COST
COUNCIL ON STATE TAXATION

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Via email

Fagan Harris, Chief of Staff
Jeremy Baker, Chief Legislative Officer
Office of the Governor
State of Maryland

Re: Opposition to House Bill 1554 and Senate Bill 1045 Business Services Tax

Dear Mr. Harris and Mr. Baker:

On behalf of the Council On State Taxation (COST), we strongly oppose House Bill 1554 and Senate Bill 1045 which impose a new and novel tax exclusively on business purchases of many services (business inputs). This new tax not only violates several principles of sound tax policy, but it is also in direct contravention of Governor Moore's laudable objective of creating an equitable, robust, and competitive Maryland economy.

A fair, efficient, and well-designed sales tax should be levied only on final consumption by the ultimate consumer. H.B. 1554 and S.B 1045 are in direct contravention of an ideal sales tax system as they only applies to services when the purchaser is a business, which creates pyramiding and a lack of transparency to both consumers and policy makers. This new tax will serve as a *de facto* gross receipts tax, which will exacerbate the pyramiding and the lack of transparency. Nowhere in the U.S. (including Maryland's neighboring states) is there a tax scheme that imposes sales tax on services only when the purchaser of the service is a business. Enactment of this proposal will have a significant negative impact on Maryland's economic competitiveness and growth. Finally, the new tax will place significant administrative burdens on Maryland's businesses due in large part to an unorthodox tax base that leaves many questions unanswered.

About COST

COST is a non-profit 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 500 major corporations engaged in interstate and international business, many of which have significant business activities in Maryland. COST's objective is to preserve and promote the equitable and non-discriminatory state and local taxation of multijurisdictional business entities.

COST Opposes Sales Taxes on Business Inputs

The COST Board of Directors has adopted a formal policy position opposing the imposition of sales taxation on business inputs.[1] 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 causes economic distortion. This distortion results primarily from pyramiding, which occurs when a tax is imposed at multiple levels of a distribution chain and thereby imposes a hidden effective tax rate that exceeds the retail sales tax rate. The hidden rate creates a lack of transparency for both the consumer and the legislature and forces companies to either pass these increased costs to consumers or reduce their economic activity in the State to remain competitive with other producers that do not bear the burden of such increased taxes. The economic burden of taxes on business inputs inevitably shifts to consumers through higher prices or to labor in the State through lower wages and fewer jobs. To put it simply, although this tax is a direct tax on businesses, the vast majority of the tax will be passed along to Maryland citizens through higher prices and/or stagnating wages.

The Business Services Tax Operates as a Gross Receipts Tax

The COST Board of Directors has adopted a formal policy statement opposing gross receipts taxes:[2]

> *Gross receipts taxes are widely acknowledged to violate the tax policy principles of transparency, fairness, economic neutrality and competitiveness; generally, such taxes should not be imposed on business.*

For many service providers selling to Maryland businesses the tax in H.B 1554/S.B. 1045 is a 2.5% tax on their gross receipts. Business consumers of such services will be forced to either absorb or pass on the tax as part of the final goods or services they sell, whether to final consumers or other businesses. As noted, the tax at each step is thus built into the price of the service sold at the next stage, which is taxed again, resulting in cascading or pyramiding.[3] Because of this, a gross receipts tax (or tax that operates similarly to a gross receipts tax) is a stealth tax with its true burden hidden from taxpayers. The public does not see the tax because it is imposed on businesses, and the public has no way of seeing the pyramiding that converts a

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[1] See https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/salestaxation-of-business-inputs.pdf..

[2] See https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/grossreceiptstaxes.pdf.

[3] See *Resisting the Siren Song of Gross Receipts Taxes: From the Middle Ages to Maryland's Tax on Digital Advertising* by Richard D. Pomp, https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/md-tax-study.pdf.

relatively low rate on business purchases into a much higher effective rate on the purchase of the final good or service.

This tax structure inhibits growth and development of the economy of an adopting state; establishes artificial incentives for vertical integration; and discriminates against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring. In this way, gross receipts taxes particularly harm small and medium-sized businesses.

