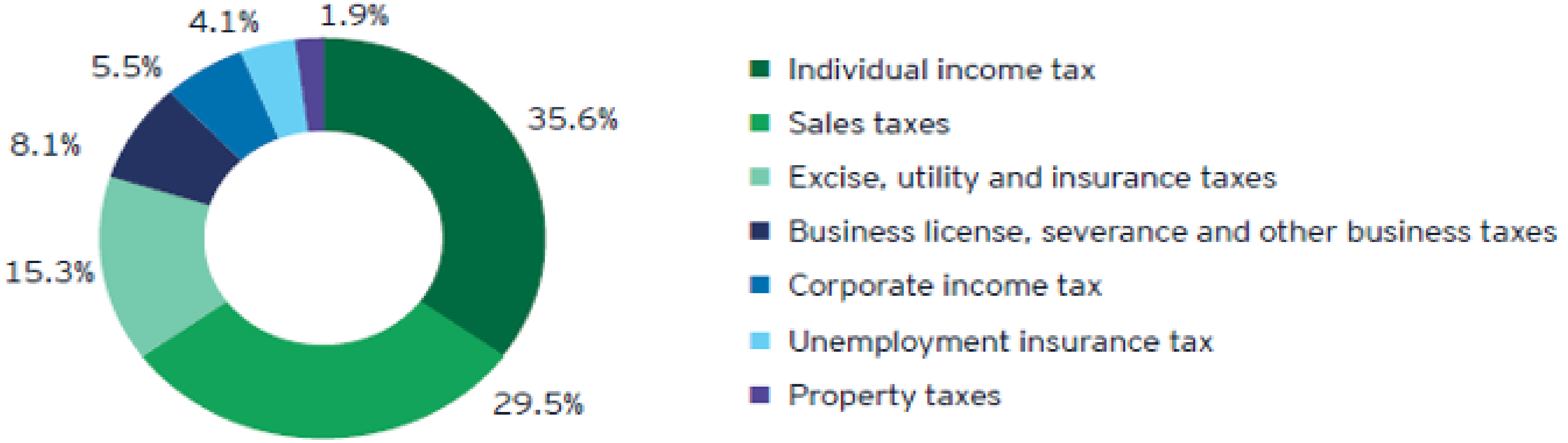
Report on Imposing Sales Taxes on Business Inputs

EY, STRI/COST report issued May 2019: "The Impact of Imposing Sales Taxes on Business Inputs"

Despite a complex system of exemptions intended to exclude specific categories of business input purchases from the sales tax base, most state sales tax systems fall short of the goal of taxing only household consumption because they impose significant taxes on business-to-business transactions.

State sales taxation of business purchases accounted for 42% of total state and local sales taxes in 2017

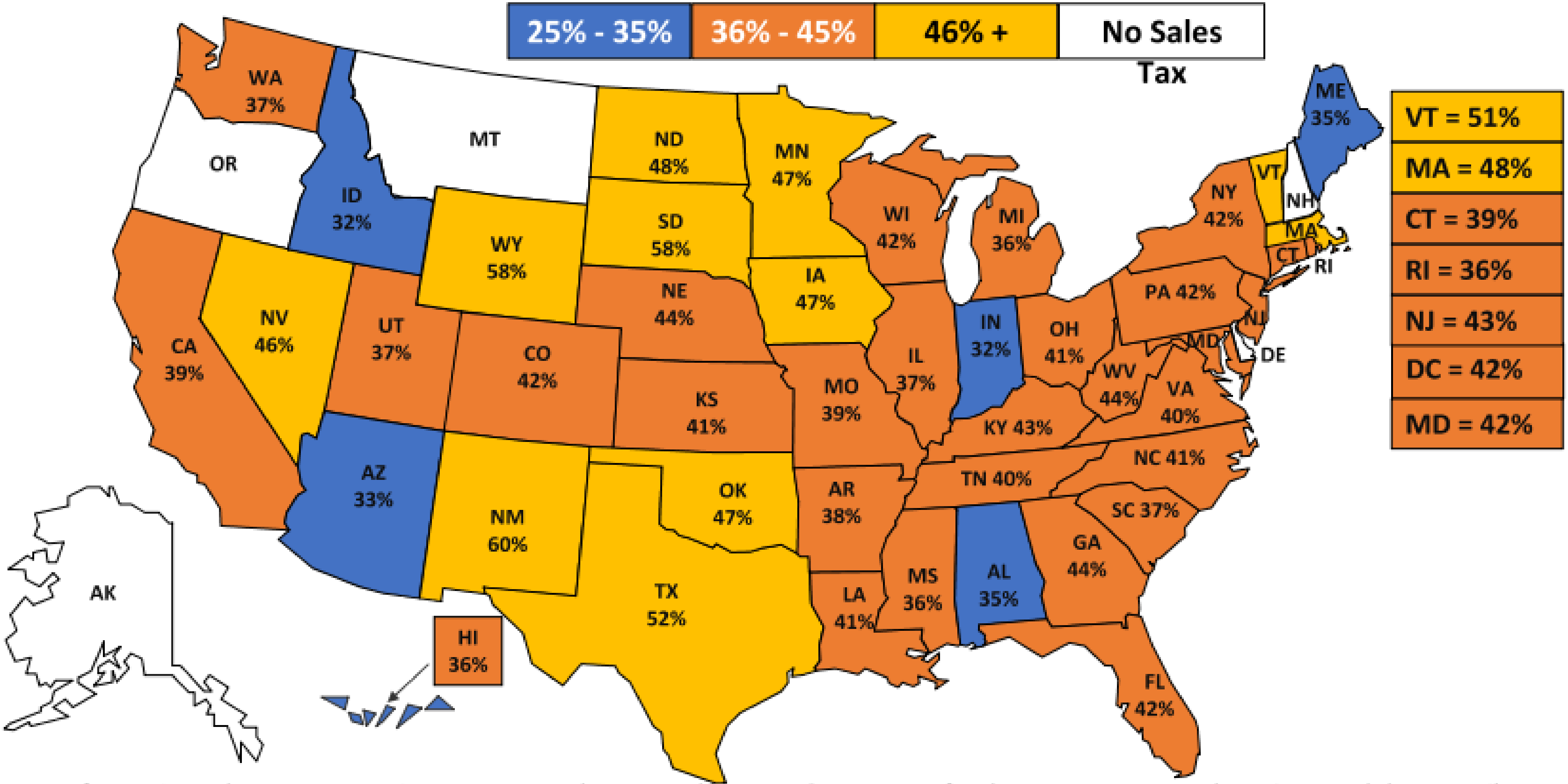
Figure 2 – Composition of state tax collections (2017) (Chart excludes local taxes)



Study Available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf

State and Local Sales Taxes Imposed on Business Inputs

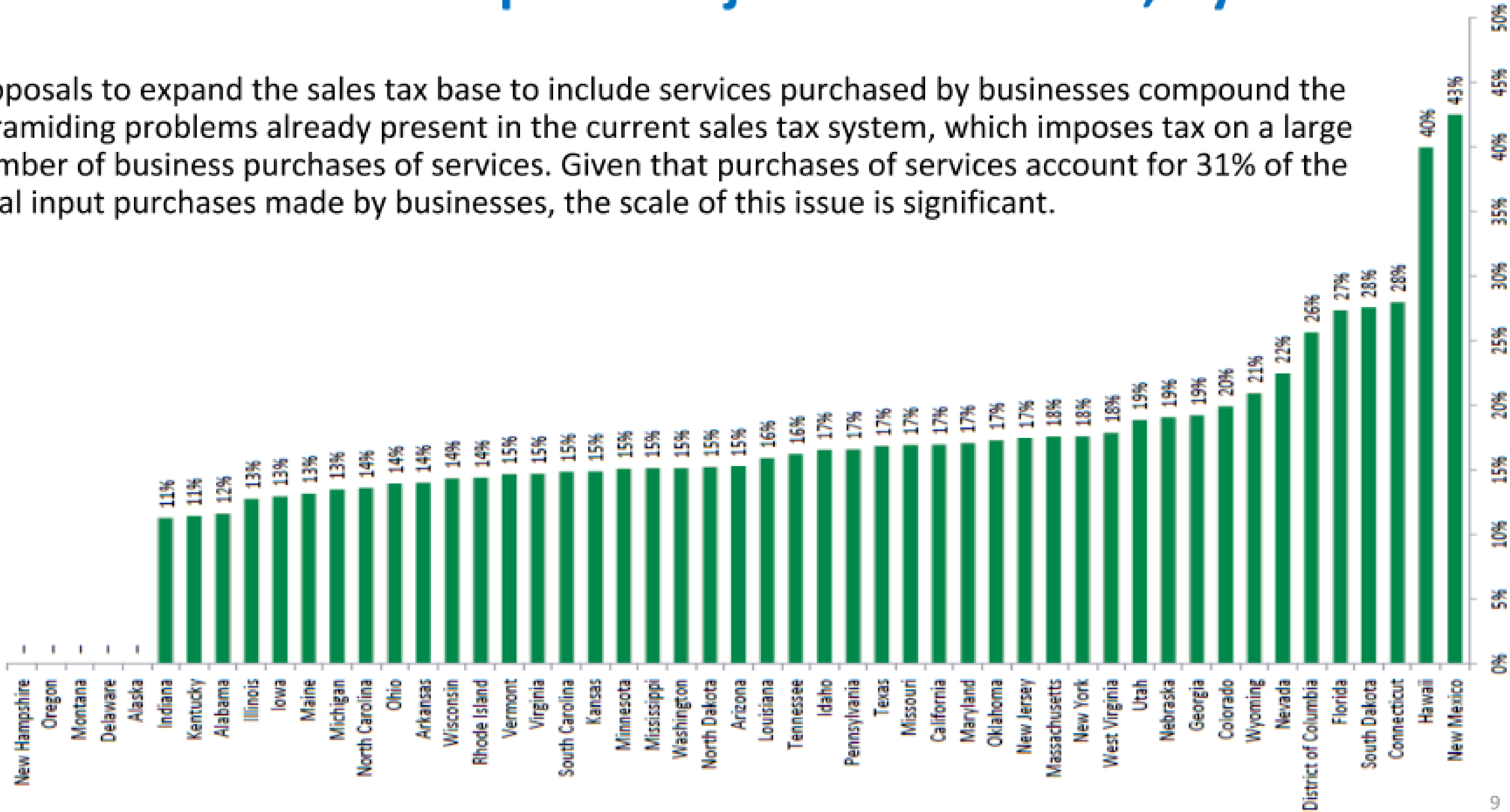
Business Inputs Share of Total Sales Tax Collected



