COST
Council On State Taxation

WHAT'S WRONG WITH TAXING BUSINESS SERVICES?

ADVERSE EFFECTS FROM EXISTING AND PROPOSED SALES TAXATION OF BUSINESS INVESTMENT AND SERVICES

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Prepared for the Council On State Taxation (COST)
by Robert Cline, Andrew Phillips and Tom Neubig, Ernst & Young LLP

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ABOUT COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. For more information, please visit *www.cost.org* or contact Doug Lindholm at *dlindholm@cost.org*.

ABOUT THE AUTHORS

Robert Cline is the Ernst & Young National Director of State and Local Tax Policy Economics. He is the former director of tax research for the States of Michigan and Minnesota. He has a Ph.D. in Economics from the University of Michigan.

Andrew Phillips is a Senior Manager in the Ernst & Young Quantitative Economics and Statistics group. He has extensive experience analyzing state and local tax policy issues for public and private sector clients. He has a B.A. from Emory University.

Thomas Neubig is the Ernst & Young National Director of Quantitative Economics and Statistics. He is the former Director and Chief Economist of the U.S. Treasury Department's Office of Tax Analysis. He has a Ph.D. in Economics from the University of Michigan.

EXECUTIVE SUMMARY

This study was prepared by Ernst & Young LLP for the Council On State Taxation (COST).[1] The study addresses key tax policy issues arising in a number of state legislatures that are debating proposals to significantly expand the sales and use tax base to include substantially more business-to-business sales. The study explains the sales tax concept and discusses the issues related to taxing business purchases of intermediate goods and services.

As legislators debate proposals to expand sales tax bases that would significantly alter the nature of the sales tax, they should be aware of the tax policy issues involved and the effects those

changes would have on a state's business tax competitiveness. This study examines these issues in some detail.

Our findings include:

- Sales tax systems vary in structure from state-to-state, but they share a common characteristic: state and local sales taxes in operation differ significantly from a theoretical retail sales tax. A properly designed sales tax on consumption would impose a uniform tax on all goods and services sold to households, but would not impose any tax on business purchases of intermediate goods and services. Sales taxes on business input purchases have significant adverse state economic development implications.
- A number of state legislatures are considering proposals by governors and legislators to extend the sales tax to more business purchases of goods and services. An extension of sales tax to these business-to-business sales would exacerbate the current economic distortions from the imposition of sales tax on business inputs.
- Current sales taxes on business inputs violate several tax policy principles (economic growth, efficiency, equity, simplicity, and transparency) and cause a number of economic distortions. The distortions are caused by what economists call "pyramiding." Pyramiding results when a sales tax is imposed multiple times on the same value of business input purchases at multiple stages in the production and distribution process leading up to a final sale to consumers. With pyramiding, the effective sales tax rate exceeds the statutory rate and varies in hidden and arbitrary ways across different types of consumer purchases.
- While most states make some attempt to reduce pyramiding of their sales tax through specific exemptions, these efforts are far from complete. The current sales tax systems impose $130 billion of taxes on business-to-business sales of products, services and equipment, representing 44% of total state and local sales taxes. Extending the sales tax to services would magnify the pyramiding problem because of the high percentage of the additional sales tax revenue that would be collected on business-to-business sales.
- 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 out-of-state customers and thus are likely to reduce their investment and employment in the state in response to relatively high sales taxes on their input purchases.
- Currently, most states do not tax services primarily purchased by business due to the pyramiding, complexity, and the additional costs of tax administration and compliance it would create.
- Expansions of sales tax bases to include additional business-to-business sales of goods and services would result in the following:
  - Significant tax increases would be imposed on businesses often with 70% to 80% of the increased revenue derived from sales taxes on business input purchases. This is the reason why the legislative debate of these proposals is a debate primarily about business taxes, not taxes on households.
  - Companies would be encouraged to self-provide business services to avoid the tax imposed on additional services rather than purchasing them from more efficient service providers and paying tax. This would penalize firms that have been focusing on their core businesses and turning to smaller businesses to provide non-core services.
  - Companies subject to higher sales taxes on their purchase of additional goods and services would be put at a competitive disadvantage to many of their competitors in other states and in foreign markets. To the extent companies are limited by market competition in their ability to pass the additional sales taxes forward through higher prices, businesses would have a strong incentive to reduce investment and employment in the state.
  - Sales taxes on business inputs result in hidden variation in effective sales tax rates due to pyramiding if the increased sales taxes are passed forward as higher consumer prices. This makes it impossible to determine who bears the burden of the sales tax and how the tax burdens vary by household income levels. As a result, it is difficult to design policies to offset this burden on lower income households.

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.

States that are considering reforms to their sales tax systems should consider the economic development impacts of increasing retail sales taxes on business-to-business sales. Several states that have adopted major sales tax changes that extended the sales tax to business purchases of inputs have subsequently, and often quickly, voted to repeal the extensions.

The answer to the report title's question of "what is wrong with taxing business services" with a sales tax is: a lot of adverse economic effects from both the existing and proposed sales taxation of business investments and services.

WHAT'S WRONG WITH EXPANDING THE SALES TAX BASE TO INCLUDE BUSINESS PURCHASES OF GOODS AND SERVICES?

Introduction

In practice, typical state sales taxes are imposed on a significant portion of business-to-business sales. Proposals to expand the sales tax to services would add significantly to sales taxes on business purchases of goods and services. This results in a number of problems, including:

- arbitrary and hidden differences in effective sales tax rates on different goods and services that distort consumer choices,
- distortions in how firms operate,
- violations of horizontal and vertical equity principles, and
- detrimental impacts on a state's business tax competitiveness.

Proposals to expand the sales tax base to include services purchased by business compound the problems created by the current level of sales taxes imposed on business input purchases. These problems include:

- Taxing business inputs is inconsistent with the rationale for a retail sales tax designed to operate as a tax on final household consumption. Because businesses are not the final consumers of business input purchases, the sales tax should not apply to their purchases. Ignoring this tax policy principle creates a hybrid tax system that is a mix of a retail sales tax on final consumers and a gross receipts tax on a large portion of business-to-business sales. It is difficult for legislators to understand what should or should not be taxed under a retail sales tax if a retail sales tax on final consumption is mixed with a gross receipts tax that, at best, is an indirect and arbitrary way to tax final consumption.
- Sales taxes on business purchases of goods and services results in multiple taxation of the cost of inputs as the goods and services are resold in multiple steps in the production and distribution process. This is the problem of "pyramiding" of the sales tax that results in the total sales tax embedded in the final sale of goods and services to households being a multiple of the sales tax that should be imposed on the final consumer.
- Pyramiding distorts consumer decisions about what to buy and business choices of what inputs to purchase, where to locate jobs and investments, and how to organize their business structures. While all taxes have some distorting effects, the sales taxation of business-to-business sales at a typical rate of 5% to 6% creates large and wide-spread distortions that affect all sectors of a state's economy.

  With pyramiding, different products and services purchased by households 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, providing goods and services internally to avoid taxable transactions, even if it results in additional business costs that reduce the value of a state's economic output.

