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In this installment of Moving Forward?, Nellen highlights a long-standing flaw with state sales tax systems, explaining why it's been prolonged and why now is a good time to finally address it. She argues that a solution would include eliminating sales taxes on business consumption, expanding the base to personal services, and reevaluating existing exemptions to prevent benefits from going to those who do not need them.

Current fiscal challenges could easily exacerbate the state sales tax system's existing flaw and make fixing it more costly in the future. So despite the global pandemic and the resulting financial uncertainty for the public and private sectors, it would be wise to consider addressing the issue now. This article not only identifies those flaws, but also outlines the benefits of fixing the sales tax base and related matters and makes recommendations to enact changes over the next few years. Any plan to fix the sales tax base's flaws must not create new, if even temporary, cost increases for low-income individuals.

I. What Is the Flaw?

The sales tax flaw is that despite being a consumption tax, a growing amount of consumption is omitted from the tax base. Also, the inclusion of nonpersonal consumption (by businesses) in the base leads to pyramiding (assessing tax on a tax), which is inefficient and improper for this type of tax.

While sales tax bases have traditionally included only tangible personal property, some states have expanded their bases to services, but not all personal or household services. The emergence of digital substitutes for tangible items — such as books and music — in the mid-1990s led several states to also tax these digital goods, but much of this growing consumption by consumers remained untaxed.

Despite improvements by a few states, sales tax bases remain inconsistent among states. For example, New Mexico and Hawaii have broad bases, while California taxes most tangible personal property and a few services — but no digital goods even if they are substitutes for tangible ones. The disparate tax bases highlight one of several aspects of the base flaw in that California's narrow base uses a state rate of 7.25 percent (highest among states as of January 1, 2020, and higher yet at 10.25 percent in Los Angeles County), while Hawaii's tax rate applies to a broader tax base and is 4 percent.[1]

In brief (more later in the third part of this article), the two elements of the sales tax base flaw in need of reform are:

[1]Federation of Tax Administrators, "State Sales Tax Rate and Vendor Discounts" (Jan. 1, 2020). California Department of Tax and Fee Administration, "California City & County Sales & Use Tax Rates" (effective July 1, 2020). Also, per 2017 FTA data, Hawaii includes 167 services in its sales tax base, New Mexico includes 164, and California includes 21. FTA, "Sales Taxation of Services, 2017 Update."

- the sales tax base is too narrow in that a significant, growing amount of personal consumption is omitted; and
- the sales tax base includes items purchased by businesses, which leads to pyramiding of this tax (in which the price of goods and services includes sales tax paid by the business and sales tax is added on to reach the customer's tax-inclusive price — resulting in tax imposed on a tax).[2]

Related matters to resolve along with addressing this base flaw include:

- Lower the rate as part of base broadening.
- Revisit what the state exempts because it is considered a "necessity of life." Base broadening to include almost all personal consumption means that goods and services viewed as necessities of life will be added to the sales tax base, which will cause hardship for middle- and low-income consumers. However, most of the dollars not collected today because of these exemptions benefit higher-income consumers who buy more expensive "necessities" and do not need the financial assistance — meaning that this assistance is wasted and misdirected. There are more targeted ways to use the considerable funds spent in providing these exemptions that can be redirected to truly benefit those who need assistance, to lower the tax rate, and to make the state's tax system more equitable.
- Identify personal consumption omitted from the base because it is exempt (for a reason other than necessity of life) or not included because of the legal definition of the base (such as one that only applies to tangible personal property). This personal consumption should be added to the base to address the base flaw.

These matters and implementation suggestions are explored further in later sections, but next I offer reasons why now is a good time to fix this long-standing, significant, and costly flaw in the sales tax system while addressing related issues.

II. Challenging Times Can Warrant Improving A Tax System

Just as businesses regularly evaluate their products and services to determine if they are keeping up with technological and societal changes, governments too should regularly review tax systems to ensure their effectiveness. Efforts to look ahead must recognize that tax systems must adjust to ongoing shifts in how we live and do business.

