Taxes on Services Overview

House Ways and Means

Patrick Titterton, Fiscal Analyst

April 5, 2023

Consumption Taxes in Vermont

Existing Consumption Taxes in Vermont

1. Sales and use tax
2. Meals and rooms tax
3. Excise taxes
   - Cigarette, tobacco, alcohol, motor fuel, cannabis

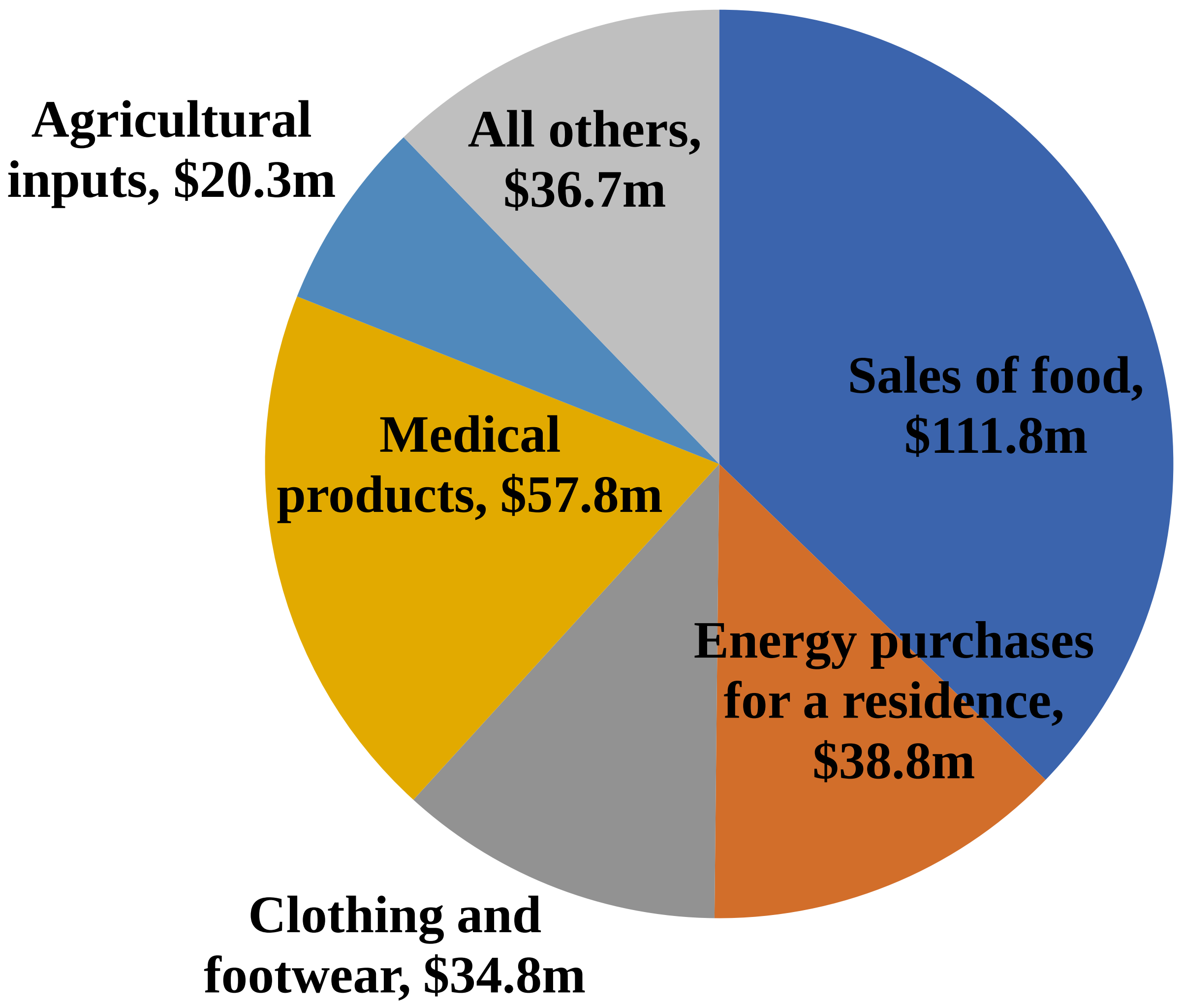
2. Health care taxes
   - Provider tax, premium tax

3. Others
   - Fuel taxes, solid waste franchise tax, electric generating tax, solar energy capacity tax

Sales Tax: what is taxed, not taxed, and exempted?

