The Dangers of Tax Pyramiding

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Context in Connection with Utah Tax Reform

- Allocation Issue
- Consumption Tax Broadening Issue
  - Consumption taxes may track inflation and population growth, but a narrower segment of the economy pays them if focused only on goods.
  - Broaden the base/lower the rate where feasible
    - Include Business Inputs/Tax Pyramid?
    - Or Focus on Final Consumption?

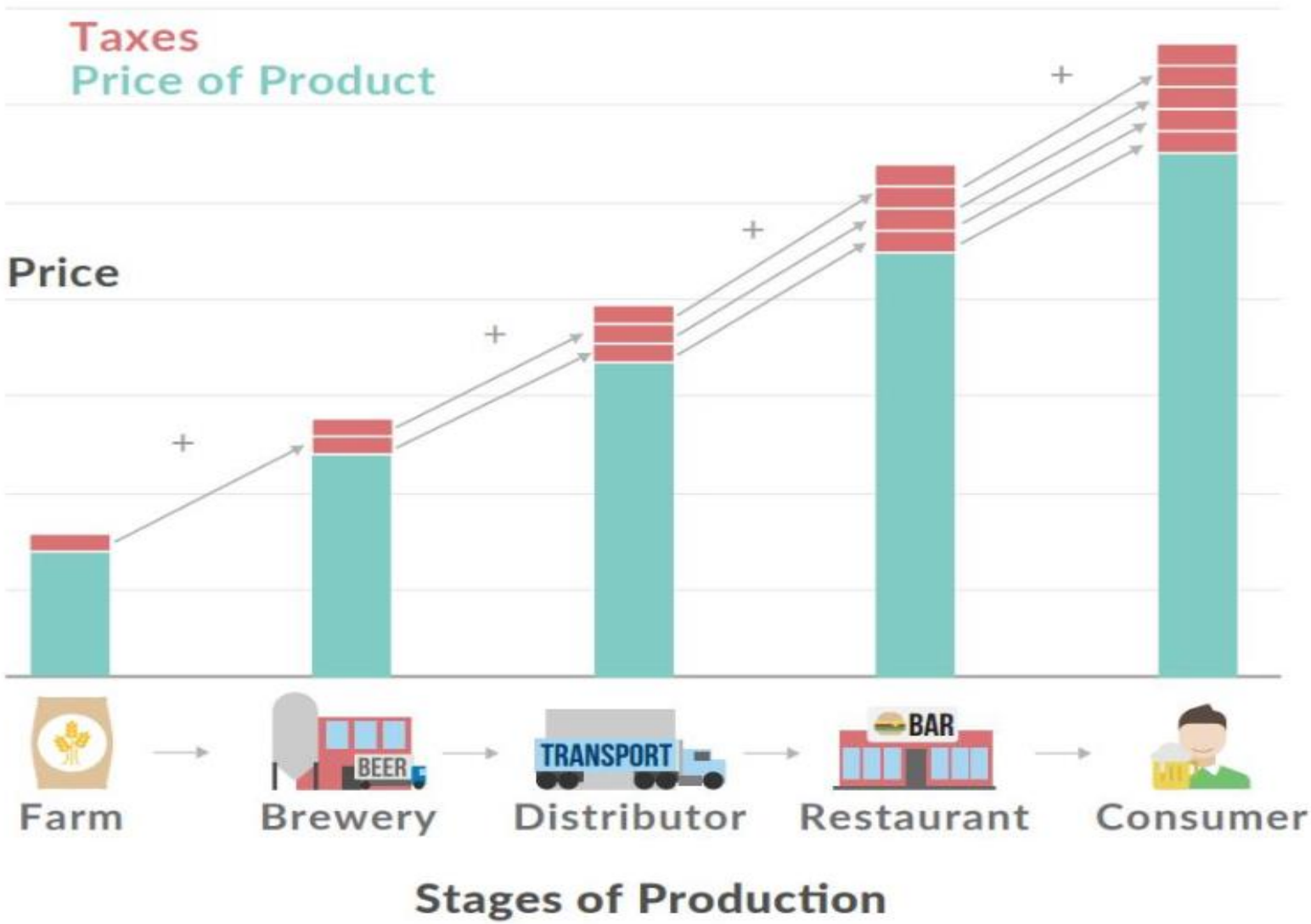
Tax Pyramiding

- Dangers of Tax Pyramiding
- Worldwide Consumption Taxes Avoid Tax Pyramiding
- Utah 2004, 2005 & 2009 Task Forces
- Experiences in Other States
- Potential Final Consumption Transactions To Tax in Utah
- Methods to Avoid Tax Pyramiding & Protect the Utah Economy