But change is rarely easy. For a tax system such as the sales tax, which generates significant revenue for the 46 states that rely on it, change is even harder. Poor understanding about taxes by most of the public can make it even more difficult, but difficult is not the same as impossible.

Is it appropriate to make a major change during the challenges of the coronavirus? Why not? Governments will be looking for significant revenue for the next several years. Consideration of fixing a flaw to better identify the sales tax's revenue limits and avoid making the flaw worse can stabilize tax revenues and likely even help with economic development — which faces challenges. Since review of tax systems and revenue streams will likely also consider new taxes in many states, having an improved, more effective sales tax should help achieve a better tax system overall.

Change in tough times is not inappropriate. People may expect significant change if it improves efficiency going forward. And tough times can be a time to make tough changes.

The United Kingdom is an example of a country addressing tax issues in challenging times. In July the U.K. Treasury Committee launched an inquiry called "Tax after Coronavirus" with the following rationale: "The reconstruction of the economy after the unprecedented economic fallout of the coronavirus crisis is an opportunity for the Committee to examine the tax system." Tasks include examining new pressures on the tax base, protecting the base from globalization and changes in technology, and the "role of tax reliefs in rebuilding the economy."[3]

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[2]Pyramiding may also be referred to as cascading. For example, per a 2016 report of the Joint Committee on Taxation: "A retail sales tax should exempt purchases by other businesses to avoid cascade effects." JCT, "Background on Cash-Flow and Consumption-Based Approaches to Taxation," JCX-14-16 (Mar. 18, 2016), at 35 (hereinafter "2016 JCT report").

[3]U.K. Parliament, "Treasury Committee Launches 'Tax After Coronavirus' Inquiry" (July 17, 2020). The inquiry includes a list of questions for which the committee seeks evidence.

III. Advantages to Fixing the Sales Tax Flaw

Fixing the two-part base flaw would eliminate pointless debates on expanding the base to more business purchases, offer opportunities to provide targeted tax relief for the consumption of necessities, end base erosion, derive a more uniform base among states, and help economic development. Ideally, the base flaw should be addressed in conjunction with lowering the tax rate, another benefit that could help many individuals and make the sales tax a more stable revenue source for states.

A. The Sales Tax Base Flaw

As the Joint Committee on Taxation put it:

> The retail sales tax is perhaps the easiest to see as a tax on a consumption base. If all final consumption (goods and services purchased for final use by households) is subject to the tax and no intermediate goods and services (those purchased by businesses and used to produce other goods and services) are subject to the tax, then a retail sales tax is tautologically a consumption tax. In practice, existing State sales taxes deviate from this comprehensive consumption base by exempting certain goods and failing to tax many services provided to households.[4]

Broadening the sales tax base to more types of personal consumption and eliminating business purchases from it are not new ideas. I have been writing and testifying about it for over 10 years, and I am not alone.[5]

As noted by the JCT, a sales tax is a consumption tax intended to be imposed on the final consumer or household. All states provide exemptions for sales for resale as evidence of this intent to focus on the final consumer. But this exemption does not relieve all business purchases of sales tax. The problem is mostly historical because state sales taxes, enacted in the early 1930s to address a drop in other tax collections in the Great Depression, was imposed on tangible personal property.[6]

Beyond the exemption for purchases of items intended for resale by the buyer, most states have various tax exemptions for businesses that are also designed for economic development purposes — including exemptions for manufacturing and research and development equipment.

Despite significant exemptions, many business purchases of goods and services are taxed, which results in pyramiding (also known as cascading) and a lack of transparency on what is truly subject to the sales tax. For example, most states exempt food,[7] yet in many states, food vendors pay sales tax on equipment purchased for the store — then factor the tax into the food's retail price. Thus, food prices indirectly include some element of sales tax.