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019)

Share of Business Inputs Subject to Sales Tax, by State

Proposals to expand the sales tax base to include services purchased by businesses compound the pyramiding problems already present in the current sales tax system, which imposes tax on a large number of business purchases of services. Given that purchases of services account for 31% of the total input purchases made by businesses, the scale of this issue is significant.



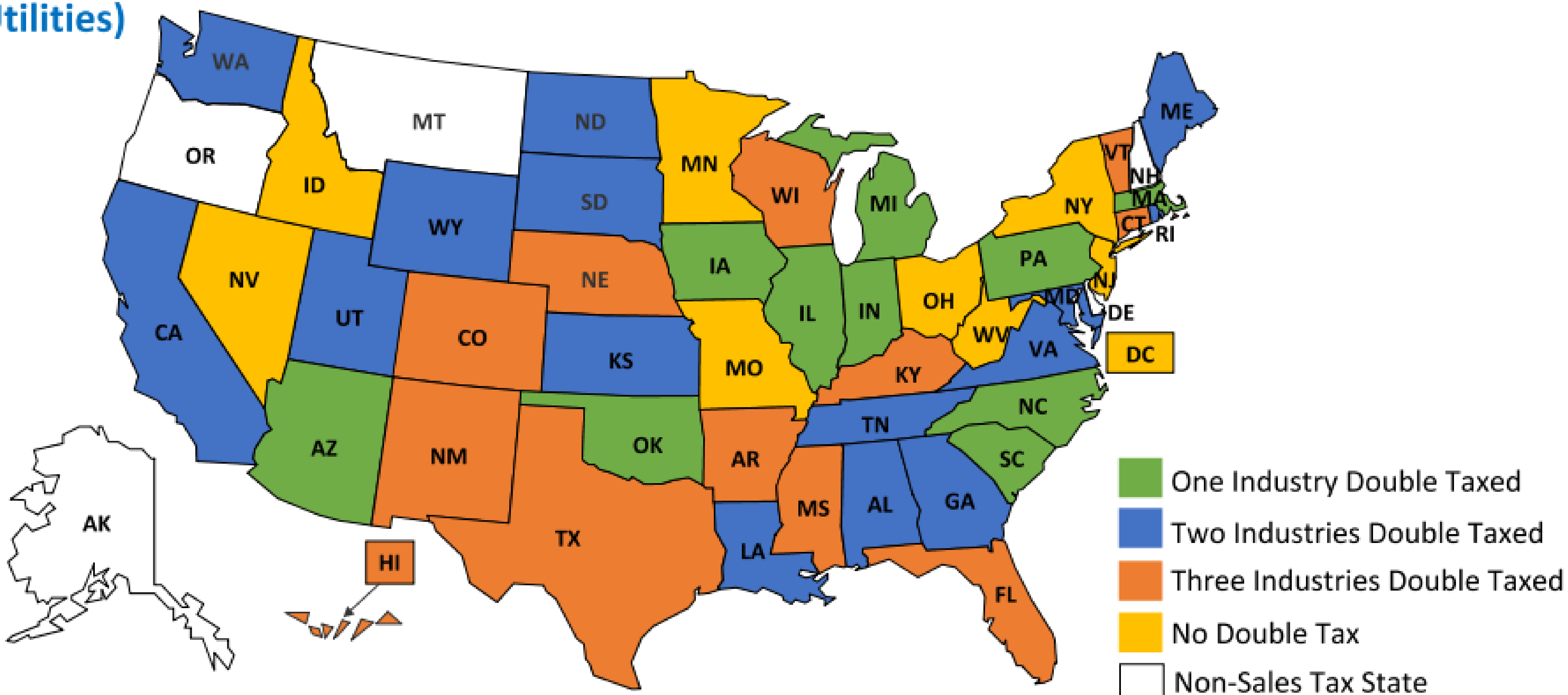
The Extensive Sales Taxation of Business Inputs in the U.S.

- **Continued trend**: this business tax burden has been virtually unchanged during the last 16 years despite a substantial growth in sales tax revenues. The first EY/COST study of the sales taxation of business inputs for fiscal year 2003 found that sales tax collections on business inputs totaled 42.8 % of total state and local sales taxes.
- **Improvement needed**: there is broad agreement among economists that the ideal sales tax system taxes final household consumption, not business-to-business intermediate transactions. The ramifications of taxing business inputs are significant, including inefficient tax pyramiding, a lack of transparency, higher consumer prices, and reduced economic activity.

U.S. Is an Outlier – Most Other Nations Exempt (or Credit) Business Inputs from their Consumption Taxes

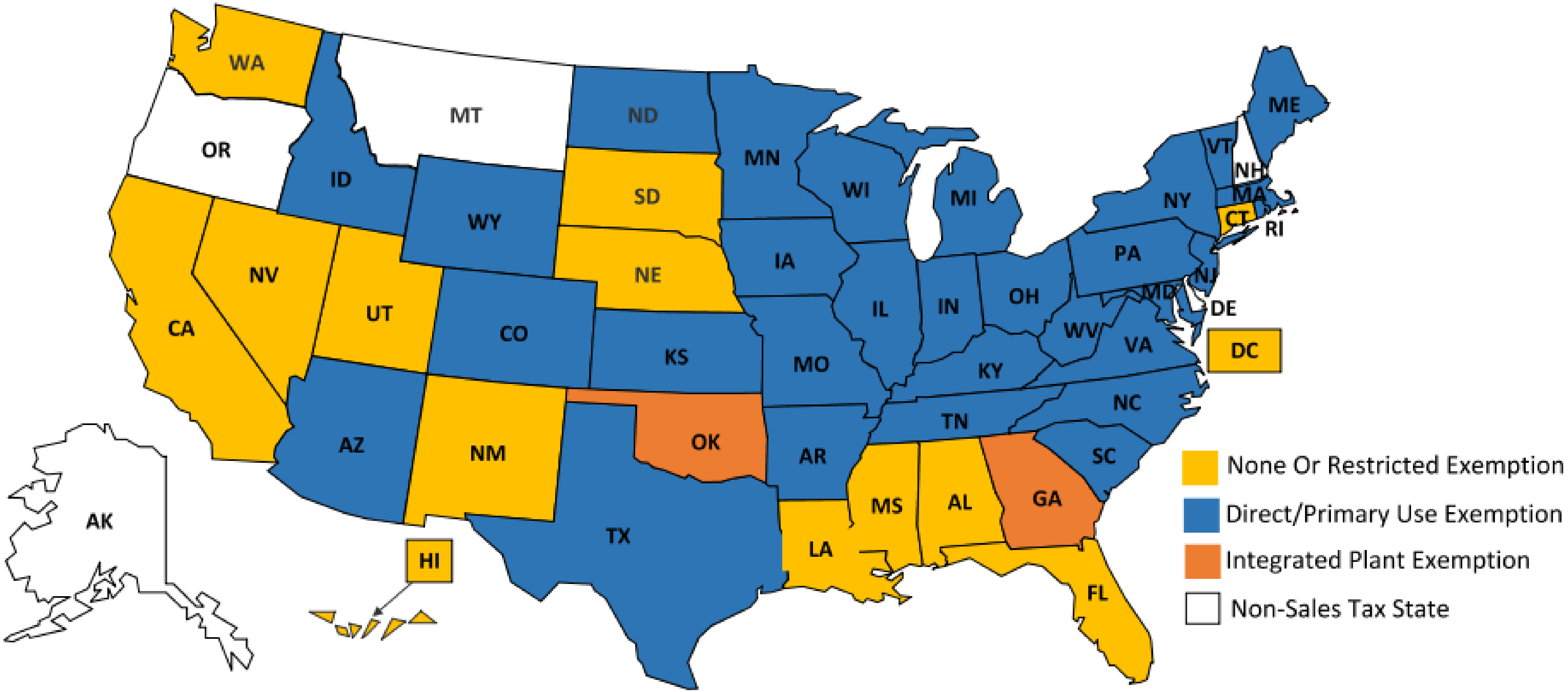
- The U.S. is virtually alone among countries in relying so heavily on the sales taxation of business inputs.
- The primary consumption tax in other advanced industrialized nations is a value added tax (VAT), sometimes also called a goods and services tax (GST).
- Generally, business inputs are initially subject to a VAT, but then a credit is provided once the VAT has been imposed on final household consumption.
- According to the Organization for Economic Co-operation and Development (OECD), "The overarching purpose of a VAT is to impose a broad-based tax on consumption, which is understood to mean final consumption by households… A necessary consequence of the fundamental proposition that a VAT is a tax on final consumption by households is that the burden of the VAT should not rest on businesses." OECD (2017), *International VAT/GST Guidelines*, OECD Publishing, Paris, p. 14.