Dangers of Tax Pyramiding

- Increases Costs of Production
  - High Tech, BioTech, Mfg, Mining, Ag
  - Drops NPV of In-State Production
  - Puts Utah businesses at a competitive disadvantage in international, national and regional markets
  - Drives capital, investment and employment outside Utah
- Creates economic distortions
  - Hidden taxes either raise consumer prices or result in lower wages
  - Lacks transparency as the true tax rate to the final consumer is much higher than the stated rate
  - Encourages companies to vertically integrate instead of using more efficient providers
- Interstate Sourcing Issues

Dangers of Tax Pyramiding



Worldwide Consumption Taxes Avoid Tax Pyramiding

- International Value-Added Taxes
  - Only Tax "Value Added," with credits for previous taxes paid to avoid pyramiding
- U.S. Sales Taxes (1930s)
  - TPP Based
  - Broad Resale Exemptions to Avoid Pyramiding
    - Ingredient & component parts
    - Containers
  - Broad Production Equipment & Fuel Exemptions

Utah 2004, 2005 & 2009 Task Forces on Sales Tax on Services

- 2004 Olene Walker Tax Advisors
  - Gary Cornia
  - Pam Hendrickson
  - Bruce Johnson
  - Leo Memmott
  - Ray Nelson
  - Val Oveson
  - Keith Prescott
  - Lynne Ward

Utah 2005 & 2009 Task Forces on Sales Tax on Services

2004 - Recommendations on a Tax Structure for Utah's Future - Full Doc.pdf - Adobe Acrobat Pro

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Governor Olene S. Walker's

Recommendations

on a **Tax Structure**

for **Utah's Future**

November 2004

Utah!

Where ideas connect

Utah 2004 Task Force on Sales Tax on Services

2004 - Recommendations on a Tax Structure for Utah's Future - Full Doc.pdf - Adobe Acrobat Pro

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One of the criteria for a fair and balanced system is that taxpayers know what taxes they are actually paying. In many cases, understanding what taxes an individual or family pays is more difficult than it may first appear. For example, taxes on business inputs are generally passed forward to the customer in the form of higher prices or passed backward to employees in terms of reduced wages.

There are, of course, some situations where the taxes are absorbed by the owners of the business firm. Those taxes, however, are hidden from the consumer, employee, and even the owner of the business. Moreover, if a customer is paying sales tax on the goods or services he or she is receiving, the customer may actually be paying a tax on a tax—the so-called "pyramiding" effect. A well-designed sales tax would be imposed only on final consumption.

would apply to all property and services that
requisite useful life, even if the taxpayer chos
expense the property under Section 179 or s
provision of the Internal Revenue Code.

Supplies and services that have a useful life o
one year would continue to be subject to sale
they were actually incorporated into a produc
resold. For example, an auto body shop coul
to buy paint tax-free because it is incorporate
taxable painting and repair services.

We believe a uniform capital asset exemption
substantially more fair and balanced than the
structure and moves the sales tax toward a tr
consumption tax. We believe it creates a busi
environment. It should enhance the competit
Utah products and services on the interstate

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Utah 2004 Task Force on Sales Tax on Services

2004 - Recommendations on a Tax Structure for Utah's Future - Full Doc.pdf - Adobe Acrobat Pro

Many services, of course, are provided to businesses. Those businesses use such services in providing products to the ultimate consumer. A tax on services to businesses would exacerbate the "pyramiding" problem discussed above. It would make Utah products and services less competitive with interstate and international competition. To avoid this problem, we recommend taxing services only if they are provided to ultimate consumers.