The pyramiding issue is exacerbated when long supply chains exist. Businesses cannot avail themselves of sales tax exemptions on all purchases, and the final price for the consumer will have sales tax embedded in it from more than the most recent link in the supply chain.

Pyramiding is not only a structural defect in state sales taxes, but is unfortunately also a significant revenue-generating one. An EY study finds that for fiscal 2017, states generated about $157 billion in sales tax from business-to-business transactions — or an estimated 42 percent of state and local sales tax collections. This is an extremely costly flaw presenting challenges in modifying the sales tax base to be what the EY report describes as a "true sales tax on consumption" that imposes "a uniform tax on all goods and services sold to

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[4] 2016 JCT report, at 37.

[5] Annette Nellen, "Sales and Use Tax Weaknesses & Possible Remedies: The Tax Base Is Too Narrow and Should Be Broadened" (2009); and Michael Mazerov, "Expanding Sales Taxation of Services: Options and Issues," Center on Budget and Policy Priorities (Aug. 10, 2009). This report states:

> Public finance economists and other tax experts have been urging states for decades to include more services in the sales tax base. Levying a sales tax on services satisfies all the criteria by which state tax policy options are normally evaluated.

Nicole Kaeding, "Sales Tax Base Broadening: Right-Sizing a State Sales Tax," Tax Foundation (Oct. 24, 2017). This report notes that "state sales tax bases have been narrower than ideal" and that "all final personal consumption" should be subject to the tax.

[6] For example, California enacted the sales tax on tangible personal property with the Retail Sales Tax Act of 1933. California State Board of Equalization, Publication 216, "The First 100 Years," The Retail Sales Tax.

[7] FTA, "State Sales Tax Rates and Food & Drug Exemptions," Jan. 1, 2020.

households, but would not tax business purchases of intermediate goods and services."[8]

The EY report also outlines the other part of the base flaw: untaxed personal consumption. According to EY, only about 21 percent of personal consumption is subject to sales tax because of numerous exemptions. In addition to exemptions, there are legal exceptions because the tax base in many states does not cover most services or intangible items. EY notes that medical, education, and housing services are usually exempt from sales tax and account for 42 percent of exempt consumption in households. However, the report further observes that even when this usually exempt consumption is ignored, only 32 percent of household consumption is currently subject to tax.[9]

A 2015 California Legislative Analyst's Office (LAO) report concluded that most spending by California households is not subject to sales tax. The largest category of untaxed consumption is housing and utilities, representing (for 2012-2013) about 30 percent of household spending. Groceries, also exempt from sales tax in California, represent on average about 7 percent of spending. The report also observed that some digital goods — such as streamed movies and e-books — are like tangible goods but are not subject to sales tax. Also, some exempt and taxed goods are similar — including taxed over-the-counter pain medicine and tax-exempt prescription pain medicine.[10]

The LAO report also noted challenges of neither exempting nor taxing all food. Generally, food for home consumption is exempt in California (and many other states). But if the food is purchased as hot food, like coffee in a cup or a slice of pizza, ready to eat, purchased at the grocery store, it is subject to tax.[11] While it's not noted in the report, consumers might think that a store clerk's question — "Do you want that heated or toasted?" — is just for added service and not realize that the answer bears on whether sales tax must be added to the food charge.

Another sales tax base problem for California and other states with narrow bases is that what is subject to tax represents a declining amount of consumer spending. That is, the value of sales of exempt goods and services has been growing faster than what is subject to sales tax. Per the LAO, California consumer spending on taxable goods peaked in 1979, when about 50 percent of household spending was taxable. But according to the LAO, since 1979 "the state's sales tax base has grown slower than the state's economy. As a result, consumers now spend about one-third of their income on taxable goods." Factors causing this result include decline in the price of many goods and an increase in healthcare spending.[12]

Tax expenditure and incidence reports by the Texas Comptroller also note challenges with sales tax exemptions — including that they continue to grow and that "the vast majority of transactions are not taxable."[13] In Texas, the value of sales tax exemptions — such as for food and materials used in manufacturing — was $34.6 billion for fiscal 2019. The value of sales tax exclusions — such as personal and business services — was $8 billion for fiscal 2019.[14] In contrast, sales tax revenue that year was $29.6 billion,[15] representing 69 percent of the combined value of the sales tax exemptions and exclusions. That is, in Texas and other states, the value of what is subject to sales tax may be less than what could be in the base but is exempt from the tax. (The Texas figures include some business purchases.)