  While public finance economists may worry more about these economic "inefficiencies" than legislators, the distortions will have real economic consequences that should be considered.
- For the portion of the sales tax on business inputs that is passed forward through higher prices to final consumers, the hidden variation in effective sales tax rates due to pyramiding of the sales tax imposed on business purchases makes it impossible to determine who bears the burden of the sales tax and how the tax burdens vary by household income levels (the issue of "vertical equity") and by different types of consumers at the same income level (the issue of "horizontal equity"). This type of hidden tax is contrary to the goal of greater tax transparency
- Sales taxes on business inputs have the same negative effects on a state's competitiveness as other "origin-based" taxes, such as the property tax. For firms that cannot pass relatively high sales taxes on their purchases from other firms forward through higher prices, because they sell into competitive national or international markets, for example, sales taxes will reduce the profitability of operating in a state. This would result in less investment and employment in the state.
- Taxing business inputs increases administrative and compliance costs for both tax administrators and taxpayers. For example, large companies purchasing significant inputs from outside vendors will normally calculate and remit the "use" tax on their purchases, as contrasted with the vendor collecting the sales tax. As discussed in more detail below, use tax compliance and auditing costs can be significant, especially for multi-state companies, given the difficulties of identifying where services are actually consumed.

Proposals to expand the sales tax base to include services purchased by business compound the problems created by the current level of sales taxes imposed on business input purchases.

Understanding the tax policy issue

One of the most unexpected state tax policy developments in 2013 is the number of proposals, introduced primarily by governors, to extend state sales and use taxes to a broad range of services and other items purchased primarily by businesses. These sales tax base-broadening proposals are embedded in tax reform proposals that would significantly reduce, or eliminate, income taxes on individuals and businesses. In their recent budget or state-of-the-state addresses, governors in Louisiana, Minnesota, Nebraska, and Ohio have recommended tax reform packages which include expanding the sales tax base to include a wide range of services purchased by both households and business or reducing exemptions from the sales tax base. (See the Appendix for a more detailed description of these proposals.)

As legislators debate these proposals that would significantly alter the nature of the retail sales tax, they should be aware of the tax policy issues involved and the impacts the changes would have on a state's business tax competitiveness and other tax policy objectives.

The state proposals to expand the sales tax base have a common tax policy objective: to increase reliance on consumption taxes by extending the sales tax to services that are not currently a significant component of the sales tax base in most states. Proponents of expanding the sales tax to services argue that this structural change will increase the built-in growth rate ("elasticity") of the sales tax base, reduce the regressivity of current sales taxes, and reduce economic distortions (inefficiencies) affecting consumer and business choices, as any target level of tax collections can be achieved at a lower sales tax rate.

Most economists would agree that these are important potential benefits *if* the sales tax base expansion is limited to services purchased primarily by households as final consumers. This critical qualification appears to have been lost in the process of designing recent sales tax reform proposals. To the extent that services are primarily consumed by business, such as professional services, including these business-to-business sales in the sales tax base will have a significant negative consequence: putting in-state companies at a competitive disadvantage relative to out-of-state competitors not subject to sales taxes on their purchases of these inputs.[2]

More generally, taxing business input purchases under a sales tax is inconsistent with the tax policy foundation on which a retail sales tax is built. While there may be widespread agreement among many legislators, policy makers and economists on the need to rebalance state tax systems to tax consumption more heavily, expansion of the sales tax base on business inputs does not achieve that objective. The next section explains why this is the case.

Most economists would agree that these are important potential benefits if the sales tax base expansion is limited to services purchased primarily by households as final consumers.

Design of a retail sales tax

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 and/or to other business purchases.

Over 40 percent of state sales taxes are collected from taxation of business inputs, whose costs are generally hidden and unrecognized in the form of higher consumer prices and/or reduced state economic activity, including reduced employment and lower wages. The sales tax reform proposals currently being debated would add significantly to this business tax burden.

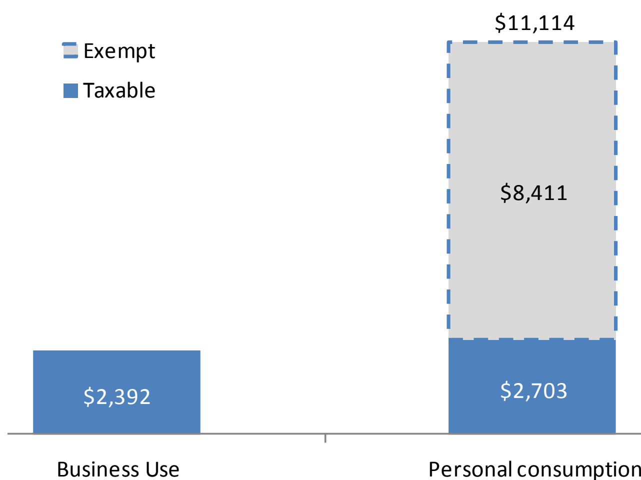
Over 40 percent of state sales taxes are collected from taxation of business inputs, whose costs are generally hidden and unrecognized in the form of higher consumer prices and/or reduced state economic activity, including reduced employment and lower wages.

The retail sales tax, theoretically, is a tax on final consumption by households with no taxation of business purchases. It is designed to tax final consumption by applying the tax to the final sales in the production and distribution of goods and services. Because business purchases are intermediate inputs in this process, not final consumption, they should not be taxed under a retail sales tax or consumption tax. In value-added tax systems, businesses get a tax credit to offset tax paid on their business purchases, thus eliminating the pyramiding.

Figure 1 (based on 2011 data) shows that, in practice, current state sales and use tax systems fall short of this ideal tax structure in two important ways:

- **They tax too *few* household purchases of goods and services.** An estimated 24% of products and services (personal consumption) purchased by households are subject to sales taxes. States exempt large segments of consumer purchases, including most medical and educational services, significant personal services plus numerous other retail goods and services, including food for home consumption. An ideal retail

Figure 1
Taxable business purchases and taxable and exempt household purchases ($billions)



Source: Ernst & Young calculations

sales tax would tax a significantly larger percentage of household purchases of goods and services as final consumers.

- **They tax too *many* business input purchases.** Under an ideal retail sales tax, business purchases of goods and services would not be taxed because the tax is designed to be a tax applying only to final sales to consumers. Figure 1 shows that $2.4 trillion of business input purchases are taxed under the sales tax.

  In practice, sales taxes are imposed on business input purchases of both services and products because most states have incomplete sale-for-resale and direct business use exemptions that should, but don't, remove the sales tax from business-to-business sales.

The current under-taxation of household consumption and over-taxation of business inputs, relative to an ideal retail sales tax, creates complexity and economic distortions, as well as potential negative impacts on a state's business competitiveness. In the political debate over expanding the retail sale tax to include services, business opposition to these proposals is focused on preventing large *increases* in sales taxes on business purchases, not on reducing the already high current level of sales taxes on business-to-business sales. This focus reflects the fact that much of the additional sales tax revenue expected under these proposals would be generated from business-to-business transactions.

State-by-state estimates of sales taxes paid on business-to-business purchases

The extent to which state sales taxes currently tax business-to-business sales is shown in Figure 2, which presents state-by-state estimates of the percentage of total state and local sales taxes imposed on business-to-business purchases.[3] Under an ideal retail sales tax system, the percentage paid by business on their input purchases should be zero.

In fiscal year 2011, state and local sales taxes on business purchases, including intermediate inputs and capital investments, totaled $129.7 billion, 44% of total state and local sales taxes of $294.9 billion. The business shares varied from 28 percent in Idaho to 57 percent in Washington State and exceeded 50 percent in nine states.

To put these estimates in perspective, aggregate state corporate income tax collections in fiscal year 2011 for all states were $46.3 billion. Sales tax collections on business inputs were 2.8 times larger than state corporate income tax collections.[4] While a retail sales tax would not apply to business-to-business purchases, state and local sales taxes, in practice, impose substantial tax burdens on business purchases, increasing the operating and capital costs of doing business in a state.