- Vermont sales tax applies to the retail sale of tangible personal property, unless an exemption applies. 32 V.S.A. § 9771(1).
  - "Retail sale" also means that most business to business purchases are not taxed.
- Unlike tangible personal property, charges for a service are generally not taxable, unless specifically enumerated. 32 V.S.A. § 9771.
- There are many exemptions to the sales tax including 38 that are covered in the Tax Expenditure Report.
  - Generally exemptions are made for basic necessities like groceries and clothing but others exist to promote the Vermont economy like agricultural inputs.
  - Purchases made for government use, and most purchases made and from nonprofit organizations.

FY2021 Estimated Sales Tax Exemptions: $300.2 million



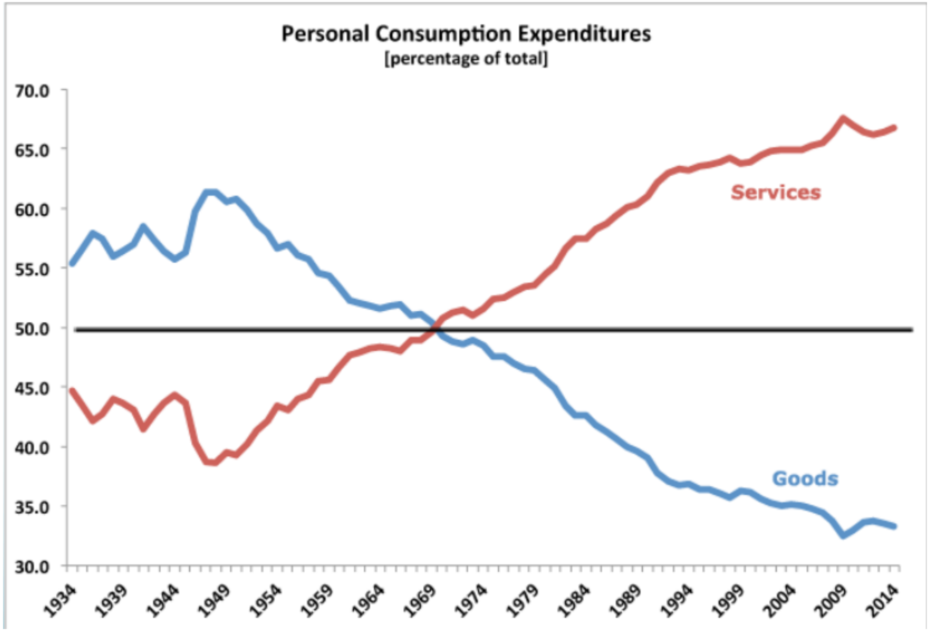
Why does the sales tax not apply broadly to services?