In summary, state sales tax bases have two significant flaws: including items purchased by businesses that should not be in the base and exempting significant amounts of household spending that should be.

[8] Andrew Phillips and Muath Ibaid, "The Impact of Imposing Sales Taxes on Business Inputs," EY (May 2019), at 1-2. The report includes a table showing the business share of sales tax collection for each state and the District of Columbia. The highest is New Mexico, where 60 percent of sales tax collections are from purchases by businesses.

[9] *Id.* at 4.

[10] California Legislative Analyst's Office, "Understanding California's Sales Tax" (May 2015), at 8-11.

[11] *Id*. at 11.

[12] *Id*. at 21-22. *See also* Mac Taylor, "Why Have Sales Taxes Grown Slower Than the Economy?" California LAO (Aug. 5, 2013).

[13] Glenn Hegar, "Tax Exemptions & Tax Incidence," Texas Comptroller of Public Accounts (Nov. 2018), at 1.

[14] *Id*. at 3-14.

[15] Hegar, "Biennial Revenue Estimate," Texas Comptroller of Public Accounts (Jan. 2019), at 35.

B. Wasting Time Answering Pointless Questions

Several recent proposals would have expanded the state sales tax base to digital goods and services primarily or exclusively purchased by businesses, but as noted, this type of base expansion would exacerbate the sales tax base flaw. Considerable time has been devoted by lawmakers to proposals to add more business purchases to the sales tax base and by businesses and practitioners countering why those changes should either not be made or should be made in a different manner.

For example, the District of Columbia and a few states recently considered taxing advertising services (including digital ads), but these purchases are only made by businesses and should not even be in the tax base. Any time spent attempting to tax them would be better invested in improving the sales tax base and exploring revenue options that are more appropriate for a sound tax system.

In considering expanding a sales tax base to include more business purchases, much of the wasted time is spent defining the taxed item and, for services and intangibles, identifying when the transaction occurs in the state. A recent *Tax Notes State* article provided numerous examples of how states define and tax digital goods and services and noted the lack of consistency.[16]

One example of industry opposing pointless proposals is a July 2020 letter from the Council On State Taxation to the District of Columbia Council explaining its opposition to the proposed expansion of sales tax to digital advertising. The letter includes a tax policy reminder addressed in this article:[17]

> 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.

Additional examples of misspent time can be summarized using tax decisions and guidance issued in the past year. While only three states are used for the examples, odds are high that all 46 states imposing sales taxes have issued guidance and court opinions in the past year on sales tax base questions that should not even exist but arise because of the base flaw. Also, tax agencies focus much of their audit time on applying sales taxes to business purchases, which is further wasted time that could be redirected if the state fixes its base flaw.

- **What's a service versus property?** A December 2019 ruling by the Colorado Department of Revenue concluded that gift-wrapping services were taxable because of the materials involved and because the "customer's ultimate goal in paying the fee is to obtain tangible personal property (the decorative packaging) that covers or otherwise conceals the product purchased."[18] This would not be a question if the tax base included the entire amount paid by the consumer.
- **What's a sale for resale?** Lower and appeals court decisions would not have been required without the flaw. In *CEC Entertainment Inc. v. Hegar, Comptroller of Public Accounts of The State of Texas*[19] the trial court and appeals court held that coin-operated gaming equipment purchased by Chuck E. Cheese restaurants was subject to sales tax. Both courts found that the sale for resale exemption did not apply to this equipment. This issue would not have existed if the tax base properly excluded all business purchases.
- **How do business exemptions operate?** In the first six months of 2020, four Tennessee DOR rulings explained how some exemptions for business purchases apply, whether sales tax applies to on-hold messaging services, and whether a provider

[16] Natalia Garrett and Grant Nülle, "Digital Goods and Services: How States Define, Tax, and Exempt These Items," *Tax Notes State*, May 18, 2020, p. 873.