The current under-taxation of household consumption and over-taxation of business inputs, relative to an ideal retail sales tax, creates complexity and economic distortions, as well as potential negative impacts on a state's business competitiveness.

Alternative consumption tax bases

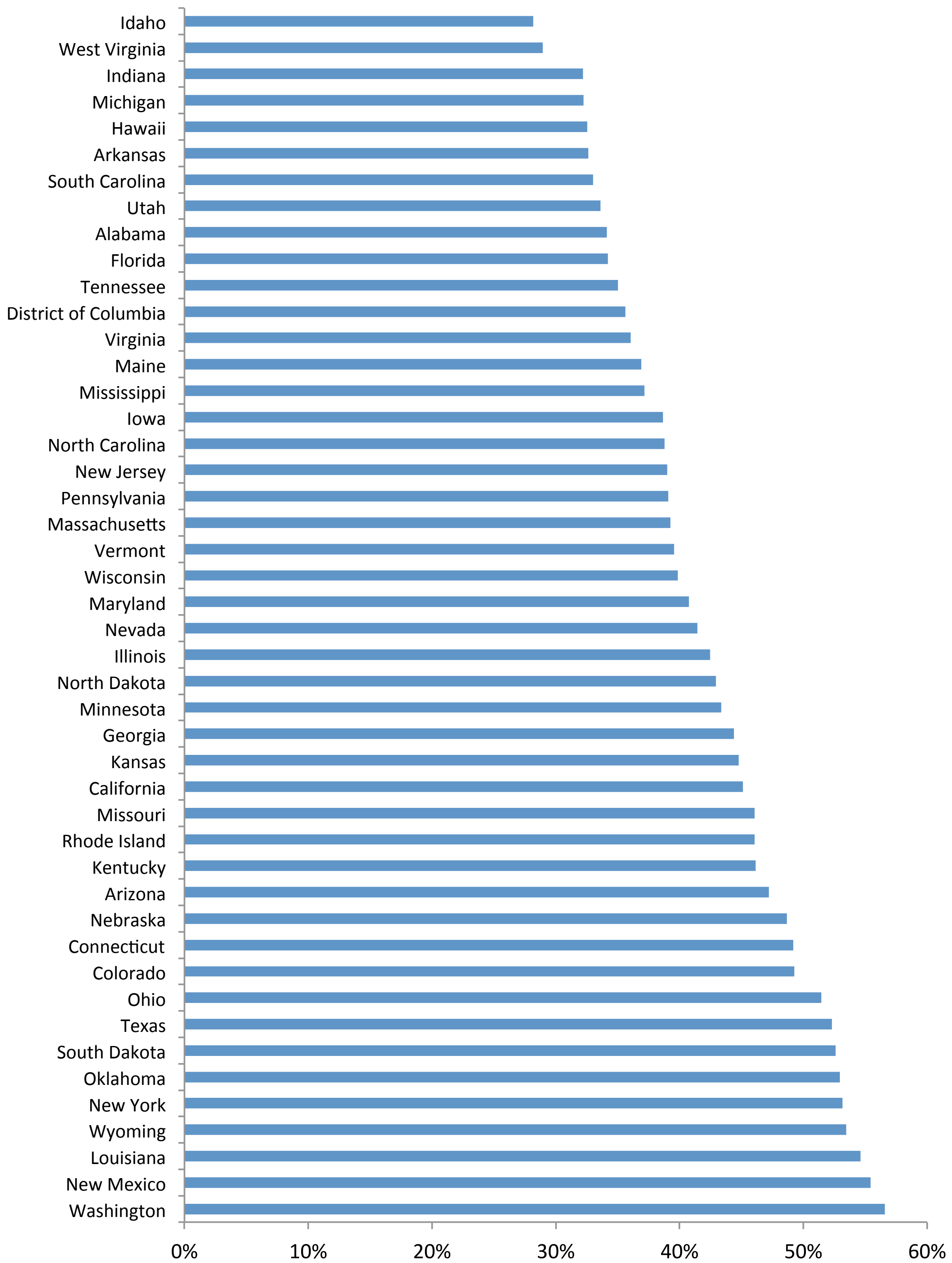
As the prior discussion illustrates, today's sales taxes fall short of comprehensive taxation of household consumption. Given the tax policy objective of expanding the sales tax base to more household services, legislators should be aware of alternatives to the retail sales tax to meet this objective. A comparison of these options to the expansion of sales taxes to services purchased by both consumers and businesses should also help legislators to understand the shortcomings of the proposed sales tax approaches.

Table 1 lists several alternative consumption tax bases along with the estimated size of the U.S.-wide tax base that corresponds to each type of tax base.

The broadest base is a gross receipts tax base, $30.6 trillion, which taxes all sales whether sold to households or to other businesses. As shown in the last column, the gross receipts tax base is almost three times as large as an ideal retail sales tax base on final household consumption. Because the gross receipts tax base includes all business-to-business sales, the base is much larger than an ideal retail sales tax base and includes significant pyramiding of the tax, a problem discussed in some detail below.

The theoretical retail sales tax base in Table 1 taxes all sales to final consumers; it excludes all business-to-business sales

Figure 2
Estimated percentage of state and local sales taxes imposed on business input purchases, 2011



Source: Ernst & Young calculations

Table 1
Alternative consumption tax bases

	Amount	Relative to ideal
Tax base	($billions)	sales tax
Gross receipts	$30,557	278%
"Ideal" retail sales tax	$11,002	100%
Current sales taxes	$4,049	37%

Source: Ernst & Young calculations; U.S. Bureau of Economic Analysis, *National Income and Product Accounts*, 2011 data.

from the base. The estimated base equals personal consumption expenditures plus a portion of investment for residential housing.[5] The actual state and local sales tax base is shown in the last row of the table. It equals the sum of actual state retail sales tax collections across all states. The last column in the table shows that the actual retail sales tax is 63% smaller than the theoretical base. This shortfall is the net effect of imposing taxes on business inputs, inconsistent with the theory of retail sales taxation, and exempting a large share (76%) of consumer expenditures.

Ohio and Washington State present interesting case studies of alternative approaches to increasing state consumption taxes on services. Both states currently use two different approaches to taxing consumption: 1) a typical retail sales tax, and 2) an indirect, entity-level tax on businesses' gross receipts, the Commercial Activities Tax (CAT) in Ohio and the Business and Occupation (B&O) tax in Washington State. The Ohio CAT, adopted in 2005, actually began with the concept of a more limited "excise" or sales tax on services with a lower rate than the sales tax rate. This concept expanded into the CAT on almost all sales in Ohio. It was pointed out during the debate over the CAT that it provided an alternative to the sales tax as a means of indirectly taxing the consumption of services. Like any gross receipts tax, the taxes in Ohio and Washington State are subject to pyramiding.

Any proposal to extend the sales tax to services primarily consumed by business, without an exemption for business-to-business sales of services required under a retail sales tax, is equivalent to imposing another level of gross receipts taxes on these sales by service providers. What is different about the two taxes, and the most important issue from a tax competitiveness perspective, is the magnitude of the tax rates under the retail sales tax compared to the gross receipts taxes. The retail sales tax rates in Ohio and Washington State are currently 5.5% and 6.5%, respectively. In contrast, the CAT rate is 0.26%, while the B&O tax rates vary from 0.1% to 0.5%. The much higher sales tax rates on business-to-business purchases of services have the potential to magnify problems with taxing business inputs under the gross receipts taxes.