States that impose a gross receipts tax typically do so in lieu of an income tax on business. However, the same businesses subject to this *de facto* gross receipts tax are already subject to corporate income tax in Maryland. Finally, in those states that levy a gross receipts tax, such taxes are imposed at a very low rate to minimize their harmful effects. Ohio's Commercial Activity Tax (CAT), for example, is levied at a rate of .26%. The tax rate in H.B. 1554/S.B. 1045 is almost 10 times that of the Ohio CAT and will add substantial costs to almost every product or service sold by Maryland businesses that are forced to pay this tax on their purchases of business services listed in H.B. 1554/S.B. 1045.

Additional Tax on Business Inputs Will Undermine Maryland's Competitiveness

With the rapid growth of the services sector in recent decades, it is understandable that a state would want to expand its sales tax base to include additional service categories. However, the direct tax only on business to business services in H.B. 1554/S.B. 1045 will significantly undermine Maryland's economic competitiveness with its neighboring states and foreign countries whose inputs are exempt from such taxation.[4] Currently, Maryland derives approximately 42% of its sales tax revenue from the taxation of business inputs.[5] Most of Maryland's neighboring states derive a similar percentage of their sales tax from business inputs: New Jersey – 43%, Pennsylvania – 42%, Virginia – 40%, and Washington DC – 42%. Delaware does not impose a general sales tax. The passage of H.B. 1554/S.B. 1045 will significantly increase the share of Maryland sales tax derived from business inputs which will put businesses selling these services into and out of Maryland at a competitive disadvantage compared to businesses entering into these transactions in neighboring states.

The New Business Services Tax Is Administratively Burdensome

The COST Board of Directors has adopted a formal policy statement urging states to impose fair, efficient, and customer-focused tax administration:

> *Fair, efficient and customer-focused tax administration is critical to the effectiveness of our voluntary system of tax compliance. A burdensome, unfair, or otherwise biased*

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[4] Almost all other countries impose a value added tax (VAT) rather than a retail sales tax. A VAT essentially has a business input exemption built into the design of the tax to avoid pyramiding of the tax. Under a VAT, all business inputs are taxed, but a refund or credit is allowed if the next stage of the supply chain is subject to VAT. This method generally ensures that the tax is applied at only one level.

[5] The COST Sales Tax Scorecard, "The Best and Worst of State Sales Tax Systems" is available at https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articlesreports/270677_cost_salestaxbk_2022_final.pdf.

> *administrative system negatively impacts tax compliance and hinders economic competitiveness.*[6]

The proposed new and unique business services taxation in H.B. 1554/S.B. 1045 violates this policy position because it is a burdensome tax that will require most taxpayers to initiate extensive system changes to collect and remit the proposed tax within a new bifurcated sales tax system. Many of the service providers implicated in H.B. 1554 do not currently collect and remit sales tax on these services in any other state and will be required to register for a sales tax account and expend significant IT resources to accommodate the new tax.

The bills leave many questions about the administration of the new tax unanswered. As just one example, how will the new services subject to the tax be sourced – to where the benefit of the service is derived or to where the service is performed? How are these distinctions defined? Numerous additional critical administrative issues with such taxes, including the bundling of goods with services, collection, remittance, and definitions are silent in the bill. Requiring taxpayers to guess which transactions are subject to the new tax and how to source them is unconscionable, particularly when taxpayers that fail to collect the proper amount of tax are liable for any taxes they failed to collect.

Conclusion

The new tax on business-to-business transactions in H.B. 1554/S.B. 1045 will harm Maryland by discouraging business activity in the State, which will negatively impact investment and job creation. Approximately 42% of Maryland's current sales tax base consists of business inputs, and taxing additional business inputs will increase that share, thereby directly increasing the costs to conduct business in Maryland and reducing the competitiveness of Maryland businesses. This new tax places significant administrative burdens on Maryland businesses, many of which do not currently collect and remit sales tax on the services they provide and leaves many critical questions about how to administer the tax unanswered. Although these bills purport to impose this new tax only on businesses, the ultimate incidence of the tax will be borne by Maryland citizens and therefore will negatively impact Marylanders' economic well-being and stall Governor Moore's economic development efforts.

We ask that you advise the General Assembly to reject this new tax on business inputs.

Respectfully,

Patrick J. Reynolds   Douglas L. Lindholm   Leonore F. Heavey

cc: COST Board of Directors

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[6] See https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/fair-efficient-and-customer-focused-tax-administration---revised-feb-2024---final.pdf.