[17] COST letter to the District of Columbia Council, "COST Opposes D.C.'s Proposed Digital Advertising Tax" (Jul. 16, 2020).

[18] Colorado Department of Revenue, GIL-19-003 (Dec. 27, 2019).

[19] No. 03-18-00375-CV (Dec. 5, 2019).

of online courses is subject to sales tax.[20] Again, these questions and rulings would not be needed if business purchases were not included in the sales tax base.

There will be some challenges of removing all business purchases from the sales tax base. As noted, the significant amount of revenue generated today with this flawed tax base is one. Another arises regarding goods and services purchased by both businesses and households, such as restaurant meals and entertainment.

But solutions exist and must be evaluated by lawmakers with taxpayer input. For example, one solution is to always impose sales tax on meals and entertainment charges — a justification for which is that there is a personal element to these expenditures. Alternatively, sales tax could be charged on all of those purchases, but a method could be provided for businesses to claim a refund (as many countries that impose a VAT do). And another challenge of exempting business purchases from sales tax is readily determining when purchases by self-employed individuals are for business versus personal use. These are among the challenges of fixing the base flaw that are addressed in the fourth section of this article.

C. Considerable Tax Breaks for Those Who Do Not Need Them

While many consumer sales tax exemptions are for so-called "necessities of life," there is no single definition of necessity of life[21] — and the exemptions tend to be broad. For example, food for home consumption is exempt in most states. This exemption generally covers the basic food groups, but also junk food and foods that might cost much more than other healthy choices, such as gourmet cheese rather than lower-priced cheese. Utilities are also often an exempt necessity of life that applies whether one lives in a 900-square-foot or 50,000-square-foot home.

Exemptions for necessities of life are poorly targeted, providing insufficient relief to low-income consumers and too much to those who do not need any financial assistance. For example, 2018 Bureau of Labor Statistics data indicate that consumers in the lowest quintile of income spent, on average, $2,709 annually on food at home — while those in the highest quintile spent $6,827. Assuming a 6 percent sales tax rate, the food exemption provided $163 of savings for lower-income individuals and $410 of savings for the highest-income quintile, which is assistance the more affluent group does not need — or could easily recover by spending less on food. Similarly, while the lowest quintile spent, on average, $344 annually on water and other public services in 2018, the highest quintile spent $906 — thereby obtaining a larger tax break.[22]

Necessity-of-life exemptions are still added to state sales tax systems despite their costs, their favoring of higher-income consumers, and the reality that alternative provisions would not only better target those who need it — but provide more relief than a mere sales tax exemption. For example, in 2019 California Gov. Gavin Newsom (D) signed into law a two-year sales tax exemption for baby diapers and menstrual hygiene products (S.B. 92). However, a LAO report released before the law's enactment laid out the weaknesses of the exemptions and offered alternatives.

The LAO stated that if lawmakers want to "offer substantial assistance to some families with acute financial needs," expanding child care would help because the current state program is underfunded and turns away eligible families.[23] The state and local sales tax losses from the diaper exemption are estimated at $52 million for fiscal 2021.[24] In June, despite budget challenges caused by the pandemic, lawmakers extended the exemption for one more year, with no change to better direct the diaper exemption's $52 million in annual assistance to parents in need; the menstrual product exemption was also extended for another year.

[20] Tennessee DOR, Sales and Use Tax, Ruling Nos. 20-02, 20-03, 20-04, and 20-05.