Sales Taxation of Business Inputs Results in Extensive Pyramiding of Tax: Double Taxation of Select Service Providers (Telecommunications, Cable, and Electric and Natural Gas Utilities)



The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity, & the Exemption of Business Inputs (April 2018)

Manufacturing Input Sales Tax Exemptions by State



The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity, & the Exemption of Business Inputs (April 2018)

Taxability of Business-to-Business Sales of Selected Goods and Services

Type of input purchased	Share of business-to-business sales of the input type that are subject to tax
Utility services	47%
Information services	36%
Manufactured goods	20%
Other services	13%
Real estate, rental, and leasing	6%
Mining products	4%
Agricultural products	3%
Transportation services	2%
Construction	1%
Financial services	1%

Ernst & Young calculations. Note: Percentages shown in this table indicate the amount of the business purchases of the various types of items that would be subject to tax. For example, 47% of utility services that are purchased by businesses are subject to tax.

The Percentage of the Total Inputs Purchased by Each Industry that is Subject to Tax

Industry purchasing inputs	Percentage of industry's input purchases subject to tax
Information	24%
Mining	21%
Wholesale and retail	21%
Real estate, rental, and leasing	21%
Services	21%
Utilities	12%
Transportation	12%
Finance	12%
Agriculture	5%
Manufacturing	4%

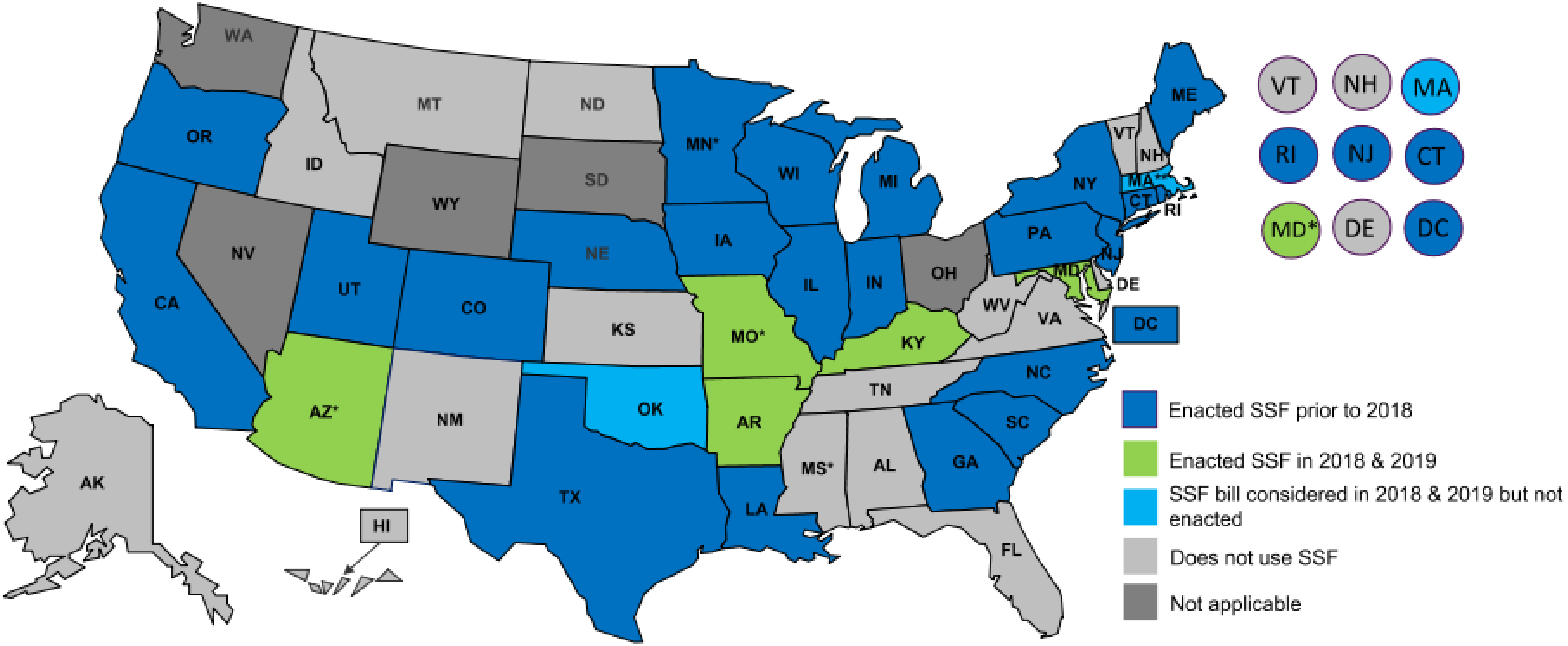
Ernst & Young calculations
(Percentages represent the dollar value of taxable inputs divided by the dollar value of total inputs purchased by each industry.)

CONVERGENCE OF THE SALES TAX BASE AND THE INCOME TAX BASE

Sales Taxation of Business Inputs Compared with State and Local Corporate Income Taxes

- For corporate income taxes, states are increasingly using consumption tax sourcing principles, rather than production sourcing principles, to apportion business income
- Over two-thirds of the states now impose single sales factor apportionment or triple weighted sales factors
- Over half of the states have moved from cost of performance to market sourcing of services/intangibles
- Thus, income taxes are increasingly prioritizing consumption tax type principles and are not focused on imposing a tax where the cost of production occurs

Corporate Income Tax - Single Sales Factor

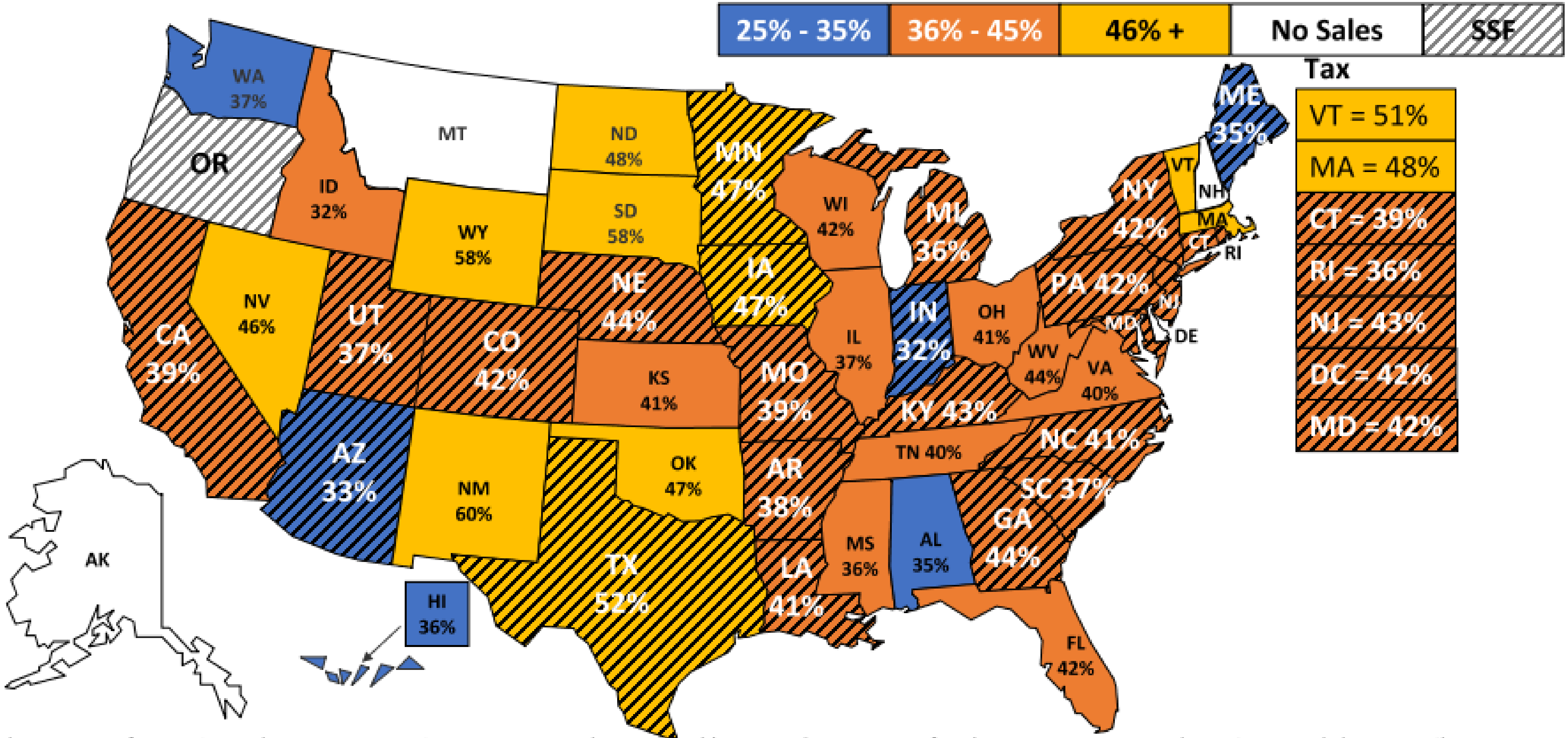


Note: **Arizona** expanded single sales factor election to additional taxpayers in 2018. **Missouri** will use a single sales factor apportionment method beginning January 1, 2020. **Maryland** approved single sales factor in 2018, and it will be phased in by 2022. **Mississippi** taxpayers may choose their apportionment method using one or more of the three factors. **Minnesota** proposed a bill in 2019 to move back to Three-Factor apportionment.