Utah 2004, 2005 & 2009 Task Forces on Sales Tax on Services

- 2005 Tax Reform Task Force
  - John Valentine
  - Wayne Harper
  - Todd Kiser
  - Ralph Becker
  - Pam Hendrickson
  - Howard Stephenson
  - Steve Urquhart
  - Rosalind McGee
  - Neil Ashdown
  - Mike Dmitrich
  - Lowry Snow
  - John Dougall
  - Marilyn Newbold
  - Greg Hughes

Utah 2005 Task Force on Sales Tax on Services

2005 - Utah Legislature Tax Reform Task Force Working Group Final Recommendations.pdf - Adobe Acrobat Pro

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Utah Legislature
Tax Reform Task Force
Working Group Final Recommendations

Recommendations and Status as of September 7, 2005

Recommendation	Date	Bill Drafted ?	Sta

11.00 x 8.50 in

Utah 2005 Task Force on Sales Tax on Services

2005 - Utah Legislature Tax Reform Task Force Working Group Final Recommendations.pdf - Adobe Acrobat Pro

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Property	Limit the property tax primary residential exemption to 45% of the first $100,000 of fair market value.
Sales	Increase sales and use tax base to include certain personal consumption services
Sales	Provide a $75 per person refundable income tax credit to compensate for sales and use taxes on food for those below certain income thresholds

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Utah 2004, 2005 & 2009 Task Forces on Sales Tax on Services

- 2009 TRC Sales & Use Tax Working Group
  - Gary Cornia
  - Rosalind McGee
  - John Dougall
  - Mark Buchi
  - Wayne Niederhauser

Utah 2004 & 2009 Task Forces on Sales Tax on Services

- Recommendations Adopted Unanimously by the TRC
  - Keith Prescott
  - David Crapo
  - Larry Barusch
  - Mark Buchi
  - Janis A. Dubno
  - Brent Goodfellow
  - Wayne Harper
  - Lyle W. Hillyard
  - Kathleen Howell
  - Bruce Johnson
  - Bruce Jones
  - Todd Kiser
  - Dixie Leavitt
  - Wayne Niederhauser
  - Gary Cornia

Utah 2009 Task Force on Sales Tax on Services

2009 - Task Force Study.PDF - Adobe Acrobat Pro

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Utah Tax Review Commission
Report of the Sales and Use Tax Working Group

January 13, 2009

I. Introduction and Background

The Utah Tax Review Commission (TRC) created the Sales and Use Tax Working Group (Working Group) to study in-depth various issues surrounding the state sales and use tax. The Working Group was originally established to draft core principles for studying sales and use tax exemptions and to organize the current sales and use tax exemptions by category.

The Working Group met several times between May 16, 2007 and January 13, 2009. As part of its study, the Working Group reviewed the criteria and principles adopted by the Utah Tax Recodification Commission and also reviewed the findings of the professional tax literature, including the recommendations of John Due, Charles E. McLure, Jr., and John L. Mikesell.

Utah 2009 Task Force on Sales Tax on Services

Recodification Commission and also reviewed the findings of the professional tax literature, including the recommendations of John Due, Charles E. McLure, Jr., and John L. Mikesell.

If adopted, the Working Group's recommendations would dramatically alter the state's sales and use tax system. The two major changes include: (a) excluding nearly all purchases of goods and services by businesses from the sales and use tax base ("business inputs"); and (b) broadening the sales and use tax base to include nearly all purchases by households, including purchases of services ("final consumption"). The Working Group believes that these recommendations, if implemented, present an opportunity to decrease the sales and use tax rate or provide other forms of tax relief. These recommendations will also improve Utah's business climate, eliminate tax pyramiding, and improve the economic neutrality, transparency and stability of the sales and use tax system.

Revenue from the sales and use tax is used by the Legislature fund important education, health, human service, and public safety priorities. The Working Group's recommendations provide an opportunity to modernize the sales and use tax -- making it a stable and adequate source of revenue for these critical public services.

Utah 2009 Task Force on Sales Tax on Services

2009 - Task Force Study.PDF - Adobe Acrobat Pro

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The Case for Excluding Business Purchases

McLure argues that the extension of the retail sales tax to business purchases results in a flawed system. He argues that:

1. "Taxing goods bought for resale creates pyramiding (repeated taxation of the same product) and creates incentives for vertical integration, as well as inequities (discrimination against those who buy products for that are subject to multiple taxation).

2. "Taxing business purchases is likely to distort decisions on how to produce and distribute products.