The comparison of tax bases in Table 1 illustrates that the taxation of services purchased by business moves the retail sales tax system further away from the concept of taxing final consumption and closer to a gross receipts tax. This results in a form of consumption tax which adversely affects business investment decisions in a state.

Pyramiding of the sales tax

What is pyramiding?

The most serious problems with applying sales taxes to business input purchases are directly related to the pyramiding of the taxes. 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 through production and distribution to final retail sale. This occurs when the purchase of an input by one business is subject to the sales tax, and then the subsequent sales of the first business include the same costs in the sales price subject to the sales tax a second time. This multiple taxation of the same business costs can occur at each stage of production and distribution prior to the final retail sale. In effect, the value of the good or service embedded in sales prices of multiple businesses are taxed multiple times. The pyramiding problem occurs whenever a retail sales tax is imposed on business-to-business sales.

Any proposal to extend the sales tax to services primarily consumed by business, without an exemption for business-to-business sales of services required under a retail sales tax, is equivalent to imposing another level of gross receipts taxes on these sales by service providers.

Table 2 illustrates the pyramiding problem. The example begins with a manufacturer of appliances that sells to a retailer. The retailer then sells the appliance to a final consumer. The state's sales tax system, typical of most sales tax systems, imposes the retail sales tax at a 6% rate on selected business-to-business ("intermediate") sales, as well as on purchases of the consumer's final purchase of the appliance. Table 2 tracks purchases of goods and services by the manufacturer, retailers and final consumers. The input costs at each stage are carried forward as components of the sales price at the next stage. For simplicity, the example ignores any markups of each cost component at later stages.

In this example, the state exempts purchases of circuit boards by the manufacturer from the sales tax as a component part incorporated into the appliance. The table shows that this input will not be taxed until the appliance is sold to the final customer, the correct treatment in an ideal sales tax. The costs of labor and capital (profits) are also exempt from the sales

Table 2
Example of pyramiding of taxes on business inputs under a retail sales tax

Components of total production and distribution costs	Appliance manuf.		Retailer		Final customer		Sales tax all stages	Effective tax rate
	Purchases	Sales tax	Purchases	Sales tax	Purchases	Sales tax		
Appliance Manufacturer								
Circuit boards	$200	$0	$200	$0	$200	$12.00	$12.00	6.0%
Labor and profits	1,000	0	1,000	0	1,000	60.00	60.00	6.0%
Office equipment	40	2.40	40	2.40	40	2.40	7.20	18.0%
Outsourced services	100	6.00	100	6.00	100	6.00	18.00	18.0%
Retailer								
Labor and profits			$100	$0	$100	$6.00	$6.00	6.0%
Office equipment			20	1.20	20	$1.20	$2.40	12.0%
Outsourced services		10	0.60		10	$0.60	$1.20	12.0%
Total appliance cost to consumer					$1,470	$88.20	$106.80	7.3%
Sales tax summary								
Ideal retail sales tax on final sales		$0.00		$0.00		$88.20	$88.20	6.0%
Actual taxes on intermediate & final sales								
Without taxes on service inputs		$2.40		$3.60		$88.20	$94.20	6.4%
With taxes on service inputs		$8.40		$10.20		$88.20	$106.80	7.3%

tax until the final sale. However, office equipment purchased by the manufacturer and the retailer are taxed as intermediate purchases; as a result these purchases are taxed multiple times as costs embedded in business-to-business sales. Although inconsistent with the design of a retail sales tax, most states do tax some of these types of intermediate business purchases resulting in significant pyramiding of the sales tax.

The next-to-last column shows that the cumulative sales tax on the initial purchase of office equipment by the manufacturer is $7.20 (three times the 6% sales tax on the initial $40 purchase by the manufacturer) on this portion of the cost of the refrigerator. The last column shows that the $7.20 cumulative sales tax on this input cost is equivalent to an 18% ($7.20 divided by $40) effective sales tax rate. The $4.80 extra tax above and beyond the $2.40 that would be collected under an ideal retail sales tax on final consumers is the dollar amount of pyramiding.[6]

Table 2 also provides insights concerning the distorting effects of sales tax pyramiding:

- The greater the number of business-to-business purchases in the production and distribution chain, the greater is the effective sales tax rate on the consumer purchases of goods and services. The example shows that the effective sales tax rate (ETR) is 18% on component costs of taxable purchases by the manufacturer compared to 12% for taxable input purchases by the retailer that are subject to one less taxable sale in the production and distribution chain.
- Because the ETR varies by the number of intermediate stages in the production and distribution process, pyramiding results in ETRs that vary significantly in unknown ways by type of product or service. This hidden variation in sales tax rates makes it very difficult, or impossible, for policy makers to know what the burden of the sales tax is on final consumers, and how pyramiding distorts purchase decisions of both consumers and businesses.
- The addition of professional services to the sales tax base would significantly increase the degree of sales tax pyramiding. This occurs because states do not generally provide exemptions for business-to-business sales and each firm in the production and distribution chain is likely to have significant taxable purchases of services. One reason for this is that businesses have increasingly been focusing on their core businesses and turning to more efficient, often small business, third-party service providers. If the sales tax is extended to services, firms would pay sales taxes on those purchases.

  As noted in the first section of this paper, recent proposals to expand state sales tax to services are primarily proposals to impose sales taxes on intermediate input purchases by business. Businesses may pay up to 80% of the increased sales taxes under these proposals. Without exemptions for business-to-business sales, these proposals would significantly compound the problems created by pyramiding.
- As shown in the last section of Table 2, taxing business services moves the sales tax even further away from an ideal sales tax on final consumption. An ideal sales tax would apply once on the final sale to consumers. The table shows that the ideal tax would generate $88.20 in total sales taxes (6% of the final sales price of $1,470). Currently, the typical state sales tax would generate $94.20 of taxes (equivalent to a 6.4% sales tax) because of multiple taxes on business-to-business products. If the services are then subjected to the sales tax, total taxes increase by $16.80 (an effective tax rate of 7.3%).

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. The lack of these exemptions would create even greater pyramiding under recent proposals to extend the sales tax to services. State legislators should understand that a sales tax on services primarily purchased by businesses is a distinctly different tax from the retail sales tax imposed on services primarily consumed by households.

How significant is pyramiding?

As illustrated in Table 2, the hidden tax on business purchases due to pyramiding results in an arbitrary additional tax on final consumer goods. This additional tax can be quite large. For example, a study by the Washington State Tax Structure Study Committee found that the Washington State Business and Occupation Tax, which is a gross receipts tax on most businesses, pyramids an average of 2.5 times.[7] In other words, $1.00 of initial tax on an industry's sales results in $1.50 of additional taxes from pyramiding, and an aggregate tax embedded in the final price that is 2.5 times the initial tax.

While states have reduced pyramiding of the sales tax with sale-for-resale and manufacturing exemptions for business-to-business sales of tangible personal property, significant pyramiding still occurs in the current sales tax system. The extent of pyramiding varies by industry purchasing taxable inputs, by type of goods and services purchased, and by state due to differences in what purchases are included in the sales tax base.