** Notes states with legislation currently pending, but which has not yet been enacted

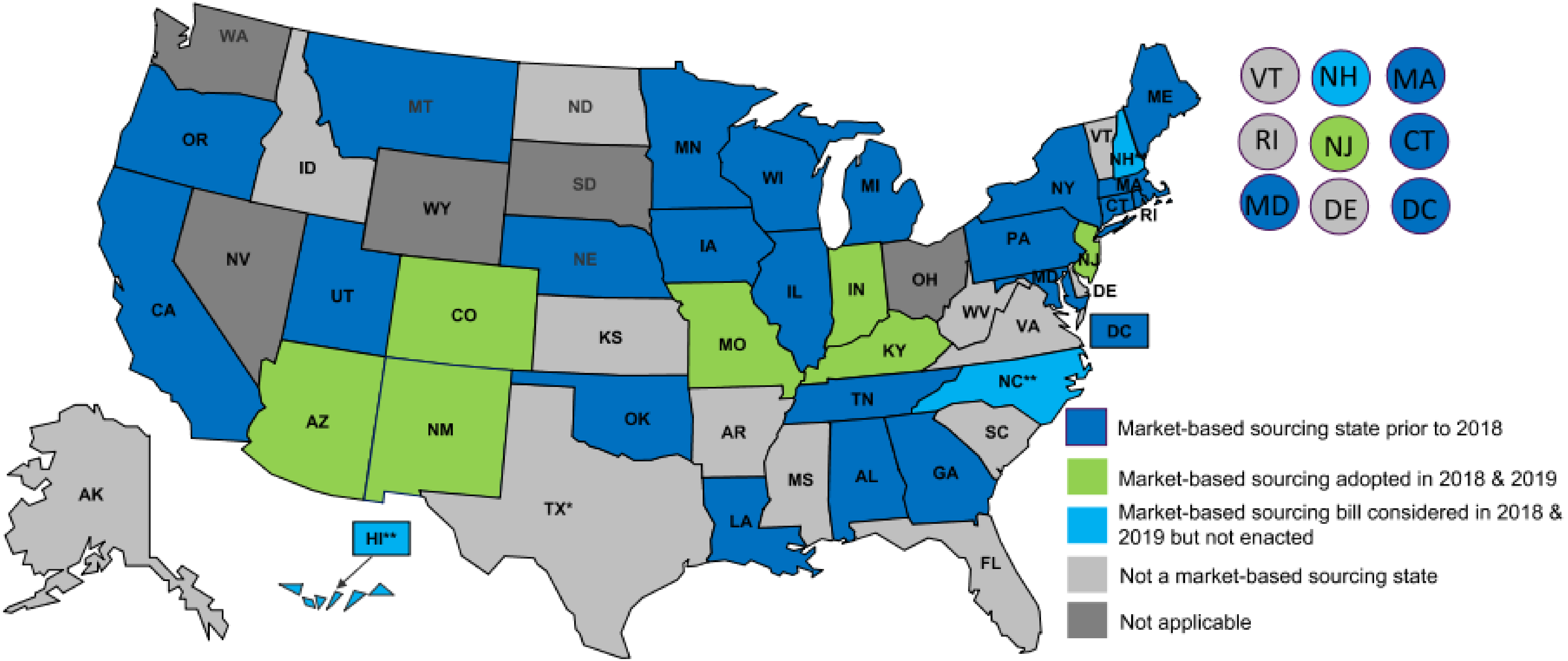
Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Sales Taxation of Business Inputs Compared with Single Sales Factor Utilization for State Corporate Income Tax Purposes



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019)

Corporate Income Tax - Market Sourcing



*Receipts from the sale of services are sourced to **Texas** if the service is performed in Texas. If the service is performed both inside and outside of Texas, the receipts are sourced to Texas on the basis of the fair value of services rendered in the state.

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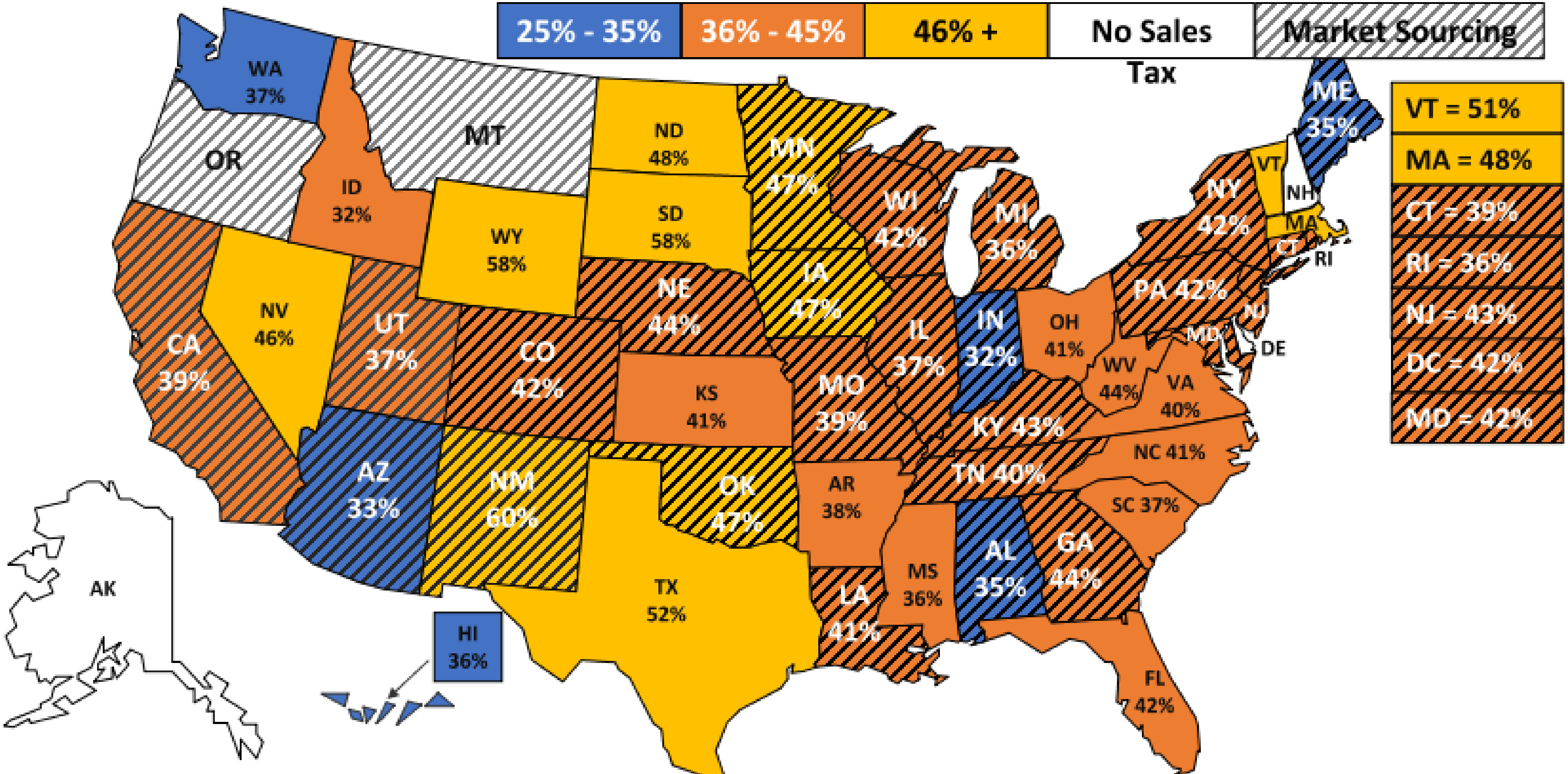
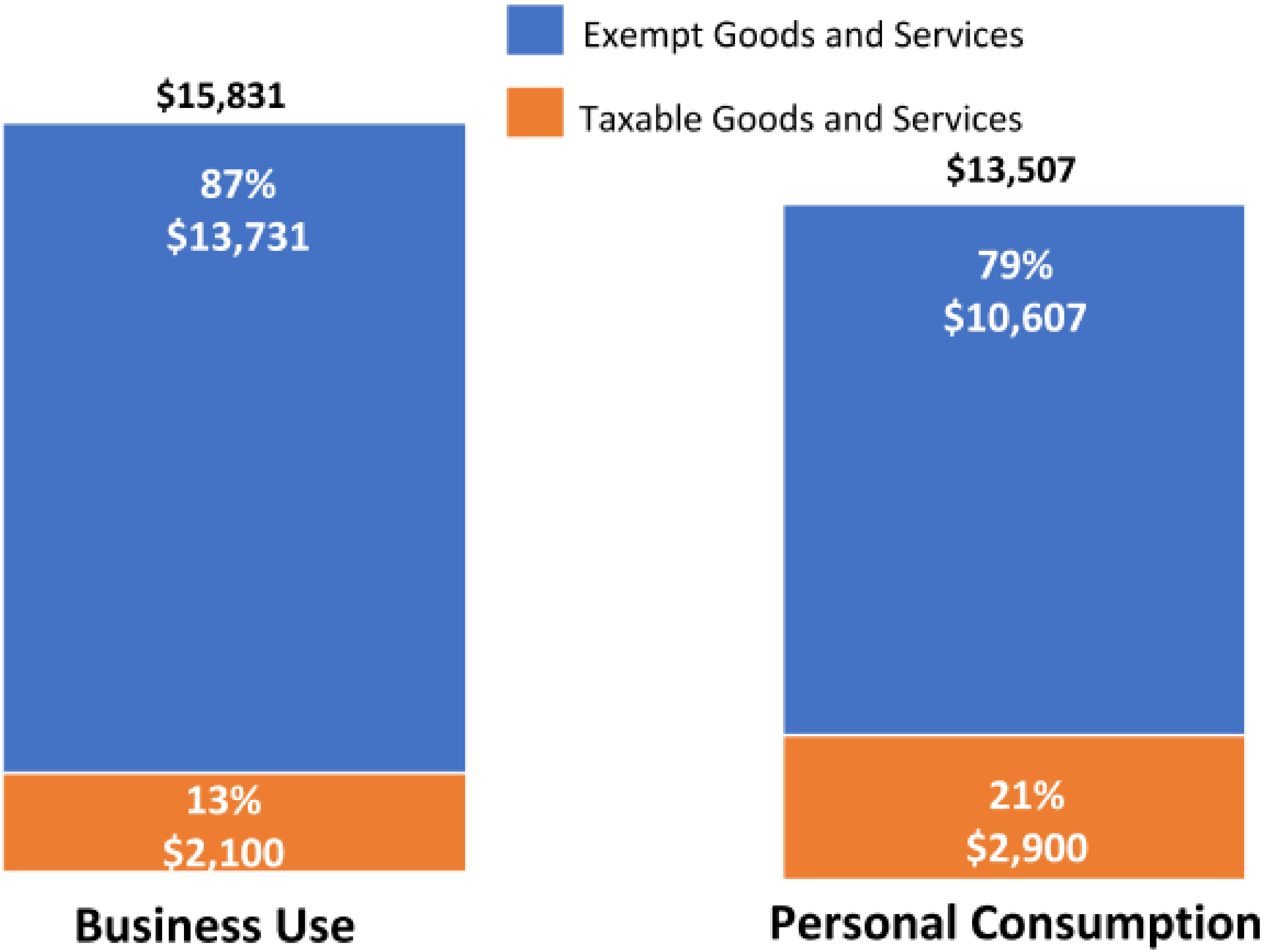
Sales Taxation of Business Inputs Compared with Market Sourcing Utilization for State Corporate Income Tax Purposes