[21] A 2019 LAO report observes that "if a person can attain a generally accepted standard of living without using something, then that thing likely is not a necessity." The report notes that California taxes many items pertaining to personal hygiene and safety, indicating that there is no single definition of necessity used among the states. This observation likely pertains to all states with a sales tax. LAO, "Sales Tax Exemptions for Diapers and Menstrual Products" (May 12, 2019).

[22] U.S. Bureau of Labor Statistics, Consumer Expenditure Surveys, CE Tables, Annual Calendar Year Tables, "Quintiles of Income Before Taxes."

[23] LAO, *supra* note 21.

[24] California Department of Finance, "Tax Expenditure Report 2019-20," at 50.

Category	Amounts Shown Are the Average for the Group				
	Lowest 20%	Second 20%	Third 20%	Fourth 20%	Highest 20%
Entertainment	$228	$271	$463	$814	$2,050
Household personal services	$108	$142	$197	$458	$1,451
Healthcare	$2,475	$3,997	$4,637	$5,866	$7,865

To get a sense of the base weakness resulting from just this one exemption for baby diapers, let's do some math. Big box retailers sell some diaper brands for about 22 cents per diaper. Assuming a baby uses 10 diapers per day, the annual diaper cost with California's 7.25 percent state sales tax rate is $861. The sales tax exemption drops the cost by $58 to $803. In contrast, if the parents can afford more expensive diapers, they might spend 50 cents per diaper (or even more). The cost without the exemption for a year is $1,957, but $1,815 with the exemption — for an annual savings of $132.

If the $52 million cost of the exemption were instead used to buy diapers for those in need, over 60,000 families could be given free diapers. Alternatively, a refundable tax credit could be provided for low-income taxpayers to help cover not only the sales tax on the diapers, but also all or a portion of the cost of diapers. Thus, rather than reducing the sales tax base to provide an inefficient benefit to taxpayers in need and a larger benefit to those not in need, the funds could be redirected to provide greater financial assistance to those who need it. The fourth section of this article provides additional ideas on how to better address tax relief for necessities of life that also fix the sales tax base flaw.

Another tax base flaw arises from considerable personal consumption that is omitted from the tax base in many states and often represents high-end consumption. Higher-income individuals tend to spend more on consumption that is not part of the sales tax base in most states — such as for entertainment, household personal services, and healthcare. The annual Bureau of Labor Statistics consumer spending survey data indicates the following average spending for 2018.[25]

Thus, a narrow base excluding many personal services provides a much larger benefit or tax break to higher-income individuals and represents a significant sales tax base omission. A broadened base that includes this high-end consumption would help enable a lower tax rate for all consumers and make the tax system more progressive. Solutions for these base flaws are discussed in the fourth section of this article.

D. Additional Benefits of Fixing the Sales Tax Base Flaw

In addition to no longer dealing with pointless questions and proposals and better directing tax relief to consumers who need it, there are at least 11 more benefits to fixing the sales tax base flaw.

1. Reduce Base Erosion

As noted, spending on personal consumption items that are often exempt from sales tax is growing faster than what is subject to sales tax. For example, when a state does not tax digital goods such as movies, music, software, and books, items shift from taxable in tangible form to nontaxable in digital form — eroding the narrow base as the nature of personal consumption shifts. If a state eliminates all exemptions for personal consumption, base erosion will end. This is unlikely to happen, however, because states are expected to continue exemptions for most medical services and education, and these items can represent growing segments of consumer spending.

2. Make the Sales Tax Base More Stable

In line with reducing base erosion, a sales tax base with more personal consumption should be more stable. Also, no longer subjecting business purchases to sales tax can aid stability. For example, if a business or industry increases its vertical integration, the sales tax base would be unaffected.

[25] U.S. Bureau of Labor Statistics, *supra* note 22.