3. "Taxes on business inputs also cause the perceived cost of government to be understated, because they are hidden and allow tax rates to be artificially low. Taxation limited to consumption would make the cost of government more transparent." [5]

Mikesell also contends that purchase by businesses should be excluded from the sales and use tax. "I think legislatures like the taxation of business inputs because these are 'taxes on business,' as opposed to 'taxes on individuals,' and because the eventual inclusion of the tax paid on business inputs

8.56 x 10.98 in

Utah 2009 Task Force on Sales Tax on Services

A. Included in the base:

1. Retail sales and leases of tangible personal property and services to households.

2. Rental of real property by households.

3. Sales of improvements to real property to households.

B. Excluded from the base:

1. Retail sales and leases of tangible personal property and services to businesses (e.g. "business inputs.")

"Business inputs" means:

a. any property or service if the purchase of that property or service by the purchaser qualifies for a deduction as an ordinary and necessary trade or business expense under Section 162 of the Internal Revenue Code[13] as amended,

Experiences in Other States

- Most recent
  - Connecticut (2019)
  - Pennsylvania (2015)
  - Maine (2015)

Experiences in Other States - Connecticut

GovBud_FY2020-21_Final CT summary of Governor's Budget.pdf - Adobe Acrobat Pro

of certain items in lieu of others.

- Business-to-business transactions are exempt from further taxation under the proposed sales tax expansion. As noted by the 2015 State Tax Panel and by the Council on State Taxation, a sales tax on business inputs is an additional cost of doing business in the state, which companies attempt to pass on to their customers. Businesses selling in regional or national markets are less able to pass on the added cost to out-of-state customers, increasing the likelihood of reducing their investment and employment in the state. Moreover, businesses would be encouraged to self-provide business services rather than purchasing from more efficient service providers, thereby decreasing economic competitiveness – and particularly hurting small businesses. Finally, sales tax on business inputs increases pyramiding, whereby sales tax is applied at various stages of production, and the effective sales tax rate would thus exceed the statutory rate.

ombination with the ruling by the U.S. Supreme Court in Wayfair, Inc. v. South Dakota, which olds the ability of the Department of Revenue Services (DRS) to collect sales and use tax on

Experiences in Other States - Connecticut

2019 CT budget proposal.PDF - Adobe Acrobat Pro

2286 Sec. 32. Section 12-412 of the general statutes is amended by adding
2287 subdivision (124) as follows (*Effective January 1, 2020, and applicable to*
2288 *sales occurring on or after January 1, 2020*):

2289 (NEW) (124) (A) Sales of services set forth in subparagraphs (QQ) to
2290 (XX), inclusive, and subparagraph (AAA) of subdivision (37) of
2291 subsection (a) of section 12-407, as amended by this act, that are
2292 purchased by a business for use by such business.

2293 (B) Each purchaser of services exempt pursuant to the provisions of
2294 this subdivision shall present, in order to qualify for such exemption, a
2295 certificate to the retailer, in such form as the commissioner may
2296 prescribe, certifying that the purchaser is a business and is purchasing
2297 such services for its business. The purchaser of the services shall be
2298 liable for the tax otherwise imposed if the certificate is improperly

Potential Final Consumption Transactions to Tax in Utah

- Already Included in Utah (where some states do not):
  - Remote Vendors (Wayfair) – as of 1/1/19
  - Marketplace Facilitators – as of 10/1/19
  - Admissions
  - Digital Goods
  - Repairs and Cleaning of TPP

Potential Final Consumption Transactions to Tax in Utah

- Many other states include and Utah does not:
  - Food (Full Tax)
  - Gas & Electricity (Full Tax)
  - Delivery Charges
  - Interstate Transportation of Goods
  - Intrastate Transportation of Goods or People
  - Copying
  - Installation Charges (to other TPP, or to RP)
  - Cleaning or repairs of RP
  - Garbage removal services
  - Lawn Care
  - Pest Control
  - Snow Removal
  - Tree Trimming

Potential Final Consumption Transactions to Tax

- Many other states include and Utah does not:
  - Water conditioning/softening service
  - Information access
  - Admission, Accommodation, Rental & Purchase Surcharges
  - Fishing/hunting guide services
  - Barber & Beauty Parlor
  - Dating & Escort
  - Moving TPP
  - Kenneling
  - Marina rental/boat docking
  - Pet grooming, SAAS, photography and engraving (clarify)