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019)

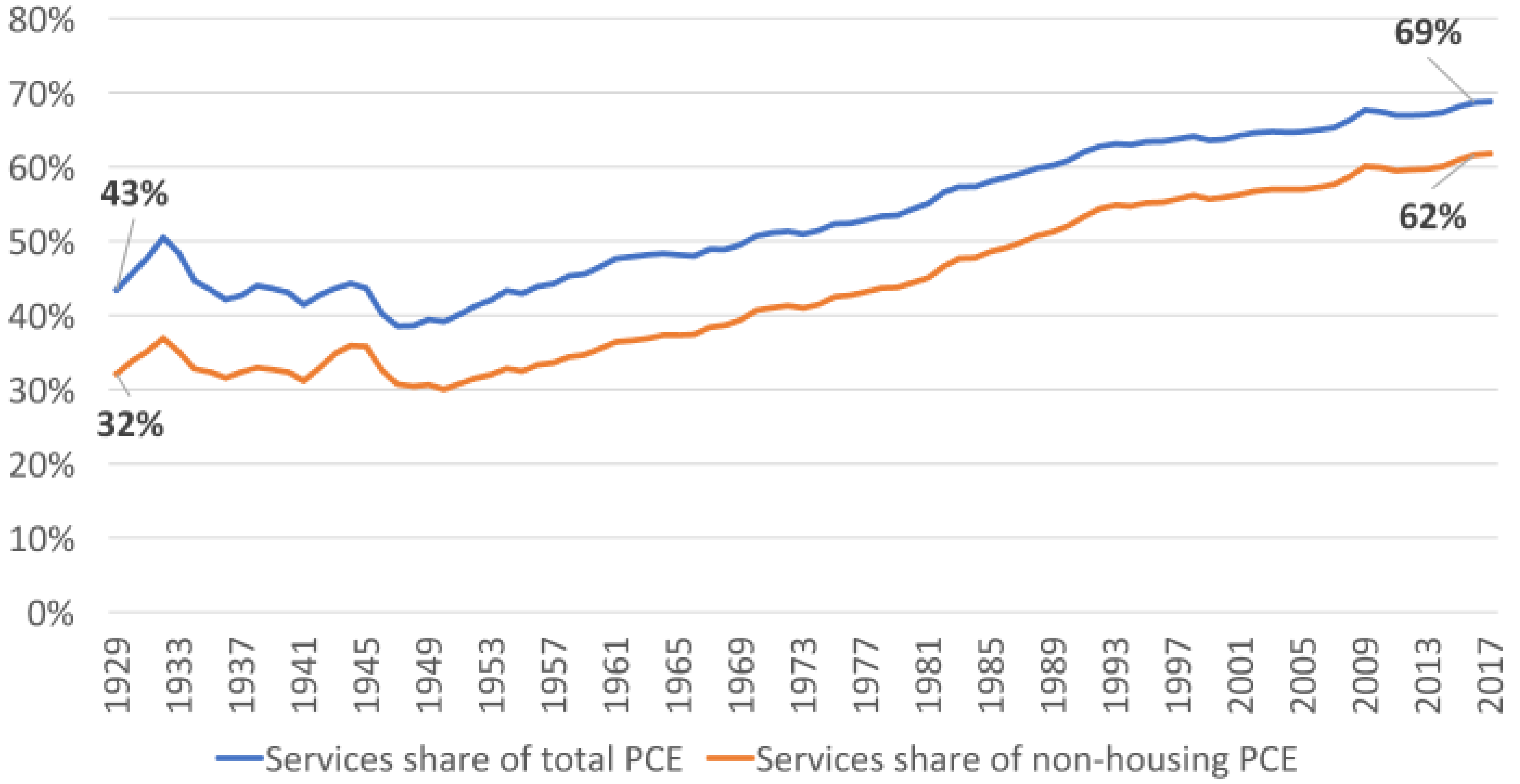
THE NARROW BREADTH OF SALES TAXES ON HOUSEHOLD CONSUMPTION

Taxable and Exempt Business and Household Purchases (in Billions USD)



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019)

Services As a Share of Total Personal Consumption Expenditures, 1929 – 2017

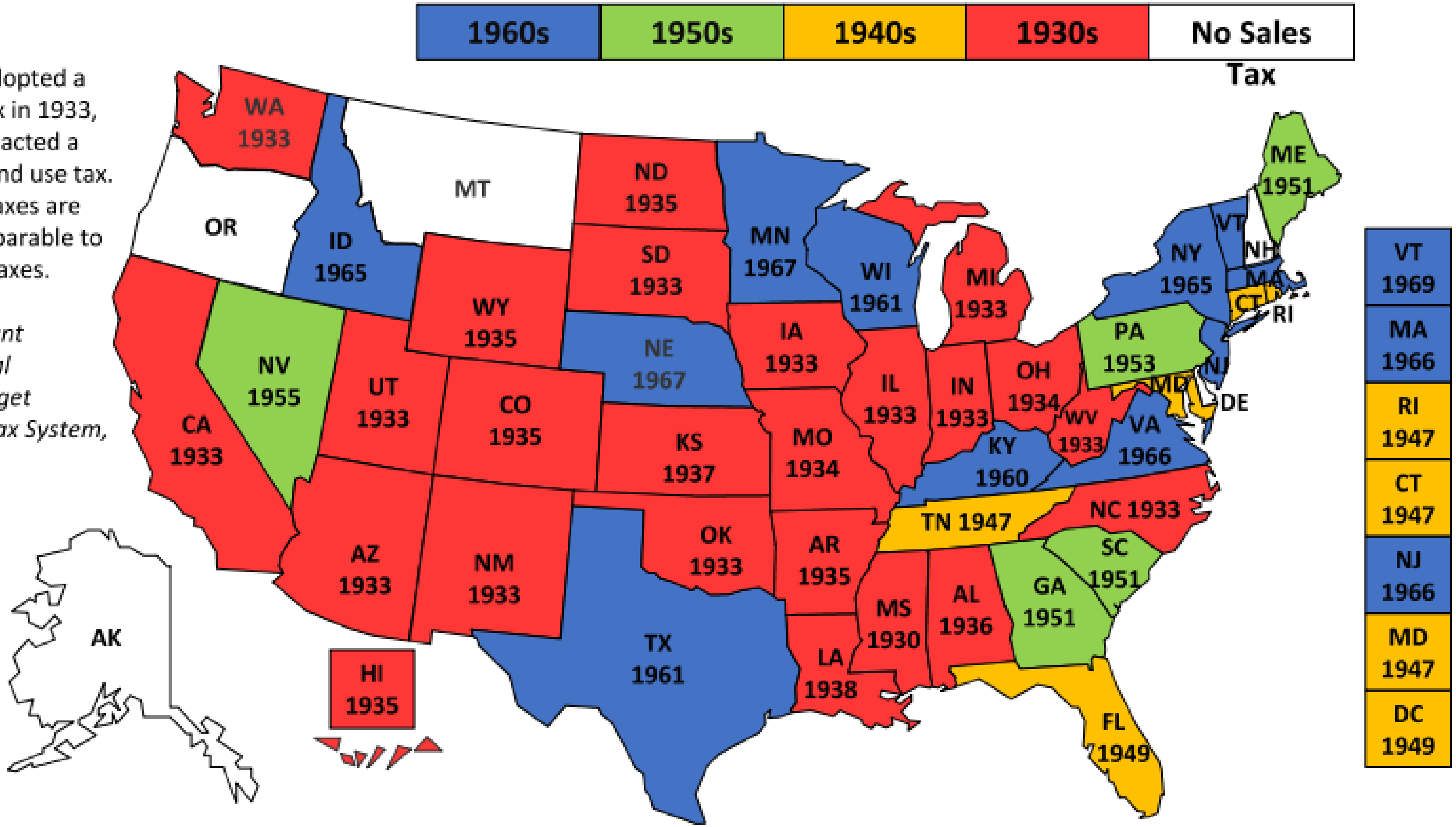


The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (June 2019)

