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Utah House Revenue and Taxation Committee

Via E-mail

Re: COST Opposes H.B. 441 - Imposition of Sales Tax on Business Inputs

Dear Chair Spendlove, Vice-Chair Quinn, and Committee Members:

I am writing on behalf of the Council On State Taxation ("COST") in opposition to H.B. 441. As drafted, H.B. 441 would inappropriately broaden Utah's sales tax base by imposing sales tax on many business inputs without an exemption for business-to-business transactions. COST does not generally oppose legislation that broadens a State's sales tax base to business-to-*consumer* transactions. However, H.B. 441's proposed expansive sales tax broadening to encompass services, many of which are predominantly provided to businesses, without providing an exemption for business inputs, is a direct violation of the economic principle that an ideal sales tax should tax household consumption and not business inputs.[1] There were similar broad-based proposals in several states such as Louisiana, Minnesota, and Ohio between 2013 and 2015 to significantly expand the sales tax to include services, and the share of the additional tax that would be imposed on business inputs was estimated to be as high as 80%.[2] If this legislation passes, Utah would be the first state in decades to impose such an expansive sales tax on business purchases. There are only a couple of states that long ago enacted a broad-based sales tax on services (*e.g.*, South Dakota, Hawaii, and New Mexico). Based on population, Utah would be the largest state in the country to impose such a tax. One can hardly imagine a worse signal to the national business community that Utah is business unfriendly. While we understand that the legislative intent of H.B. 441 is to broaden the base and lower the sales tax rate, the proposed rate reduction does not mitigate COST's concerns regarding the expansion of the tax base to business-to-business transactions.[3]

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[1] See John l. Mikesell, "Reversing 85 Years of Bad State Retail Sales Tax Policy," *State Tax Notes*, February 4, 2019; Robert Cline, Andrew Phillips and Tom Neubig, Ernst & Young LLP, "What's Wrong with Taxing Business Services? Adverse Effects from Existing and Proposed Sales Taxation of Business Investment and Services," prepared for the Council On State Taxation, April 4, 2013; Analysis of Proposed Changes to Select Ohio Taxes Included in the Ohio Executive Budget and Ohio House Bill Number 64, issued in 2015, available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/analysis-of-proposed-changes-to-select-ohio-taxes-included-in-the-ohio-executive-budget-and-ohio-house-bill-number-64.pdf.

[2] Cline, Phillips, Neubig, pages 15-17.

[3] Businesses will certainly benefit from the sales tax rate reduction on the business inputs that are currently taxed under Utah law. But since the business share of purchased services included in sales tax base broadening legislation is generally much larger than the business share of purchased goods subject to sales tax, H.B. 441 is likely to lead to a substantial net increase in sales tax paid by businesses in Utah.

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 approximately 550 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Policy Against Imposing State Tax on Business Inputs

The COST Board of Directors has adopted a formal policy position opposing the imposition of state taxation on business inputs.[4] That policy position provides:

Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.

Imposing sales tax on business inputs specifically violates the tax policy principles of neutrality, equity, simplicity and transparency, and it causes a number of economic distortions. The inclusion of a resale exclusion and phase down of the sales tax rate on tangible personal property is not sufficient to mitigate these concerns. Notably, these distortions result primarily from pyramiding. Pyramiding occurs when a tax is imposed at multiple levels that results in a hidden effective tax rate that exceeds the retail sales tax rate. Pyramiding forces companies to either pass these increased costs on to consumers or reduce their economic activity in the State to remain competitive with other producers who do not bear the burden of such increased taxes. Because of these choices, the economic burden of taxes on business inputs inevitably shifts to labor in the State (through lower wages and employment) or consumers (through higher prices).

H.B. 441 would create other significant adverse economic distortions from the current taxation of business purchases in Utah. For example:

- Taxing business inputs encourages companies to self-provide business services to avoid the tax rather than purchasing them from more efficient providers and paying tax (vertical integration);

- Taxing business inputs places companies selling in international, national and regional markets at a competitive disadvantage to many of their competitors, leading to a reduction in investment and employment in the State;

- Taxing business inputs unfairly and inefficiently taxes some products and services more than others by imposing varying degrees of tax on inputs in addition to a general tax rate on final sales; and

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At a minimum, before moving forward, the Legislature should do a study of the legislation's overall impact on sales tax paid by businesses in Utah.

[4] *See* http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/sales-taxation-of-business-inputs.pdf.

- Taxing business inputs unfairly hides the true cost of government services by embedding a portion of the sales tax in the final price of goods and services.

H.B. 441 Would Undo Much of the Benefit of Utah's Legislative Shift to a Single Sales Factor

Ironically, Utah's recent tax policy has moved in a diametrically opposite direction with regard to understanding the importance of providing a tax structure that encourages in-state production and investment. For corporate income tax purposes, Utah has recognized the value of relying on consumption rather than production tax principles as a central tenet of sound tax policy by shifting the apportionment formula for its corporate net income tax to rely almost wholly on the sales factor. By removing the property and payroll factors from the corporate apportionment formula, Utah is taxing businesses not based on the jobs or investment in the state, but only based on their proportion of sales into the state. Indeed, beginning in 2019, Utah is transitioning away from utilizing a single sales apportionment factor for some key industries only to phasing it in for all businesses. To then turn around and enact sweeping sales tax base broadening legislation the burden of which will fall largely on business will move Utah in the exact opposite direction, penalizing businesses for investing, making purchases, and creating jobs in Utah.

H.B. 441 Would Negatively Impact Utah's Sales Tax Scorecard Grade

In April 2018, COST released a Scorecard evaluating "The Best and Worst of State Sales Tax Systems,"[5] in which COST graded the states on the administration of their state and local sales and use taxes. The Sales Tax Scorecard, like other COST scorecards,[6] is meant to help improve tax administrative systems which will ultimately increase compliance. The Sales Tax Scorecard objectively evaluates state statutes and administrative rules that govern the administrations of the states' sales taxes by the states' taxing agencies. COST's scorecards are ultimately directed at policymakers, who are in the best position to make improvements to the state's sales tax through statutory changes. In the Sales Tax Scorecard, COST considered the following categories:

- The extent of taxation of business inputs or pyramiding of the sales taxes;
- Fair sales tax administrative practices;
- Uniformity of state and local sales tax bases and centralized administration;
- Simplification and transparency of the sales tax;
- Reasonable tax payment and credit administration; and,
- Fair audit and refund procedures.

Considering these categories, Utah received a "B" grade and was in the top one-third of all the states. If H.B. 441 is passed, however, Utah's grade would definitely be impacted adversely. Specifically, its grade would likely be lowered to a "C," significantly lowering its ranking amongst the other states. H.B. 441 would directly impact Utah's score in the categories evaluating the taxation of business inputs and pyramiding of the sales tax. H.B. 441 will significantly

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[5] http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/the-best-and-worst-of-sales-tax-administration-2018-final.pdf.

[6] Since 2001, COST has issued scorecards reviewing the states' tax administration, and has issued its unclaimed property laws and property tax administrations scorecards since 2007 and 2009, respectively.

increase Utah's percentage of state and local sales tax derived from business-to-business transactions, which currently is estimated at 37 percent. By way of comparison, South Dakota and New Mexico, two of the states that tax the broadest range of services (without exemptions for business inputs), also have the highest share of state and local sales taxes derived from taxing business inputs at 58 percent and 60 percent respectively.[7]

For the reasons discussed above, COST urges the Committee to reject H.B. 441.

Sincerely,

Nikki Dobay

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

[7] COST, "The Best and Worst of State Sales Tax Systems, pages 2 and 9.