Potential Final Consumption Transactions to Tax

- Many other states include and Utah does not:
  - Safe deposit box
  - Storage
  - Tanning
  - Tattoo Parlor
  - Taxidermy
  - HVAC
  - Sign-painting/lettering
  - Credit reporting
  - Security Services
  - Interstate Telecommunications
  - Paging

Potential Final Consumption Transactions to Tax

- Professional Services?
  - Most states do not include because primarily B2B and thus significantly impacts economy
  - Not that professional services are special. It's that the capital of those that use professional services is mobile.
  - Where not B2B:
    - Legal:
      - Taxing those in crisis (Criminal/Domestic)
      - Taxing landlord and not tenant, patient & not hospital in same case
    - Accounting:
      - Taxing government mandate of tax preparation

Potential Final Consumption Transactions to Tax

- Professional Services?
  - No state with a sales tax on the final customer (like Utah) taxes them
  - 45 States Have a "Sales Tax"
    - 31 states tax the buyer like Utah – seller is only a collector
    - 5 states tax the seller, but require collection
    - 9 states tax the seller and do not require collection
      - AZ, AR, CA, HI, IL, MI, NM, SD, WI
      - Functionally a Gross Receipts Tax
      - No sourcing issues

Potential Final Consumption Transactions to Tax

- Professional Services?
  - Only three states in this "gross receipts" category tax professional services (SD, NM, HI)
    - All are much smaller than Utah
    - SD has no income tax
    - HI is not trying to attract production
    - NM has chosen to impose both an income tax and a gross receipts tax on the seller. Has amongst the highest tax pyramiding in the nation.

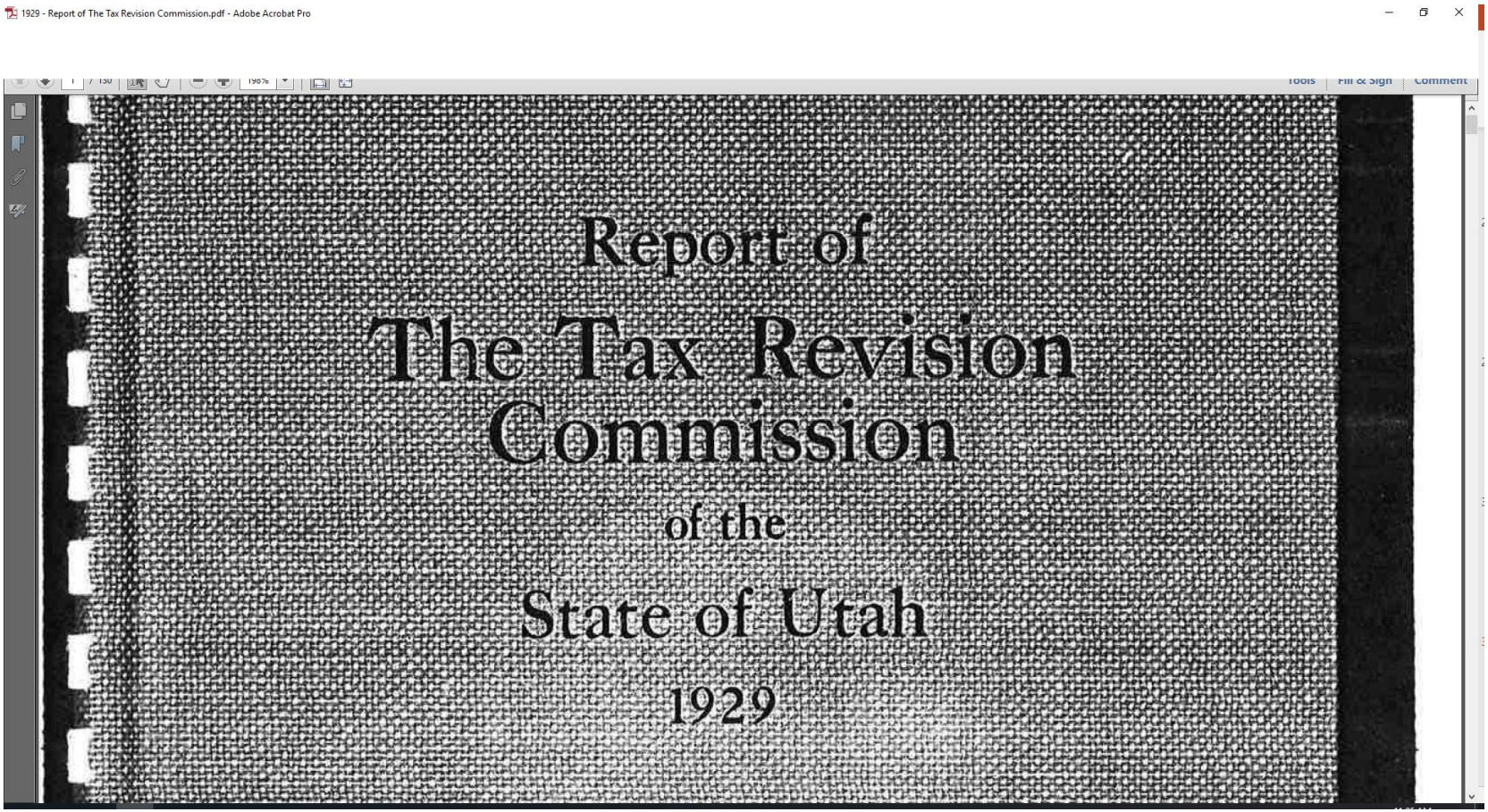
Methods to Avoid Tax Pyramiding if Business Services are Taxed