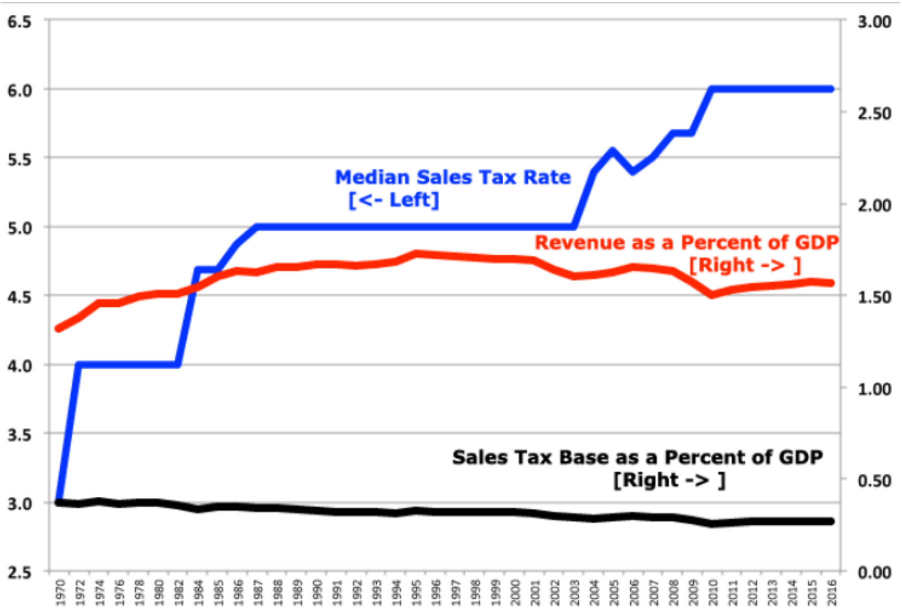
- Vermont has historically largely and statutorily applied the sales tax only to tangible personal property.
- There are some services specifically determined to be taxable, but these are the exception rather than the rule.
  - One example are ski rentals which are considered a substitute for a purchase like buying skis.
  - Many of these are determined to be taxable through administrative rule under the Department of Taxes' rule making authority.

Changes in consumer spending

Sales and Use: Services vs Goods

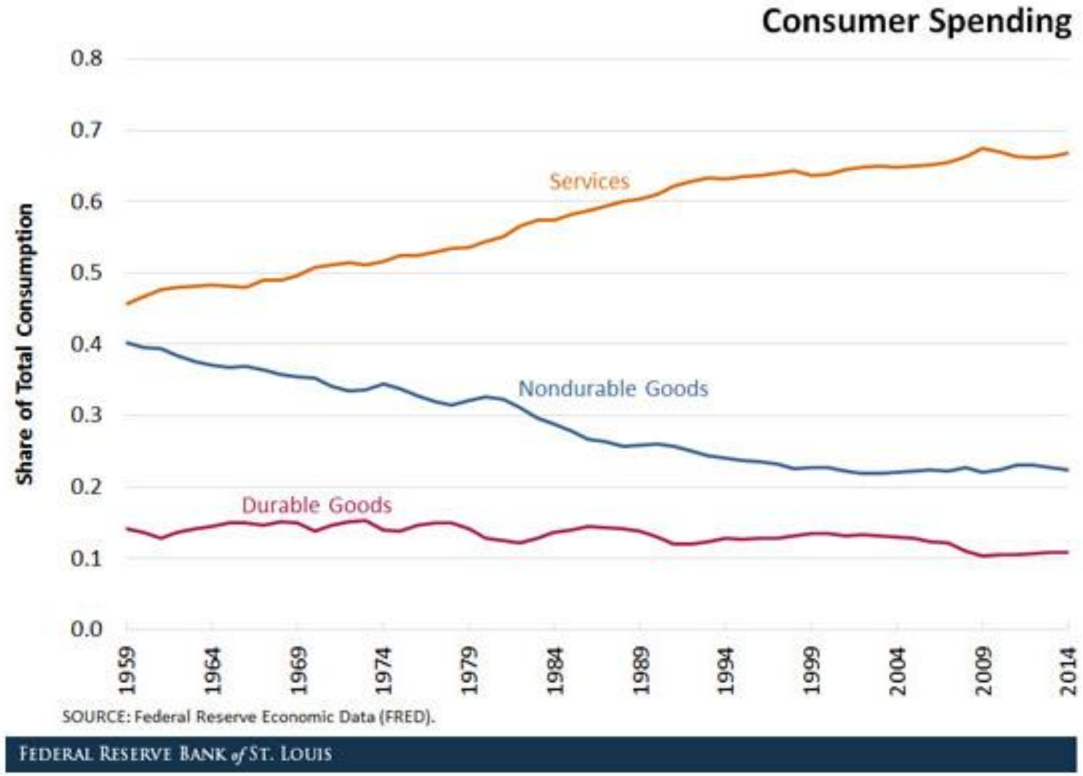
Nationwide Trends in the Sales and Use Tax

