COST
COUNCIL ON STATE TAXATION

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Stephen G. Roberts
President
West Virginia Chamber of Commerce
1624 Kanawha Blvd. East
Charleston, WV 25311

Re: Concerns with Sales and Use Tax Provisions in S.B. 335

Dear Mr. Roberts,

On behalf of the Council On State Taxation, I am pleased to provide you with an analysis of the sales tax changes contained in S.B. 335, which would significantly expand the sales and use tax base in West Virginia along with increasing the tax rate by two percent. COST has undertaken substantial research in the area of sales and use tax base expansion, noting that many legislative "base-broadening" proposals commonly fall on business-to-business (B2B) transactions. This is counterproductive because it harms a state's competitiveness to attract and retain businesses.

COST's Research on Taxing B2B Transactions. Our research[1] in this area reveals:

- 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.
- An extension of sales tax to additional business-to-business transactions 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), which create economic distortions. One of the major distortions is caused by what economists call "pyramiding." Pyramiding results when a sales tax is imposed multiple times on business transactions when products move through multiple stages in the production and distribution process, with the tax ultimately imposed again when the products are finally sold to consumers. Pyramiding causes the effective sales tax rate to far exceed the statutory rate. Additionally, businesses that are vertically integrated are advantaged over those (often small businesses) that are not.

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[1] *What's Wrong with Taxing Business Services? Adverse Effects From Existing and Proposed Sales Taxation of Business Investment and Services*, by Robert Cline, Andrew Phillips, and Tom Neubig, Ernst & Young LLP for the Council On State Taxation, April 4, 2013, available at: http://cost.org/WorkArea/DownloadAsset.aspx?id=83841.

- 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. Often 70% to 80% of the revenue from taxing a service is directly derived from sales taxes on business input purchases. For example, some services, such as engineering services, are predominately provided to the business sector.
- A sales tax on business inputs is an additional cost of doing business in the state, which causes companies to either attempt to pass on such cost 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 compete with out-of-state businesses that do not have such taxes on their business inputs. Thus, the likely result is reduced business investment and employment in the state.
- 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 also result in the following:
  - 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 traditionally focus on their core business and use smaller businesses to provide its 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. Companies that are limited by market competition in their ability to pass the additional sales taxes forward through higher prices 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 because the increased sales taxes are often passed forward as higher consumer prices.

COST Concerns with S.B. 335 Violating Sound Sales Tax Policy. As introduced, S.B. 335 provides for the repeal of the State's current sales and use tax and adopts a general consumption tax. While a "general consumption tax" may sound like a value-added tax, in reality the proposal would institute a new sales and use tax at a higher rate. There is no offsetting credit mechanism (unlike in a value-added tax) to prevent pyramiding of the tax. The following is a non-exclusive list of the primary concerns with the proposal as drafted:

- **Base Expansion Fails to Carve Out B2B Transactions.** The tax base is broadly applied to all services in the proposal, without sufficient exemptions for services commonly included in B2B transactions. The legislation includes a "sale for resale exemption," but this exemption is insufficient in that it provides the exemption for the resale of services "as such." Few services can be passed-through directly to end consumers. Likewise, the legislation includes an exemption for sales between related business entities, but this exemption does not address the bulk of commerce between unrelated business entities. **A blanket exclusion for business-to-business transactions would remedy these deficiencies, with appropriate administrative relief including the liberal use of direct pay permits.**

- **Manufacturing Exemption is Too Narrow.** The manufacturing/production exemption is too narrow, such as requiring the "direct" use of tangible personal property in manufacturing and excluding services. While the current sales tax law also has the "directly used" in manufacturing requirement, it includes services as being eligible for the exemption. **The manufacturing/production exemption should be expanded to cover business purchases for the entire manufacturing facility (*i.e.*, the "integrated plant" approach). Further, especially with any contemplated expansion of the base to new taxable services, services should be specifically eligible for the manufacturing exemption.**

- **There Should Be No "Prepay" Requirement for the Manufacturing Exemption** – The use of "refundable" exemptions creates significant administrative complexity for consumers. Of particular concern to business taxpayers, the manufacturing/production exemption continues to be a "refundable exemption," which creates administrative and cash flow problems for purchasers. While the use of direct pay permits may mitigate this issue, it is still a defect in the proposal to continue to require refund or credit applications for a return of tax paid on exempt manufacturing machinery, supplies, and materials.

Please let me know if you have any questions regarding our analysis or research in this area.

Sincerely,

Ferdinand Hogroian

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director