A final important point is that pyramiding of the retail sales tax creates unintended and unknown distributional impacts. Because pyramiding results in a wide range of unknown ratios of sales taxes per dollar of final sales, the distribution of sales tax burdens by household income levels is very difficult to determine. This creates a challenge, for example, in determining how to structure tax credits to partially reduce the regressive impacts of sales taxes on lower-income households if sales taxes are passed through in higher prices to final consumers. If the tax is passed back in fewer jobs and lower wages to a state's residents, the negative impacts will be even more difficult to identify and offset with state policies.

The hidden tax on business purchases due to pyramiding results in an arbitrary additional tax on final consumer goods. This additional tax can be quite large.

Lack of transparency

As explained, pyramiding results in hidden variations in the effective sales tax rates that apply to different goods and services ultimately purchased by consumers. While the multiple levels of sales taxes on intermediate steps in the production and distribution chain may be passed along in higher prices to consumers, only the sales tax imposed on the final sale is transparent to the buyer. The amount of pyramiding at each earlier stage is "invisible." A number of economists have argued that the lack of transparency results in residents underestimating the level of taxes they pay for government services. To the extent that this occurs due to pyramiding of the retail sales tax, the actual level of government services may exceed the level that would be demanded if residents were aware of the full amount of sales taxes they are paying.

Pyramiding is exacerbated by extending the sales tax to services

The degree of pyramiding, and its associated problems, are even greater when the sales tax is applied to services. There are several reasons for this:

- Sales tax systems are typically designed to reduce pyramiding related to the purchases of tangible personal property through sale-for-resale exemptions and exemptions for inputs used in production and processing. However, states provide few, if any, exemptions for the business-to-business sales of services. This subjects sales of services to more rounds of multiple taxation than is typical for business-to-business sales of products.
- The business share of services potentially taxable under a retail sales tax, including professional and business services, is much greater than the business share of products that are typically subject to current sales taxation. As a result, sales taxes on services fall primarily on business-to-business sales that create pyramiding.
- The problem of pyramiding due to taxing services is spread over all sectors of the economy, not just the service sectors that provide the services. To the extent that sales taxes are passed through in higher prices to the purchasers of the service, every industry using the taxable services would be affected by pyramiding.

Table 3 provides another perspective on the potential impacts of subjecting services to retail sales taxes by comparing the distribution of tax increases by *selling* and purchasing industries. The first set of columns shows the Ohio Department of Taxation's estimate of increased sales taxes by *selling* industry. The second set of columns, prepared by Ernst & Young for the Ohio Business Roundtable, shows the estimated distribution of the sales tax increase by *purchasing* industry. This distribution shows the extent to which the tax increase would be imposed on services purchased by all segments of the economy. The proposal would impose an estimated $2.0 billion in additional sales taxes on business purchases of services, a little over 75 percent of the total $2.7 billion estimate of the total increase from including services in the sales tax base.

The share of the retail sales tax paid on business purchases would exceed 10% for manufacturing; education and health;

Table 3
Estimated distribution of additional Ohio sales taxes on households and business-es, by selling industries and by purchasing industries for business-to-business sales ($millions)

Industry	Taxable sales by selling industry* Tax increase	Taxable sales by selling industry* Percent distribution	Taxable sales by purchasing industry** Tax increase	Taxable sales by purchasing industry** Percent distribution
Agriculture, mining, utilities			$33	2%
Construction			109	5%
Manufacturing			331	16%
Wholesale and retail trade			185	9%
Transportation	$263	10%	$72	4%
Information and communications	360	14%	152	7%
Finance, insurance, and real estate	584	22%	307	15%
Professional services	910	34%	175	9%
Management and business services	320	12%	159	8%
Education and health		0%	260	13%
Entertainment, hospitality and personal services	85	3%	$197	10%
Other industries	130	5%	$53	3%
Total for business purchases			$2,033	100%
Household purchases			619	
Total tax increase	$2,652	100%	$2,652	

*Taxable sales by selling industry are from Table 5, Ohio Department of Taxation, *Ohio's Jobs Budget: 2.0 Reforms Book,* Febru-ary 4, 2013, p. 47. The sales tax rate is 5%.

** Ernst & Young estimates for the Ohio Business Roundtable based on taxable sales by selling industry, using an Ohio input-output model to distribute the increases to purchasing industries.

finance, insurance and real estate; and arts, entertainment and personal service major industry groups. Note that education and health are expected to pay $260 million (13% of the total $2.0 billion sales tax increase) in sales taxes on *input purchases,* even though the proposal exempts their *sales* to households from the tax on services. This illustrates the pyramiding problem caused by the taxation of business-to-business services that are widely distributed across all industries. Consumers of health and education would be protected from the direct sales tax, while simultaneously subject to price increases from the indirect effect of pyramiding from the sales tax on business inputs.

Negative impacts on interstate business tax competitiveness

Perhaps the most important policy problem with taxing business-to-business sales of services (and products), is the potential negative impact on a state's 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 business 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.

By design, the sales tax paid by the consumer on the final retail purchase is a "destination tax"; it is imposed on the good or service a consumer purchases regardless of where the good or service was produced. If the sales or use tax is generally imposed on all in-state purchases by consumers, the sales tax would not create differences in delivered prices. In contrast, applying the retail sales tax to business-to-business purchases can, in fact, alter delivered prices and put a state's producers at a competitive disadvantage.

Perhaps the most important policy problem with taxing business-to-business sales of services (and products), is the potential negative impact on a state's business tax competitiveness.

The fact that the business purchaser uses the taxed inputs to produce goods and services that are then sold to their customers converts the retail sales tax into an "origin-based tax." In effect, because the business purchasing the taxable goods and services is not the final customer, the sales tax gets embedded in the producer's costs. Like all other producer costs, the sales tax on business inputs is a cost of producing goods and services tied to the location (origin) of production. If a state subjects its producers to a higher level of sales taxes on business-to-business sales, a producer may be put at a competitive disadvantage when selling into other states because the higher costs of production due to the sales tax results in higher delivered prices.

Indiana University professor John Mikesell has clearly framed the economic competitiveness issue in terms of sales taxes on business-to-business sales of products:

> 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.[8]

If states extend the retail sales tax to services purchased by business, the competitive disadvantage would 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 sales taxes on services purchased 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 would lose significant sales to competitors in other states. 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 would eventually shift the burden of the tax backwards to labor in the state through lower wages and employment.[9] If this happens, "business" would not bear the burden of the tax on business services, but the state's residents would.

Note that this would adversely affect a state's competitiveness even if the state exempts exports of business services from the retail 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 subject to the sales tax would be burdened by the cumulative amount of sales taxes on business services used in each step of the production and distribution process.

For in-state companies selling to in-state customers, the negative impact on competitiveness would occur through a different mechanism. Because it is difficult to collect a use tax on business services imported into a state, it would be more difficult for in-state providers of business services to raise prices to recoup the sales tax on intermediate purchases. In effect, these in-state companies would be put at the same competitive disadvantage that many in-state retailers currently face from out-of-state remote competitors who sell goods to in-state customers without collecting sales taxes and where use tax compliance is low. This disadvantage could average six percent of gross sales, which is often more than the entire profit margin on many sales. Once again, in-state firms would have to reduce their employment in the state and/or lower employee wages to remain competitive.

States imposing gross receipts taxes also face the possibility that the tax puts in-state businesses at a competitive disadvantage in competing with out-of-state firms. In New Mexico, for example, 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 to the New Mexico purchaser within the state. This disadvantages New Mexico companies. In addition, New Mexico has only a limited sale-for-resale exemption for service providers, leading to substantial pyramiding. Ohio has adopted detailed sourcing rules for the CAT tax, along with asserting economic nexus over out-of-state sellers, in an effort to impose the CAT on imports of goods and services into the state.