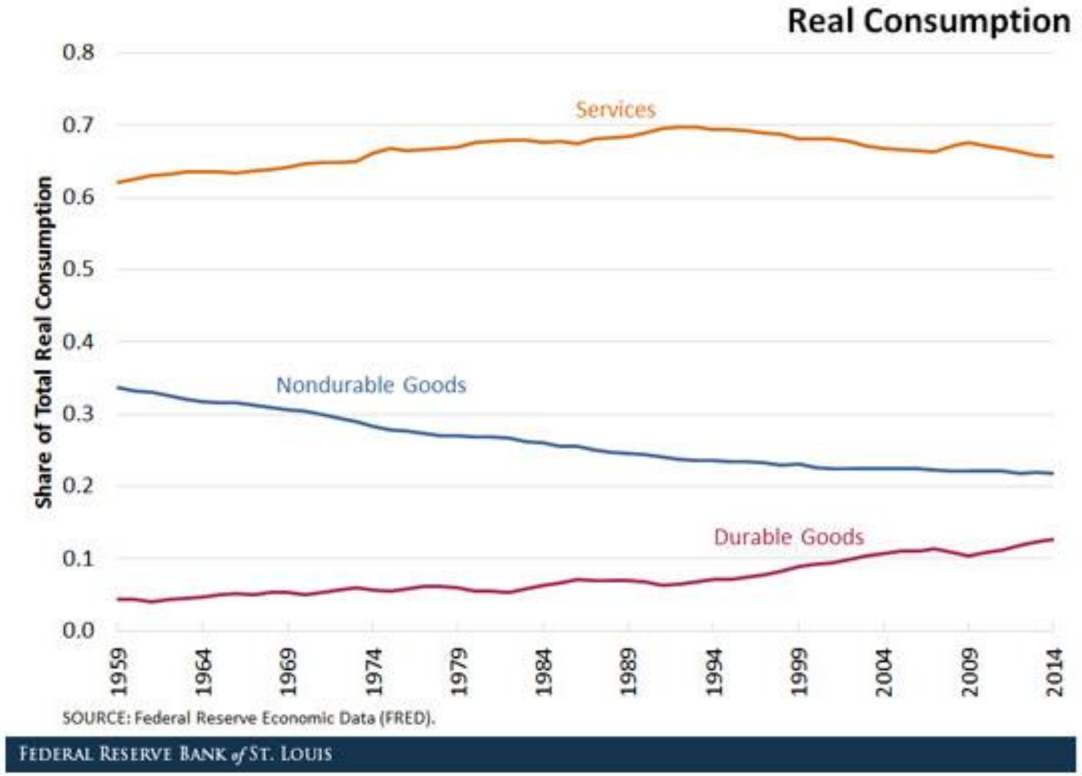




Source: Federation of Tax Administrators, FTA Services Taxation Survey 2017

Sales and Use: Services vs Goods





- In nominal terms you can see consumer spending has skewed heavily towards services, but goods and services have different inflation rates.
- When adjusted for inflation you can see that real consumption on services has been relatively flat.
- What this chart shows is really that the inflation rate on services has been higher than on nondurable goods.

Principles of Taxation

Principles

- The Joint Fiscal Office has highlighted 6 important pillars of taxation that are directly related to this conversation
  1. Sustainability/Reliability
     - Economic conditions, population growth, demographic change, the overarching shift to a service-based economy are all important factors
     - Applying the sales tax to some or all services would broaden the tax base and make it less susceptible to changes from many of these factors
  2. Fairness
     - Younger and/or lower-income households spend a greater share of income on goods.
     - Older and/or higher-income households spend a greater share of income on services.
  3. Simplicity
     - Exemptions from sales tax can make the system complex.
     - Removing many of the exemptions currently in place could ease compliance for multi-state sellers.
     - A sales tax on services would represent a new tax to be collected and remitted for many new businesses.