- Exclude All B2B Transactions
  - Removes Items Presently in Tax Base
- Exclude All B2B Service Transactions
  - 2004, 2005 & 2009 Utah Task Forces Here or above
  - Connecticut, Pennsylvania & Maine
- Exclude B2B Service Transactions for Production Industries
  - Discriminates against small business and other industries
- Exclude "Integral" Service Transactions
  - Uncertainly itself chills investment
  - Taxpayers argue everything is integral (IRS), government argues nothing is integral (SD), and exemptions are construed against taxpayers.
  - Big winners are attorneys arguing over what is integral.

Allocation Issue

- Only State with a Constitutional Restriction on a Major Revenue Source
- Why?
  - 1896 – Statehood. Primarily Property Tax
  - 1929 – Income Tax Adopted – 75% to school fund
  - 1947 – 75% Moved to 100%
  - 1996 – Higher Ed Included

Allocation Issue



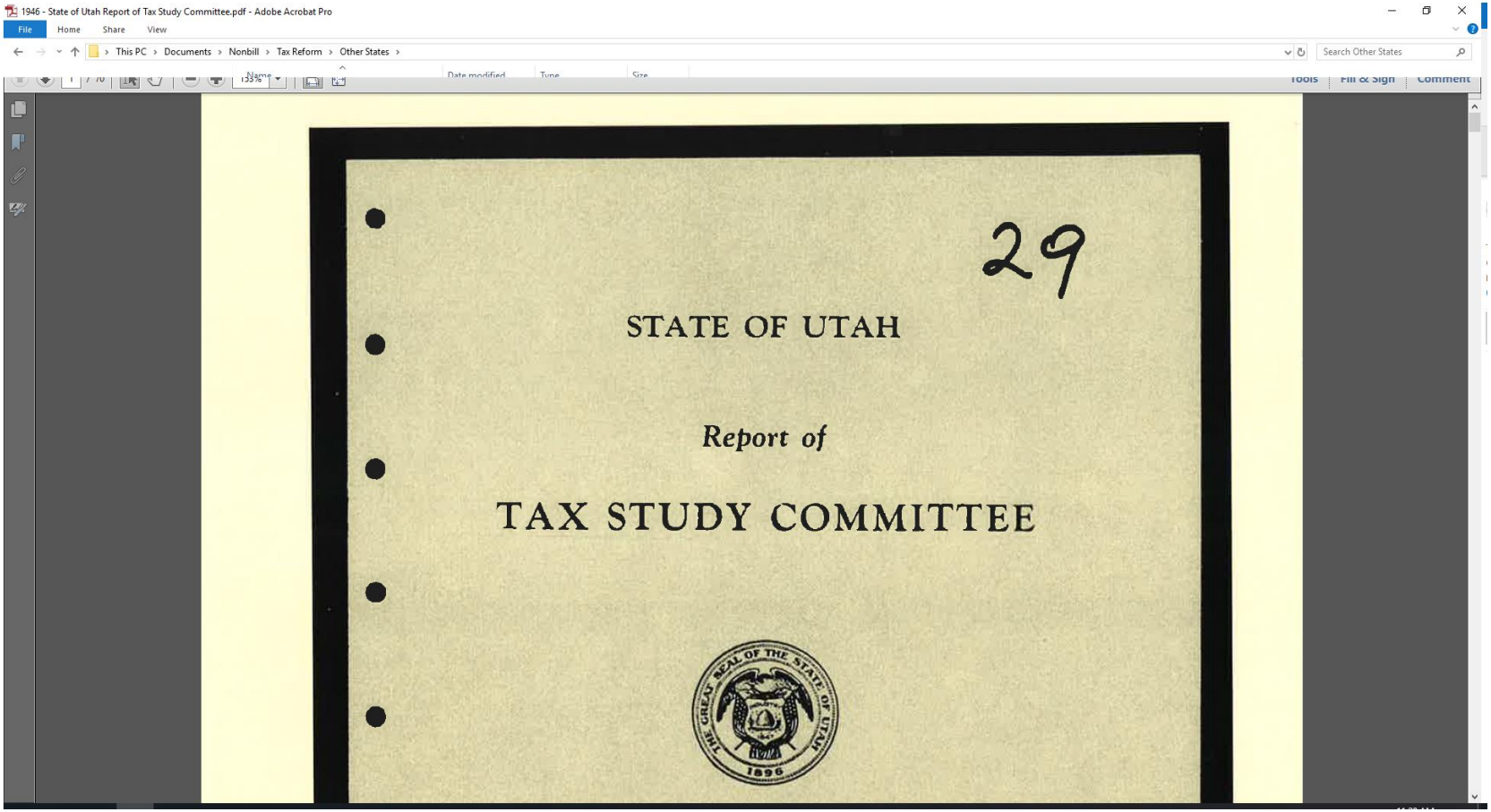
Allocation Issue

1929 - Report of The Tax Revision Commission.pdf - Adobe Acrobat Pro

5. The revenue which is derived from the business tax and the personal income tax shall be devoted to the state district school fund, and the levy for state district school fund purposes shall be reduced accordingly.

We have studied very carefully the dispostion of the revenue which will be derived from the business tax and from the personal income tax and have concluded that all of this revenue should be distributed to the state district school fund for the purpose of reducing the tax on property throughout the state. We are very earnest in the belief that this revenue should not be used in such a way that the imposition of these new taxes will simply mean an increase in the tax burden of the people of the state, but on the contrary that the revenue should be used for the purpose of reducing the tax on property. If all of the revenue from these new sources is put into the state district school fund it will immediately reduce the amount of taxes to be levied on every dollar of assessed valuation in the state. In making this rec-