If states extend the retail sales tax to services purchased by business, the competitive disadvantage would 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.

Impact on total state business taxes of extending the sales tax to services

Table 4 provides estimates of the potential size of state business tax increases if sales taxes are extended to services. The first four columns of the table show Ernst & Young's estimates of state business taxes under current law for the ten states with the largest private sector GDP. The next set of columns illustrate the potential magnitude of the increase in business sales taxes from taxing services, including professional and business services, as well as certain intrastate transportation, information services, and certain other services.[10] The final column in the table shows the potential impact on state business taxes of such a proposal, expressed as a percentage of total state business taxes. Extending the sales tax to the services described above would increase total state business taxes by 12% to 28%, depending on the state. This would have an adverse effect on a state's business competitiveness without offsetting tax changes, and would affect industries and individual companies differently.

Given the high percentage of sales of services that are business-to-business sales, state policy-makers should be concerned about the negative impacts on in-state companies from taxing services consumed by business. If states cannot effectively enforce sales tax collection on out-of-state service providers, a tax on services could put in-state service providers at a competitive disadvantage. Whether these taxes are paid by the businesses providing services or passed along in higher prices to purchasing businesses, the sales tax on services should be

Table 4
Impact on total state business taxes if all business services were subject to state sales tax for the 10 largest states, FY2011 ($billions)

	Current law business tax				*Including a tax on services*		
State	Corporate Income Tax	Existing Sales Tax on Business Inputs	Other state business taxes	Current Total	Increase in Sales Tax from Taxing Services	Total with sales tax on services	Percent Increase in Business Taxes
California	$9.6	$14.0	$28.0	$51.5	$13.0	$64.5	25%
Texas	0.0	11.4	15.7	27.1	4.9	31.9	18%
New York	4.0	6.2	16.8	26.9	3.1	30.1	12%
Florida	1.9	6.6	7.3	15.8	3.3	19.1	21%
Illinois	1.9	3.1	8.1	13.1	3.6	16.8	28%
Pennsylvania	2.0	3.5	9.4	14.9	2.3	17.2	15%
New Jersey	2.2	3.2	6.6	12.0	2.4	14.4	20%
Ohio	0.2	3.3	7.8	11.3	1.7	13.0	15%
North Carolina	1.1	2.4	4.6	8.1	1.7	9.8	21%
Georgia	0.7	2.3	2.9	5.8	1.4	7.2	24%

Source: EY/COST *50-State Total State and Local Business Taxes, FY2011* plus EY calculations

considered principally a state business tax that will negatively affect a state's business tax competitiveness.

ADMINISTRATIVE COMPLEXITIES OF TAXING BUSINESS SERVICES

Most states have been reluctant to extend the sales tax to business services, including professional services provided by engineers, technology consultants, lawyers, accountants, and other professionals. 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 sales tax. Hawaii and New Mexico impose gross receipts taxes that in practice are similar to a sales tax on most professional services.

A factor contributing to this reluctance is the fact that taxing services primarily consumed by business under a sales tax is a challenge for legislators to design, tax agencies to administer, and taxpayers to determine and remit the correct amount of taxes. These challenges are discussed in this section.

Defining the tax base

A significant legislative challenge is determining how to define what services are taxable or not taxable. States have typically taxed only a select number of services that are specified in law. If the sales tax is extended to most services, should the legislation specify that all services are taxable unless explicitly exempt in statute, or should the law specify all the services that are taxable?

The latter would require an extensive list, to say the least, including mining, transportation, communications, construction and real estate, banking, legal, accounting and other professional services, health, education and the very extensive list of personal service categories. To put this challenge in perspective, the federal government's comprehensive catalogue of U.S. economic activities (the NAICS system) lists over 500 separate industries providing services, each of which can contain a number of specific services they provide. In the legislative debates over extending the sales tax to services, there will be constituents who question the inclusion of each of these services in the base.

Connecticut is an example of a state that specifically identifies at least 50 categories of services that are taxable under its sales tax. These services were generally added to the tax base prior to the state's adoption of the income tax in 1991. A number of services are purchased primarily by business, including business management consulting, computer and data processing services, building management services and employment services,

In contrast, if the law specifies that all services are taxable unless exempted, the list of exemptions might also be quite extensive. Experience shows that legislatures often make numerous changes in either list every year to address issues of equity, compliance, and economic development. The changes almost always have been in the direction of adding, not subtracting, exemptions.

Determining which state should tax a service

To avoid multiple taxation of the same service transaction by multiple states, sales taxes are generally structured to assign the sale to the location of the buyer of the good or service. This is the destination concept discussed earlier. The nature of services creates a much greater complexity in determining this location than in the case of goods.

In determining where a service should be taxed (the "sourcing" issue), states generally look to where a service is "used" or consumed. 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 col-

lected 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 use or 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) distributed 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? An additional question is: How does a service provider know where the service will be used by the business purchaser of services? Under state sales tax systems, it is generally the responsibility of the retailer to determine whether the good or service is taxable.

To illustrate, assume that a corporate headquarters located in Ohio buys consulting services from Ohio service providers. The headquarters uses these services to support the general business operations of multiple affiliates in a number of different states. While the services were purchased by the corporate headquarters in Ohio, where are they used? Should the services be sourced to Ohio or assigned to each state where an affiliate is located? If they should be assigned to multiple states, how should each state's share be determined?

South Dakota's approach to taxing legal services illustrates how complex the answer to the sourcing question can be in the case of sales taxes imposed on business-to-business sales of mobile, professional services.[11] 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 additional Florida revenue from expanding the sales tax to services was from business-to-business sales of services, this became the key focal point for opponents of the tax.[12] In effect, the heated Florida debate was principally a debate about business taxation, rather than a debate about extending the sales tax to services purchased by households.

Florida adopted an entirely new method of determining the location of the use of business services for purposes of imposing the 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. Following this logic, the new law adopted Florida's three-factor formula for apportioning corporate income to determine where the use of the service took place.[13] 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 real and personal property, cannot be known for a specific state, but can only be apportioned by arbitrary factors.[14]

Florida's adoption of the net income formulary apportionment to divide the use of business services purchased by a business among the states where the purchasing business operates 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 sales tax structure.

The resulting hybrid tax system was strongly criticized by business as creating very high compliance costs relative to the sales 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.[15] While it is not clear what type of tax this was, it is certain that it was not 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.[16]

An important tax policy issue directly related to the difficulty in determining where business services are used is the 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 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 tax policy issue is that it is extremely difficult to determine where many business services are consumed and, therefore, how to determine which states should impose sales and use taxes on service transactions and which states should provide offsetting tax credits to avoid multiple taxation. Ad hoc approaches to deal with these problems would quickly lead the retail sales tax to a new, additional business tax.

CONCLUSION

The problems with extending the sales tax to business inputs become more evident as states debate applying the tax to business-to-business services. As already discussed, these problems have resulted in several states reversing sales tax law changes shortly after adoption and governors withdrawing proposals before legislative votes occur. Examples of these reversals include:

- Florida's six-month experiment in 1987 with an apportioned sales tax on services.

  The in-state vs. out-of-state competitiveness issue was one of the key factors that caused Florida's legislature to repeal its sales tax on services. The business community's opposition to the new law was swift, loud and, ultimately, successful. After repeal of the extension of the sales tax to services, Florida's legislature replaced the lost revenue with an increase in the sales tax rate on the previous tax base.