… continued Principles

- The Joint Fiscal Office has highlighted 6 important pillars of taxation that are directly related to this conversation

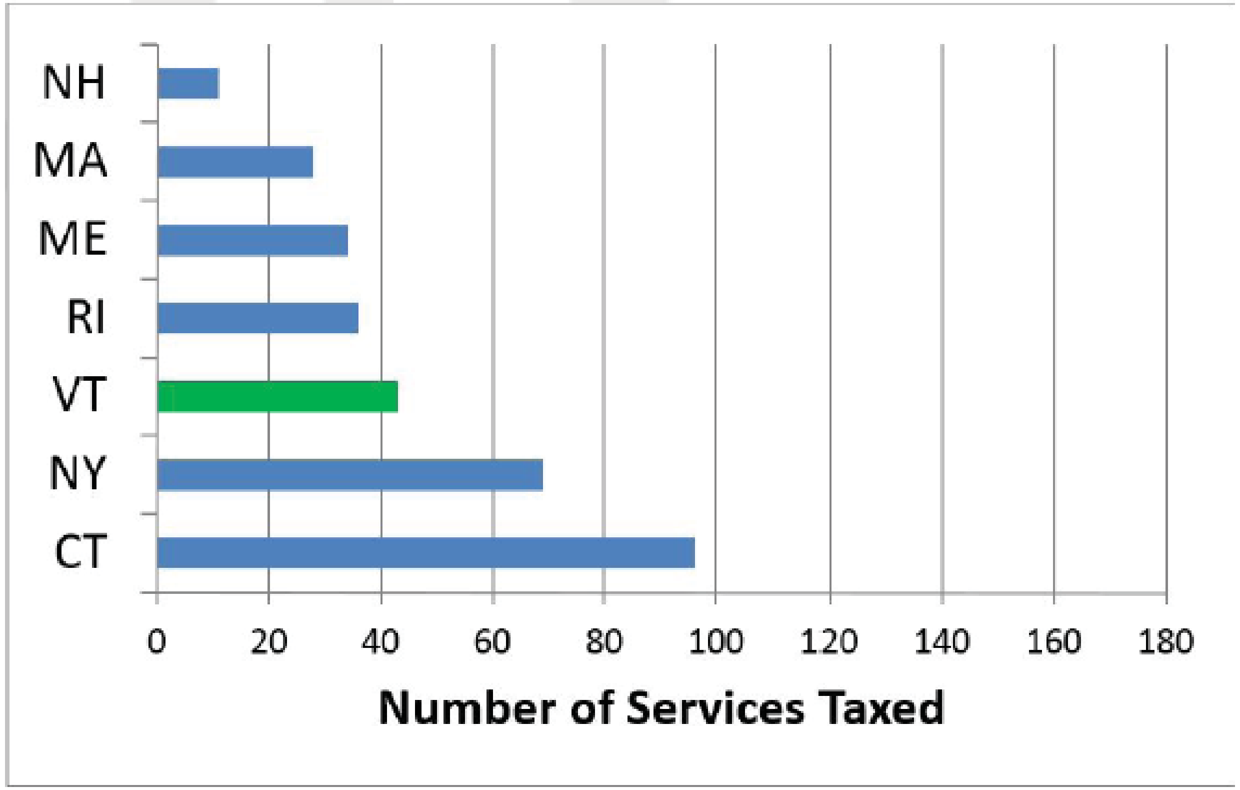
4. Economic Competitiveness
    - New Hampshire taxes the fewest services in the northeast and also does not have a sales tax.
    - Only a small number of states tax services broadly.
    - A broadening of the base would allow for lower rates overall.
5. Accountability
    - Tax Expenditure Report attempts to catalog all exemptions on current sales taxes
    - Vermont does not collect actual data on forgone sales tax revenue so while rigorously studied and estimated the estimates for forgone sales tax revenue may not capture the full picture. This would apply to any exemptions on services.
6. Tax Neutrality
    - Sales taxes may influence some consumer behavior. For example, individuals may shop in New Hampshire to avoid sales taxes.
    - The Tax Structure Commission recommended that the sales tax base be broadened by including most services and removing many or all of the existing exemptions. In conjunction it argued that a lower tax rate on a broader base would not produce a significant impact on consumer demand for currently exemption goods.