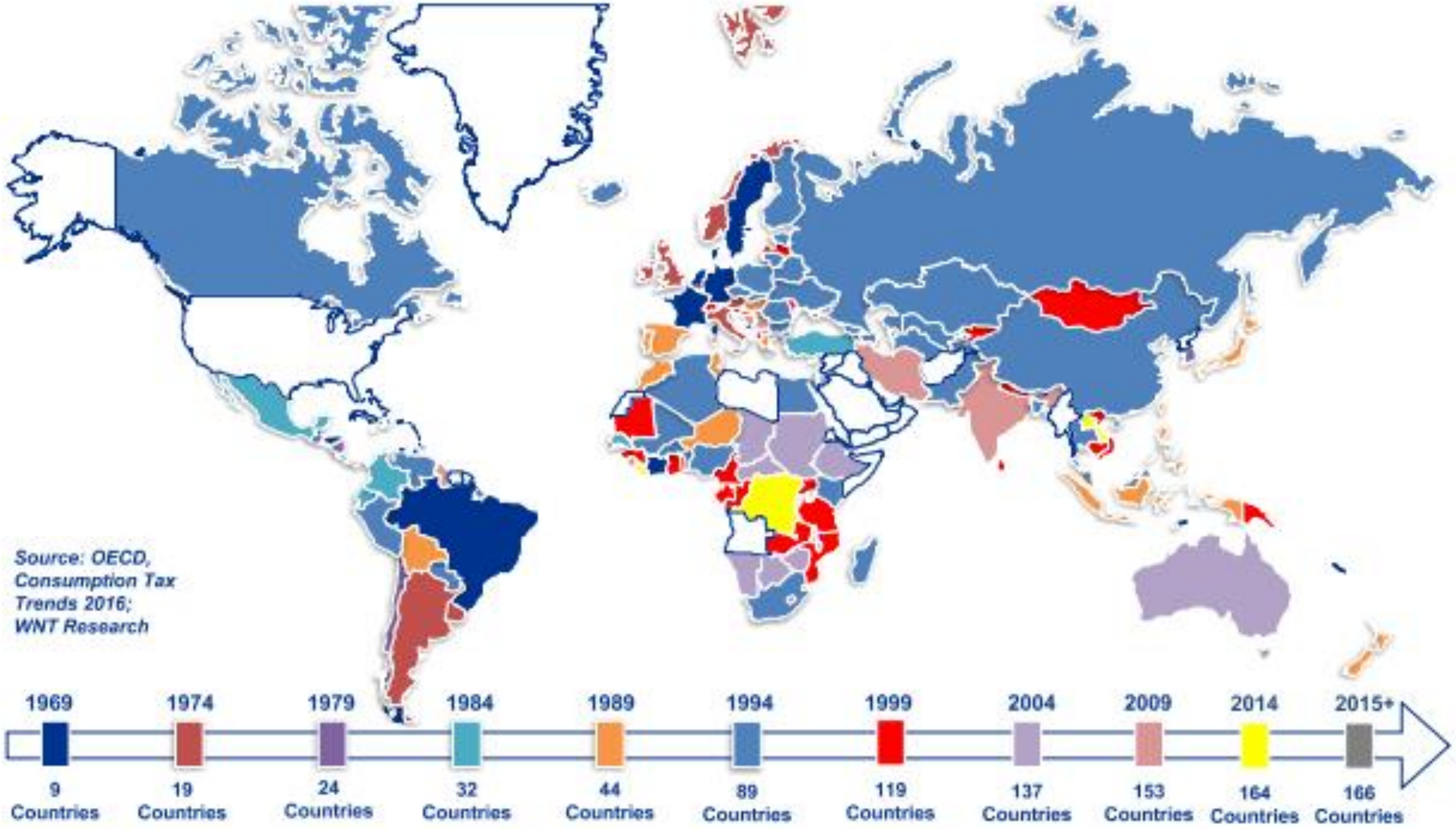
Most Sales Tax Statute Enactments Pre-Date the Growth of Services

Note: Indiana adopted a gross income tax in 1933, but in 1963 it enacted a 2% retail sales and use tax. Gross receipts taxes are not strictly comparable to the retail sales taxes.

Source: *Significant Features of Fiscal Federalism: Budget Processes and Tax System,* Vol. 1, 1994



Most VAT Statute Enactments Post-Date the Growth of Services



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Countries with Value Added Taxation (VAT)

- As of 2018, 166 out of 193 United Nation membership counties employ some type of VAT
- All the OECD members, except the U.S., impose a VAT
- Example of some countries with a VAT:

  France – 1954 – Standard Rate 20% (first country with modern VAT)

  Mexico – 1980 – Standard Rate 16%

  China – 1984 – Standard Rate 16%

  Canada – 1991 – Standard Rate 5%

  South Africa – 1993 – Standard Rate 14%

  Australia – 2000 – Standard Rate 10%

The Historic Decline in the Breadth of the Sales Taxation of Household Consumption in the U.S.

- Existing state sales tax systems tend to exempt a large number of household purchases of goods and services. Currently, only 21 percent of household personal consumption expenditures are subject to sales taxes.
- States typically exempt most medical and educational services, as well as most housing services consumed by households, which account for 42% of exempt household consumption.
- However, of the total household consumption not related to educational, medical or housing services, only 32% is taxable. (Source: *The Impact of Imposing Sales Taxes on Business Inputs,* study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019), p. 4).

The Historic Decline in the Breadth of the Sales Taxation of Household Consumption in the U.S.

- The state and local sales tax base is much narrower than the consumption tax base in other industrialized countries. The value-added tax (VAT) levied in Organization for Economic Co-operation and Development (OECD) countries collects an amount equal to 56% of final consumption compared to the U.S. sales tax system which collects an amount equal to 37% of final consumption. This comparison actually understates the differential in the breadth of taxation of household goods and services because it also includes the taxation of business inputs in the numerator.

(Source: *The Impact of Imposing Sales Taxes on Business Inputs, p. 6.)*

The Historic Decline in the Breadth of the Sales Taxation of Household Consumption in the U.S.

- Instead of expanding the sales tax base, there has actually been a significant narrowing by statute since 1970 of the number of states that tax certain categories of goods and services including residential electricity, gas and water; prescription medicine; and food for in-home consumption.
- In relative terms, the 2017 state and local sales tax base is slightly over two/thirds (69.3 percent) of its 1970 level. Conversely, the mean statutory sales and use tax rate has increased from 3.53 percent in 1970 to 5.6 percent in 2017, making the rate 58.6 percent higher. (Source: John Mikesell, "Reversing 85 years of Bad State Retail Sales Tax Policy," State Tax Notes, February 4, 2019, p. 395.)