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

  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.[17] Purchases of services consumed by a business in the general running of the business were considered taxable.

- Michigan's one-day experiment in 2007 with imposing retail sales taxes on services.

  The bill to impose sales tax on services went into effect on December 1, 2007 with a projected sales tax increase of $1 billion annually. Businesses strongly opposed the tax change and voiced concerns over the law's complexities, arbitrary determination of which services would be taxable, and potential negative impact on business tax competitiveness. The bill was repealed less than twenty-four hours after it was adopted. The legislature decided

to immediately repeal the sales tax on new services, but replaced it with a 21.99 percent surcharge on the state's newly adopted Michigan business tax, a combination of a modified gross receipts tax and a business income tax.

- Maryland's 2008 repeal of its extension of the sales tax base to include computer services within five months after adopting the law change.
- Minnesota Governor Dayton's withdrawal of his fiscal 2014-15 budget proposal to expand the sales tax base to include additional services before the beginning of legislative debate on the proposal.
- Nebraska Governor Heineman's withdrawal of his support for a bill to expand the sales tax base several weeks after the bill was introduced.

The state experience highlights the shortcomings of the current sales tax system because it differs from a theoretical retail sales tax, and violates fundamental tax policy principles of competitiveness, fairness, simplicity, equity, and efficiency. The fundamental tax policy problem is that the current sales tax is far from a properly designed sales tax: it taxes too many business purchases and too few consumer purchases. Extending the sales tax to services primarily consumed by business will exacerbate this problem.

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 among firms that differ in how they operate. In contrast, 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."

Current proposals in a number of states to expand the sales tax base to include a wide-range of services would compound the problems associated with imposing sales taxes on business-to-business sales. In particular, a large share, in the range of 70% to 80% based on Ernst & Young estimates and in some cases state bill analyses, of the additional state sales tax revenue expected from the adoption of these proposals would be collected from business-to-business sales of services. Taxing services that are primarily consumed by business, as well as taxing additional business-to-business sales of products, would create more pyramiding, increase distortions in after-tax prices of different goods and services, and reduce the competitiveness of in-state companies, adversely affecting a state's economic development efforts.

The current debate over expanding the sales tax is spotlighting the limitations inherent in the design of the sales tax as a transaction tax being applied to increasing cross-border sales of tangible and intangible goods, as well as services. If states have the goal of raising additional taxes that fall primarily on consumption, they should pay careful attention to providing expanded business exemptions or adopting alternatives to the retail sales tax to avoid imposing high-rate sales taxes on business-to-business sales.

APPENDIX: RECENT STATE PROPOSALS TO INCREASE SALES TAXES ON BUSINESS PURCHASES OF GOODS AND SERVICES

Legislative bills to expand the sales tax base to include services or reduce exemptions have been introduced in 2013 in Louisiana, Minnesota, Nebraska, and Ohio. These bills would fundamentally alter the structure of the retail sales tax. This section looks at the features of some of these proposals. As will be discussed, the proposals to expand the sales tax base are primarily proposals to impose additional sales taxes on business inputs. Under the specific legislative proposals in the three states, the business share of the additional tax collections from base broadening may be as high as 80% of the total increase, resulting in additional sales taxes on business input purchases that range from $1billion to $2 billion a year in each state. The following sections describe the details of the sales tax reform bills that have been introduced in Louisiana, Minnesota, Nebraska, and Ohio.

Louisiana

Governor Bobby Jindal introduced a tax reform plan in March 2013 that included a restructuring of all of the state's major taxes. The overall proposal is designed to be revenue neutral. The proposal includes:

- Eliminating the individual income tax and the corporate income and franchise tax
- Expanding the sales tax base by including a broad range of services purchased by both businesses and households and reducing existing sales tax exemptions. Under the proposal, all services would be taxable unless specifically exempted by law or constitutionally protected. Initial service exemptions include health care, education, construction, real estate, financial services, legal services, oil and gas field services and funeral services. Also excluded are the costs of buying ads.
- Increasing the state general sales tax rate (from 4% to 5.89%) and the cigarette tax rate (by $1.05 per pack)
- Increasing severance taxes by eliminating a number of current exemptions

- Expanded tax relief for low-income households and the elderly to offset the regressivity of the sales tax increase
- Eliminating a number of current law sales tax exemptions

As is the case in the other states proposing to expand the sales tax to services, a significant portion of the additional sales tax revenue from expanding the base to include services would initially fall on business-to-business sales of services.

Minnesota

Governor Mark Dayton in Minnesota proposed a significant restructuring of the state's retail sales tax as part of a tax reform package that includes individual income tax rate increases, adjustments in the corporate income tax and expanded property tax relief for homeowners. The sales tax component combines an expansion of the sales tax base to services purchased primarily by business, and a 23% reduction in the sales tax rate. The expansion of the sales tax base to a number of services is described as "sales tax reform."[18] The proposed additions to the sales tax base include:

- Professional and technical services, such as accounting and bookkeeping, advertising, architectural, engineering, design, computer systems design, management consulting, research and development, logistics, and legal services,
- Office administration, business support, computer and data processing services,
- Travel agent, repair, and warehousing and storage services,
- Personal services, and
- Selected products consumed primarily by households.

The expansion of the sales tax base is estimated to raise $2.6 billion in additional revenue in FY 2015. Based on the revenue estimates for the governor's tax reform proposal, $1.9 billion (80%) of the total increase would be paid on business purchases of services.[19] In contrast, businesses would only receive 44% of the reduction in taxes on currently taxable goods and services due to a lower state sales tax rate. On balance, the proposal would increase business sales taxes by over $2 billion a year. In contrast, the net sales tax change for households (as final consumers) would be a small reduction in sales taxes paid.

The new services included in the proposed sales tax law change are intended to be "sourced" to where the customer (client) "receives" the services. The sourcing provisions, designed to avoid multiple taxation of the same transaction in more than one state, determines in which state services should be taxable. This destination principle is consistent with Minnesota's current-law sourcing of the sale of goods (tangible personal property). If an out-of-state seller of a service (or good) that is delivered to the client (customer) in Minnesota does not have "nexus" in Minnesota, the purchaser of the service or product would have to pay a use tax to Minnesota. This sourcing rule also implies that a Minnesota firm selling services, such as advertising, that are delivered to an out-of-state company does not have to collect Minnesota sales tax on the sale.

The original sales tax proposal received stiff opposition from Minnesota business taxpayers. Less than two months after the original budget proposal was submitted, Governor Dayton introduced a revised budget proposal that eliminated the proposal to expand the sales tax base to include additional services purchased by businesses and households; it also eliminated the planned reduction in the sales tax rate.[20]

Nebraska

A bill introduced in the 2013 Nebraska legislature (LB 405) would increase sales taxes to pay for the elimination of all state income and franchise taxes. The additional sales tax revenue would have come from taxing substantially more business-to-business sales of tangible personal property. The following describes the magnitude (for fiscal year 2016 when the changes are fully effective)[21] of the tax redistributions in the bill:

- The bill would eliminate the individual income tax, a tax decrease of $2.2 billion in FY 2016.
- The elimination of the corporate income and financial institutions tax would reduce state taxes by $275 million a year in FY 2016.
- The total income tax reduction, $2.5 billion, would be mostly offset by a $2.3 billion increase in sales taxes due to the elimination of sales tax "exemptions." The bill raises sales tax revenues by eliminating a number of exemptions, including: exemptions for property shipped outside of Nebraska, business purchases of agriculture and manufacturing machinery and equipment, purchases of ingredients and component parts, purchases of seeds and chemicals used in agriculture, and energy and fuel used in agriculture and industry. In addition, other changes would impose sales taxes on purchases and selected sales by health care, education, and nonprofit institutions.