Allocation Issue



Allocation Issue

1946 - State of Utah Report of Tax Study Committee.pdf - Adobe Acrobat Pro

lative requests.

Perhaps the most critical problem faced by the last two Legislatures was the financial needs of the schools, particularly on the elementary and secondary level. Prior to the 1943 Legislative Session the so called district schools had been financed largely by local property tax levies supplemented by a $30 per capita state aid system frozen into the State Constitution. Faced with rising school costs to keep the schools open, school officials and their supporters appealed to the 1943 State Legislature for additional financial aid. In response to this request the 1943 Legislature appropriated $2.6 million for the biennium out of the State General Fund—out of the eighteen per cent of so called free revenue—to the local school districts

Allocation Issue

1946 - State of Utah Report of Tax Study Committee.pdf - Adobe Acrobat Pro

Most everyone was well aware of the critical financial needs of the schools but the difficult problem faced by the State Legislature was this new demand on the State General Fund—the only free revenue available to the Legislature—for $4.6 million out of a total of $12 million, all of it badly needed to finance other State Government needs—for state institutions, departments and agencies, for higher education, courts and other functions of State Government dependent upon Legislative appropriations.

It was obvious that some change in the present method of financing the schools was mandatory. Yet the Legislature was unable to work out a permanent solution, largely because of constitutional limitations. The Tax