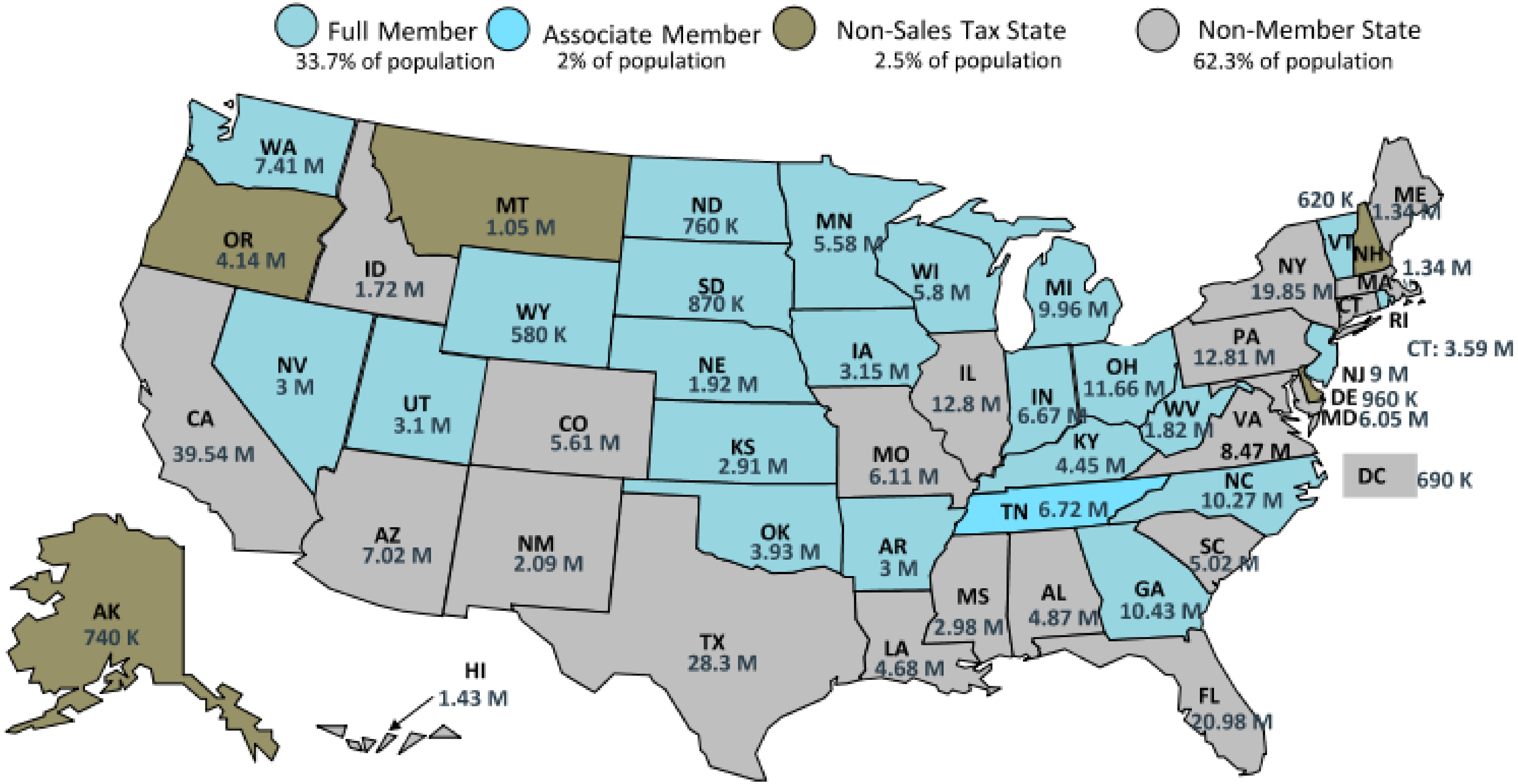
EXPANDING THE SALES TAX BASE WOULD BE LESS COMPLEX IF THE STATES HAD MORE UNIFORMITY

State Remote Seller Collection Versus Efficient and Fair Sales Tax System

- While the U.S. Supreme Court overturned the longstanding *Quill* precedent in the *Wayfair* case, **attaining a level of sales tax simplification and uniformity that satisfies a constitutional "commerce clause" requirement should <u>not</u> be confused with constructing an efficient and fair modern-day sales tax system.**

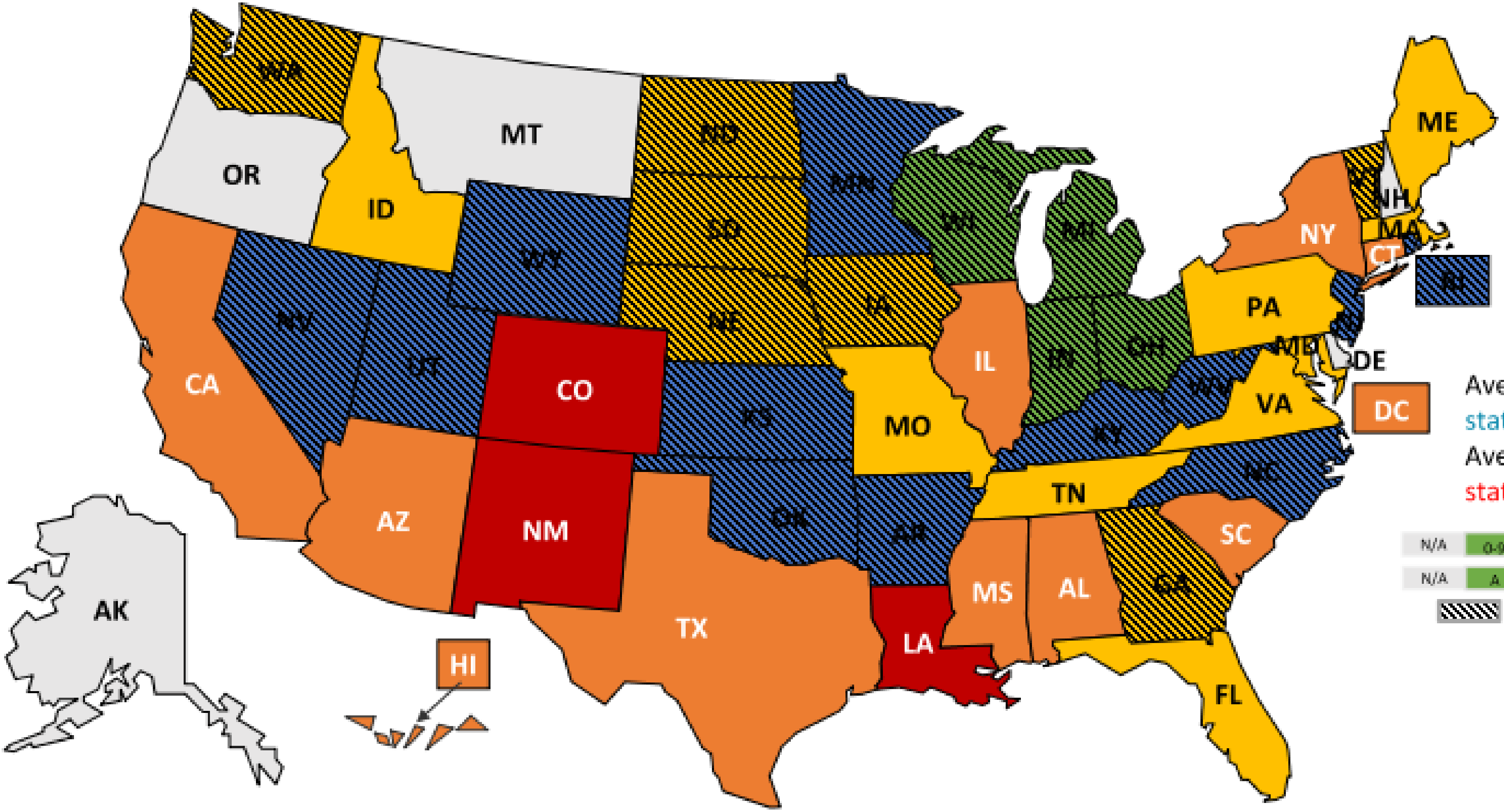
- Three Features the U.S. Supreme Court highlighted with South Dakota's law:
  - No retroactivity
  - Small seller exclusion
  - State was a member of the Streamlined Sales & Use Tax Agreement (SSUTA)

Will More States Join the SSUTA?
Streamlined Sales Tax States by Population



Source: U.S. Census Bureau

Overall Scorecard Grades
SSUTA vs. Non-SSUTA States



Average score of SSUTA states: B (12 pts.)

Average score of non-SSUTA states: D+ (19 pts.)

N/A	0-9	10-13	14-17	18-22	22+
N/A	A	B	C	D	F

SSUTA Full Member

State Sales Tax Systems: COST'S Categories for Grading States

- **The Best & Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity and the Exemption of Business Inputs**
  - First Edition released April 2018
- **Scorecard Categories**
  - Exemption for Business-to-Business Transactions
  - Fair Sales Tax Administration
  - Centralized Sales Tax Administration
  - Simplification & Transparency
  - Reasonable Tax Payment Administration
  - Fair Audit/Refund Procedures
  - Other Issues Impacting Fair Tax Administration
- **What the Scorecard Does Not Grade**
  - Tax Rate Differences
  - Tax Base Breadth (other than Taxing Business Inputs)