Nebraska Governor Dave Heineman described the need for sales tax reform by pointing out that the sales tax exempts more in sales taxes each year ($5 billion) than it collects ($1.5 billion).[22] The implication is that the $5 billion of exemptions represent erosion of the sales tax base over time relative to the base of a comprehensive retail sales tax, and eliminating the exemptions would be a tax policy improvement. The $5 billion exemption figure appears to have been taken from estimates of specific exemptions reported in the Nebraska Department of Revenue's 2012 *Tax Expenditure Report*.

In fact, many of the exemptions listed in the *Tax Expenditure Report* are not "loopholes" that represent base erosion; instead, they are business-to-business sales that should be excluded from a retail sales tax because they are not final purchases by households. In other words, the business-to-business sales tax exemptions are fundamental features in the design of a retail sales tax, not deviations from the ideal.[23]

The revenue estimates for LB 405 illustrate the confusion over what should be in the base of a retail sales tax. The largest tax increases from eliminating sales tax exemptions would be paid by businesses on their purchases of capital and operating inputs from other businesses. The largest increase comes from imposing the retail sales and use tax on purchases of property by manufacturers that is incorporated into final products ultimately sold at retail. Eliminating this necessary exemption would increase business taxes by $1.3 billion annually, 57% of the estimated total sales tax increase.[24] Imposing the sales tax on other business input purchases, including machinery and equipment, seeds and energy, accounts for an additional 20% of the estimated total sales tax increase.

Businesses would also lose exemptions for products shipped outside of Nebraska, a necessary feature of a retail sales tax designed to ensure that the tax operates as a "destination" tax that assigns the taxable sale to the state where final consumption occurs.

Based on information accompanying the introduction of LB 405, businesses would pay almost 90% of the total Nebraska sales tax increase through taxes imposed on their input purchases of tangible personal property and energy services. Most of the increased taxes on business purchases results from eliminating exemptions that apply to *tangible property, not services*. These exemptions are common features found in most state retail sales tax systems. Eliminating them is consistent with the design of a gross receipts tax, not a retail sales tax.

After business groups in agriculture and other industries expressed strong opposition to the proposal to expand the sales tax base by eliminating business-to-business sales tax exemptions, the governor withdrew his support for the proposal. Subsequently, the Nebraska Legislative Revenue Committee voted to indefinitely postpone debate on LB 405.

Ohio

Governor John Kasich's tax reform proposal (H.B. 59) expands the sales tax base to include most services and dedicates the additional revenue to a 20% across-the-board reduction in individual income tax rates. The bill takes a very broad approach to taxing services by stating that all services are taxable under the sales tax unless specifically exempted. Features of the Ohio proposal include:

- An annual $1.8 billion reduction in individual income taxes for households (by FY 2016) due to the 20% rate reduction
- An additional $900 million reduction in individual income taxes on business income due to the rate reduction and a new deduction for 50% of business income (up to a maximum deduction of $325,000) from pass through entities
- A reduction of $900 million in sales taxes due to a rate reduction from 5.5% to 5% for currently taxable goods and services
- The individual income tax and sales tax rate reductions are partly paid for by a $2.8 billion increase in sales taxes from an expansion of the base to most services.
- Netting out the sales tax rate reduction benefits on currently taxable goods and services, the net sales tax change on business purchases is an estimated $1.7 billion. To put this in perspective, the $1.7 billion is equivalent to the current revenue generated by Ohio's entity-level state business tax, the CAT tax.

ENDNOTES

1. This study is an update and expansion of an earlier Ernst & Young study prepared for COST. See Robert Cline, John Mikesell, Tom Neubig and Andrew Phillips, *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sale Tax to Business Services* (January 2005).
2. The adverse competitiveness impacts of expanding the sales tax to more business purchases applies to business purchases of both taxable goods and services. In this paper, the focus will be on business purchases of services, but the discussion is equally applicable to business purchases of tangible personal property subject to the retail sales tax.
3. The estimates of sales taxes paid by business on their purchases are derived from the Ernst & Young 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, Ohio, New Mexico and Hawaii.
4. Estimates of business taxes by tax type are from *Total State and Local Business Taxes: State-by-State Estimate for Fiscal Year 2011,* study prepared by Ernst & Young in conjunction with the Council On State Taxation. (July 2012). The sales taxes imposed on business purchases do not include sales taxes collected by business on sales to consumers.
5. The ideal sales tax base, in theory, is equal to a consumption-style, value-added tax (VAT) similar to a credit-invoice transactions tax used in many other countries or an entity-level business tax using value added as the tax base, the concept underlying Michigan's former single business tax and Japan's consumption tax. Under the entity-level VAT, firms would get a full subtraction for any business-to-business input purchases, including capital purchases, so there is no tax imposed on intermediate sales between businesses. With both the ideal sales tax and consumption value-added tax bases, taxes are only imposed on consumption purchases by final consumers.
6. 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 sales tax imposed on the manufacturer's intermediate input purchases would be also be subject to a 6% tax rate on sales to the retailer and sales to the final customer. This small, additional pyramiding component is not included in Table 2.
7. 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.
8. 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.
9. 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.
10. The estimated impact of extending the sales tax to services assumes the sales tax would be imposed on intrastate transportation services, information and data processing services, professional services, business services, entertainment, repair, cleaning, and personal services. The estimated additional sales tax on services assumes that 20% of the sales taxes would not be collected due to non-compliance.
11. See Commerce Clearing House, *South Dakota State Tax Reporter*.
12. 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.
13. 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.
14. 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).
15. 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).
16. 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.

17. 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.
18. See Minnesota Department of Revenue, "Budget for a Better Minnesota: Sales Tax Reform," February 2013.
19. The revenue estimates are from Minnesota Department of Revenue, Analysis of H.F. 677, the Governor's Tax Bill, February 26, 2013. The business share of sales tax base broadening revenue includes a portion of new sales taxes on vehicle repairs and warehousing and storage.
20. The revised budget also reflected an improved revenue outlook that reduced the estimated general fund budget deficit in fiscal year 2015 by $500 million.
21. Nebraska Legislative Fiscal Analyst Estimate, Fiscal Note LB 405, February 4, 2013. The revenue estimates are the Legislative Fiscal Office estimates of the bill's general fund tax revenue impacts. They do not include local sales tax option tax increases due to eliminating exemptions.
22. Governor Dave Heineman, *2013 Tax Reform,* January 2013.
23. The Nebraska Tax Expenditure Report defines "tax expenditure" as "a revenue reduction that occurs … as a result of an exemption, deduction, exclusion, tax deferral, credit or preferential rate introduced into the tax structure." Nebraska Department of Revenue, *2012 Nebraska Tax Expenditure Report* (p. ii). This is a standard description found in state tax expenditure but it does not differentiate between adjustments that are features of a tax's design and "loopholes" that are deviations from the basic structure.
24. The dollar estimates of the increased sales tax revenue from eliminating business exemptions are from the Nebraska *2012 Nebraska Tax Expenditure Report.*

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Council On State Taxation
122 C Street, NW, Suite 330
Washington, DC 20001
Phone: (202) 484-5222
Fax: (202) 484-5229
www.cost.org