COST
COUNCIL ON STATE TAXATION

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California Senate Governance and Finance Committee

Via E-mail

Re: COST's Opposition re S.B. 993, Imposing a Sales Tax on Business Services

Dear Chair McGuire, Vice-Chair Nguyen and Committee Members:

The Council On State Taxation ("COST") is submitting these comments in opposition to S.B. 993, which if implemented would impose a sales tax on certain business services. Specifically, S.B. 993 would phase in a sales tax on the purchase of services by businesses in California ("Services Tax") while phasing down the State's sales tax rate on sales of tangible personal property. Because the Services Tax would be imposed on business, and not end-user consumers, S.B. 993 is in direct violation of the economic principles of how a sales tax should operate by avoiding imposing a tax on business inputs.[1] The taxation of business inputs, including the taxation of business services, violates several tax policy principles, including economic growth, equity, simplicity and efficiency.

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. A significant number of COST's members are doing business in California and purchase a significant amount of services used in the State.

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.[2] That policy position states:

[1] S.B. 993 does have some exemptions for certain types of businesses, which includes businesses with yearly gross receipts of less than $100,000.
[2] http://cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/sales-taxation-of-business-inputs.pdf.

> *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.*

Specifically, imposing sales tax on business violates the tax policy principles of economic growth, equity, simplicity and efficiency, and it causes a number of economic distortions. The inclusion of a resale exclusion and phase down of the sales tax on tangible personal property is not sufficient to mitigate these concerns. Notably, these distortions result from pyramiding, where a tax is imposed at multiple levels, such that the effective tax rate exceeds the retail sales tax rate. Companies are forced 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 taxes. Because of the choices businesses are forced to make, 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).

Although all states that impose a sales tax currently tax business inputs to some extent, no other state broadly subjects only services provided to business to its sales tax. S.B. 993 would exacerbate the adverse economic distortions from the current taxation of business purchases. 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,

- 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

The Imposition of S.B. 993 Would Negatively Impact California's Sales Tax Administration Grade

Just last month (April 2018), COST released its first "The Best and Worst of Sales Tax Administration" scorecard ("Sales Tax Scorecard")[3], in which COST grades the states on the administration of their state and local sales and use taxes. The Sales Tax Scorecard, similar to

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[3] 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.

other COST scorecards,[4] is meant to improve tax administrative systems and, therefore, ultimately increase compliance. The Sales Tax Scorecard objectively evaluates state statutes and rules that govern state and local tax departments' administrations of the states' sales tax, and it is ultimately directed at policy makers, who are in the best position to make improvements through legislation. 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 the above categories, California received a D+ and was among the 10 bottom-ranked states. If S.B. 993 were passed and implemented, California's grade would most definitely be impacted adversely—it's grade would likely be lowered to an F and it would likely become the third or fourth lowest ranked state. S.B. 993 would directly impact California's score under the category of the taxation of business inputs and pyramiding of sales tax, because S.B. 993 will increase California's percent of tax derived from business-to-business transactions and would impact its taxation on certain service providers.

Further, S.B. 993 would also directly impact California's score under the fair sales tax administrative practices category, because it unclear how the exemption for business with gross receipts under $100,000 would be administered. How would a seller of services know if a purchaser's business has gross receipts under that threshold? California has a requirement that a seller acceptance of an exemption certificate must be in "good faith." Would a seller have to ask to review a purchaser's tax returns and/or financial statements to comply with that requirement? This good faith requirement would also apply to a resale certificate and it creates similar compliance problems. Lastly, California would be significantly penalized for being the only state to broadly impose a sales tax on services on business purchases (as opposed to end-user consumer purchases).

For the reasons discussed above, COST urges the Committee to reject S.B. 993.

Sincerely,

Nikki Dobay

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

[4] 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.