Sales tax treatment of services elsewhere

Sales tax treatment of services in the United States

- There is no sales tax at the federal level and states first began implementing sales tax laws in the 1930's.
  - The economy at the time was largely manufacturing based and so taxes at the time were applied to goods or tangible personal property.
- Five states do not impose any general statewide sales tax on goods or services (NH, OR, MT, AK, and DE)
- Four states tax services by default (HI, SD, NM, and WA)
- WV taxes services generally, but exempts many services including professional, contracting, personal, and employment services
- In the remaining 40 states services are not taxed unless specifically enumerated by the state
  - Every state in this cohort taxes a different set of services which can make it difficult for multistate operators to determine which states require them to file a return as well as which specific elements of their services are taxable.

Sales tax treatment of services in the United States



Source: Vermont Department of Taxes: Sales Tax on Services Study, January 2016

Additional notes about VAT

- Worldwide more than 170 countries and 37 of 38 OECD countries have a VAT on general consumption which includes goods and services.
  - The United States is the one OECD country without a VAT and that largely exempts services from the sales tax in most states.
- The United States is an outlier where the most common state sales tax model is as a “retail sales tax” which is only charged once at the last point of sale.
- Because the United States does not have a sales tax on the national level there is no entity at the federal level to give businesses credits for the amount of VAT they have paid.

Example of how a VAT works

Step 1:

- Mine sells $1,000 worth of iron ore to a smelter and collects a 20% VAT ($200) meaning the sale price is $1,200.
- The mine purchased $240 worth of tools and supplies to mine the iron ore which included the 20% or $40.
- They then deduct that $40 that they paid in VAT from the $200 they collected in VAT and must remit $160 in tax.

Note:

- This system is designed so that goods and services that add value in the production process are taxed and it removes “cascading” or “tax pyramiding” by allowing businesses to deduct the amount of VAT they have already paid.
- https://taxation-customs.ec.europa.eu/what-vat_en

Step 2:

- The smelter has paid $200 in VAT to the mine and $20 in VAT on other purchases of supplies.
- The smelter turns the iron ore into $2,000 worth of steel and imposes the 20% VAT when it sells it so it collect $400 in VAT for a total price of $2,400.
- The smelter has already paid $220 in VAT when purchasing it’s inputs so it can deduct that amount from the $400 in VAT they collected when selling the steel.
- They must then remit $180 in VAT.
- In total the mine has remitted $160 and the smelter has remitted $180 in VAT for a total of $340.

Sales tax treatment of services in Canada

- Canada introduced a Federal value added tax in 1991 that is currently 5%
  - This tax applies to all goods and services purchased except for some essentials like groceries, rent, medical services, and many financial services.
  - Businesses that purchase goods and services for commercial activities can claim “input tax credits” that they can deduct from their remittances, which help eliminate “cascading” or “tax pyramiding.”
- Provinces also apply a provincial tax between 6-10%.
- By applying the tax to a broad base that includes services and does not include many of the exemptions on goods that Vermont has it allows the tax rate to be lower.
- This helps fix the problem of a shrinking tax base as consumer expenditures have been trending towards services and away from goods.

Sales tax treatment of services in European Counties

- All European countries levy a value-added tax (VAT) on goods and services. VAT's are assessed on the value added in each production stage of a good or service.
  - Businesses receive a tax credit for the VAT already paid

Value-Added Taxes: How other places tax services

- The United States is unique globally in that there is no federal general consumption tax, and the structure of the sales tax in Vermont is at the final point of sale rather than structured as a VAT.
- VAT's are the most commonly use general consumption tax globally and typically apply to all transactions for goods and services with few exemptions (medical care, education, and food are a few examples).
- VAT's are structured so that businesses receive a credit for the amount of VAT they paid on goods and services for commercial activities, which eliminates "cascading" or "tax pyramiding."
- VAT's require an entity at the national level to coordinate collection and to appropriately give credits to businesses for their purchases for commercial activities.
- As the most common form on general consumption tax globally, how it treats services provides some insight into global best practices.