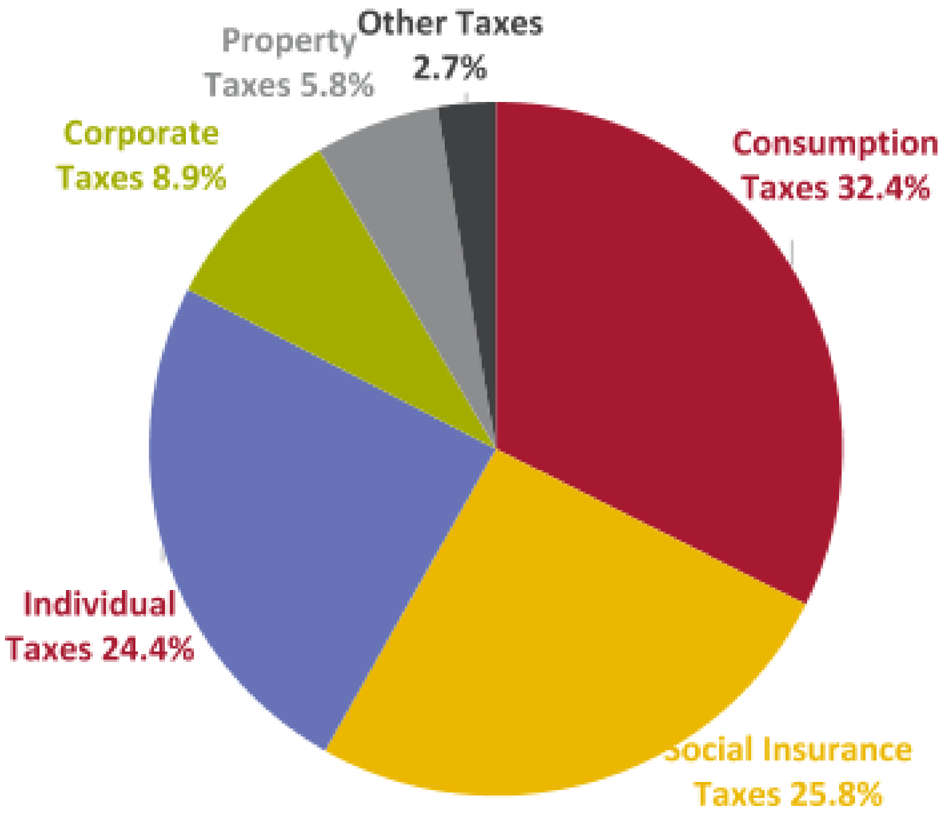
AN INTERNATIONAL PERSPECTIVE ON THE U.S. SALES TAX SYSTEM

The US Relies Less on Consumption Taxes Than Virtually All Other Countries

- Based on the most recently available OECD data, in FY2015, consumption taxes **accounted for about 17 percent of all taxes in the United States compared to 33 percent for all OECD countries.**
- Moreover, nations in other parts of the world have an even higher reliance on consumption taxes. Twelve of the thirteen countries in Latin America rely on consumption taxes for **over 50 percent** of their total tax base. In Asia, 10 of the 14 Asia Pacific countries are above the OECD average for consumption taxes and China relies on consumption taxes for **over 60 percent** of its total taxes.
- By contrast, the U.S. relies more on taxes on income, profits and property than most other countries. In FY2015, taxes on income and profits accounted for about **47 percent of all taxes in the U.S. compared to the OECD average of 33 percent**. In that same year, property taxes accounted for about 11 percent of all taxes in the U.S. compared to the OECD average of 6 percent.

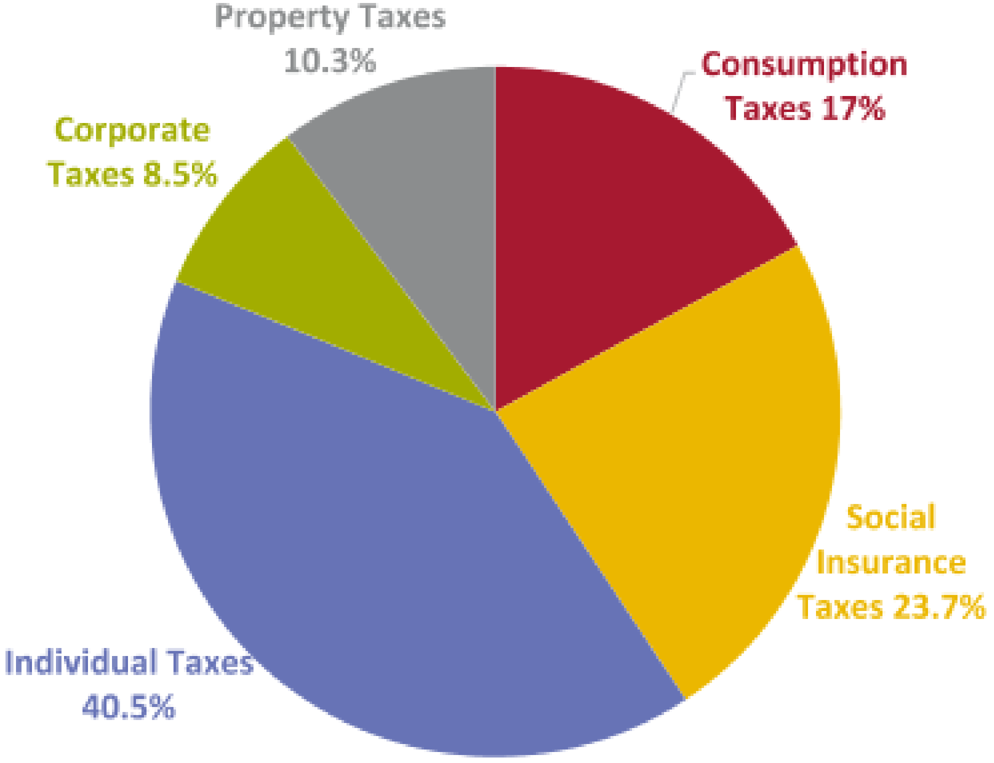
Share of Consumption Taxes: 32.4% OECD vs. 17% U.S.

OECD AVERAGE SOURCES OF TAX REVENUE, 2015



Source: OECD.Stat, http://stats.oecd.org/

United States' Sources of Tax Revenue (Federal, State, and Local, 2015)



Source: OECD.Stat, http://stats.oecd.org/

The U.S. state and local sales tax system is one of the most complex and inefficient consumption tax systems in the world.

- **Exemption of Business Inputs**: Sales taxes were designed to tax end-user consumption (not a general gross receipts tax) – however, on average, 42% of the states' sales tax revenue is derived from business inputs. Virtually all other countries mitigate pyramiding of their consumption tax by providing more expansive credits for business inputs
- **Uniformity and Simplification**: There is a much higher level of consumption tax uniformity in Europe (harmonization through the EU) and Canada (harmonization through the GST) than in the United States where the largest states with about two-thirds of the U.S. population have not adopted SSUTA.
- **Central Administration**: While 45 states have sales taxes (plus DC), when taking into account local sales tax jurisdictions, there are over 10,000 separate taxing jurisdictions. Accordingly, the U.S. has one of the most decentralized tax consumption systems in the world. There is no local consumption taxation in the EU or Canada.

THE DIFFICULTY WITH SWEEPING SALES TAX BASE BROADENING LEGISLATION

The Difficulty with Sweeping Sales Tax Base Broadening Legislation

- Over the last three decades, states have repeatedly sought to extend the sales tax base to cover a wide range of services.
- The state and local political landscape is littered with examples of states that failed to enact (or sustain) major sales tax base expansion even with significant gubernatorial or legislative support.
    - Florida (1987)
    - Massachusetts (1991)
    - Michigan (2007)
    - Nebraska (2013)
    - Ohio (2013)
    - Louisiana (2013)
    - Minnesota (2013)
    - Pennsylvania (2015)
    - Maine (2015)
    - Utah (2019)

The Difficulty with Sweeping Sales Tax Base Broadening Legislation

- Several factors are responsible for the failure of wide-scale sales tax base expansion, including the difficulty of enacting large-scale tax reform, the objection of impacted service providers, and general public resistance to new taxes.
- But certainly the most important common factor has been the principled opposition from the business community. Generally, the policy objections were not to the expansion and modernization of the sales tax base to include the growing services sector, but to doing so without limiting the base expansion to household purchases and exempting business inputs.

The "Catch 22" of Sales Tax Base Expansion

- By now, the historic lesson should be clear: the extension of the sales tax base to include business services is inconsistent with creating a more efficient and modern sales tax system.
- States that include business purchases in sales tax base expansion not only diverge from theoretical norms of an ideal sales tax system, but also risk near-certain defeat of comprehensive base-expansion legislation.
- States should recognize that if their goal is to modernize and broaden the sales tax base, expansion to include more services purchased by households, but not businesses, is better than no reform at all.
- An improved understanding of the extent and negative impact of sales taxes imposed on business inputs will enhance the potential for future sales tax reform to better comply with the principles of taxing final consumption of household goods and services while exempting intermediate business inputs.

Recent State Attempts to Expand Their Sales Tax Base

- On January 30, **Utah** Gov. Herbert (R) in his State of the State address proposed sales tax base broadening while lowering the sales tax rate from 4.85 percent to 1.75 percent (H.B. 441 had limited exemption of B2B services)
- On February 20, **Connecticut** Gov. Lamont (D) in his budget proposal proposed broadening the sales tax base to include digital goods, streaming services and a number of other services (H.B. 7410 exempted digital goods and services purchased by business)
- **South Carolina** H.B. 4532 proposed expanding the State's sales tax base to include many services, and also eliminating various exemptions from sales tax, many of which are business-to-business exemptions. The bill didn't move this year but is subject to carryover to the 2020 session

Other Problems with Sales Tax Base Expansion Efforts

- Legislation fails to adequately exempt business inputs which puts businesses in a state selling to other markets at a competitive disadvantage
- Encourages companies to self-provide business services to avoid the tax rather than purchasing them from more efficient providers
- Sale for resale exemption does not work for most services
    - Is a service really resold in the same form as provided?

Share of Services Purchased by Businesses and Personal Consumption, 2016

Industry	Business share	Personal consumption share
Administrative and support services	93%	7%
Broadcasting and telecommunications	50%	50%
Computer systems design and related services	100%	0%
Data processing, internet publishing, and other information services	77%	23%
Federal Reserve banks, credit intermediation, and related activities	67%	33%
Food services and drinking places	23%	77%
Insurance carriers and related activities	67%	33%
Legal services	68%	32%
Management of companies and enterprises	100%	0%
Publishing industries, except internet (includes software)	37%	63%
Rental and leasing services and lessors of intangible assets	73%	27%
Securities, commodity contracts, and investments	54%	46%
Waste management and remediation services	78%	22%

Bureau of Economic Analysis, 2016

Examples of Recently Enacted Sales Tax Base Expansion

- **North Carolina** (2017) with an emphasis on taxing services delivered by sellers with an existing sales tax obligations.
- **Kentucky** (2018) added to the sales tax base a number of (primarily) personal services including landscaping, janitorial services, fitness and recreational sports, laundry, dry cleaning, weight loss centers, limousine services, extended warranties, and select other personal services.
- **Many states** have expanded the sales tax base to include newly digitized goods and services that were previously taxed as tangible personal property

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