What services does Vermont already tax?

What services are already taxed in Vermont?

- Two authoritative sources that give details on services that are subject to the sales tax include:
  - 32 V.S.A. § 9771 is the statute that lays out the imposition of the sales tax
    - https://legislature.vermont.gov/statutes/section/32/233/09771
  - Vermont Sales and Use Tax Regulations (Vt. Reg. § 1.9701) released by the Tax Department
    - https://tax.vermont.gov/sites/tax/files/documents/SU%20Regs%20Effective%201%201%2019.pdf

What services are already taxed in Vermont?

- For general information regarding services taxed in Vermont visit the FTA 2017 Services Taxation Survey:
  - Ski rentals
  - Dog grooming
  - Health clubs and tanning parlors
  - Photo copying and printing services
  - Streaming services
  - Bowling alleys
  - Cable and direct satellite TV services
  - Aircraft rentals
  - Taxidermy
  - Non-exhaustive list. For more information follow the link below

  https://www.statetaxissues.org/services/2017/service_state.php

Insights from the Vermont Tax Structure Commission, Blue Ribbon, and other past Legislative reports

Insights

- Sales tax is considered a regressive form of taxation. Low income Vermont households spend a relatively larger share of income on goods than higher income households.
- The reports recommended applying the sales tax more broadly at a lower rate to make the tax more fair and sustainable.
  - This also includes removing many of the existing exemptions on goods and retaining exemptions on certain health and education services and business-to-business service transactions.
- Not taxing services represents an inequity between businesses who sell goods versus services.
- Excluding services from the sales tax inflates the rate required to raise the amount of revenue currently generated.

Insights

- Lowering the overall rate and applying the sales tax to services would be a more effective way to reduce regressivity. While it would not eliminate regressivity the report argues that it would reduce it.
- There are other ways Vermont can help low-income households offset regressive taxes.
  - The 2023 Tax Expenditure Report found that the EITC is highly effective in offsetting regressive taxes fully or substantially for all claimants.
  - 2021 Clothing Exemption full review by JFO pointed to credits like Maine's Sales Tax Fairness Credit as a targeted way to reduce regressive rather than broad exemptions.

Estimates on Taxing Services

Applying the Sales Tax to Services

- Recently the RAND report on Vermont Early Care and Education Financing Study provided two estimates for applying the sales tax to services
- The estimates were provided under the assumption of maintaining the current 6% sales tax rate
- One estimate was provided for limited services
- One estimate was provided for extended services

Applying the Sales Tax to Services

- The estimate for applying the sales tax to **limited services was $105 million**
- The estimate for applying the sales tax to **extended services was $143 million**

Sectoring Services

Limited

- Personal Services
- Entertainment

Extended

- Personal Services
- Entertainment
- Broadcasting
- Publishing

Applying the Sales Tax to Services

- JFO publishes Fiscal Facts annually and it includes a "Potential Revenue Sources" section, which includes estimates on applying the sales tax to many different types of services.
- Includes estimates for:
  - Professional, scientific, & technical services
  - Administrative & support services
  - Finance, insurance and real estate
  - Health care & social assistance
  - Other services
- These estimates can give you a sense of the size of the market, but they do not exclude business to business sales and does not account for out of state operators.

Considerations

Non-Exhaustive List of Considerations

1. How would regressivity concerns be addressed?
   - Broad exemptions or targeted back-end credits?
2. If the purpose of sales tax exemptions is to make basic necessities more affordable or to support local industries does the current system overcompensate for some of these goals? Should services be defined as taxable?
3. How would a sales tax on services treat business-to-business transactions?
4. What types of taxpayer education and compliance costs would be required?
5. For out-of-state service providers to a Vermont customer: what is the nexus for determining the final delivery of a service?
   - For tangible personal property the location of final delivery is relatively simple
   - For services, what is more preferable? Where the service is delivered or where it is produced/completed?

Thank you!