3. Improve Progressivity of a State's Overall Tax System

As explained earlier, some personal consumption omitted — because of the legal description of the sales tax base in many states — involves greater spending by higher-income individuals. Affluent residents also spend more on exempt necessities of life. Thus, high-income individuals experience significant tax breaks that should end with a broadened sales tax base. Their increased sales tax payments would increase the state tax system's progressivity.

4. Address Hidden Problems of Ineffective Tax Breaks

Use of the term "necessities of life" to justify exemptions can be misleading by making it appear that a problem has been addressed when it has not been adequately remedied. For example, states with a sales tax exemption for baby diapers still have nonprofit diaper banks to help low-income individuals.[26] In other words, the sales tax exemption did not solve the need for assistance to low-income families to obtain diapers. The sales tax is a minor part of the total cost of diapers and other necessities and does not adequately address all financial assistance needs.

If instead of using poorly designed exemptions for necessities of life, most personal consumption were subject to sales tax, lawmakers would ideally find better ways to provide assistance to obtain necessities — such as furnishing diapers to low-income families or increasing the state's earned income tax credit if infants are part of the taxpayer's family.

Replacing most necessities-of-life exemptions with targeted relief measures could also address more hidden problems. For example, the National Diaper Bank Network states that some daycare facilities require parents to provide diapers for their child. In many instances, if the parents do not have diapers, they are turned away from the facility for the day and then also lose income because of loss of work for the day, further exacerbating problems of acquiring necessities of life.[27]

Similar issues are inherent in the larger sales tax exemption for food in most states. Tax savings can mask the issue of low-income households not having enough food — because sales tax savings are minimal compared with the cost of the food itself. And the funds used to provide these broad exemptions can be redirected from aiding high-income individuals to providing greater benefits to low-income residents.

5. Achieve a More Uniform and Simpler Base Among States

While all states exempt sales for resale, similarities in the sales tax as applied to business purchases generally end there. Even where states may seem similar in exempting equipment used in manufacturing or research and development, definitions and the method used to obtain the exemptions vary.

Exempting all or almost all business purchases from sales tax would end this problem in the simplest manner. Efforts to standardize definitions and exemptions among states have failed in that not all states participate. For example, only 23 states are full members of the Streamlined Sales Tax Governing Board, which launched as the Streamlined Sales Tax Project in 2000.[28]

Also, if states broaden their sales tax bases by taxing most personal consumption and using more targeted and effective means of providing tax relief for necessities of life, those bases would be more uniform among states, to the benefit of vendors. A good example is that a broader base would include not only food but also candy. Several states distinguish food and candy in their tax bases. For example, in Arkansas the definition of candy includes that it does not contain flour. Yet some items in the candy aisle, such as Kit Kat bars, have flour and are taxed at the lower sales tax rate for food. Arkansas retailers need to know that Kit Kat and Twix bars have a reduced rate of 1.5 percent while Milky Ways are taxed at 6.5

[26] The National Diaper Bank Network reports that as of January 1, 2020, nine states that impose sales tax had an exemption for baby diapers (California, Connecticut, Massachusetts, Minnesota, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont). The network's directory of member diaper banks indicates that all nine states have diaper banks despite the sales tax exemption.

[27] National Diaper Bank Network, "California Diaper Facts" (Nov. 2018) at 3. This report notes that throughout the United States, 57 percent of parents who lacked diapers and lost child care missed an average of four days of work in the past month.

[28] Streamlined Sales Tax Governing Board Inc., "State Information."

percent.[29] Having far fewer — if any — exemptions would eliminate this confusion and lead to a more uniform base among states and fewer compliance errors.

6. Aid Economic Development

Any state that removes all or nearly all business purchases from the sales tax base should become attractive to out-of-state and new businesses, particularly those that do not benefit from many of today's exemptions. Eliminating the sales tax on business purchases would also benefit companies that do not use a high degree of vertical integration — and end up paying more sales tax directly and indirectly relative to more vertically integrated businesses.

In states where the sales tax is significant to localities, an improved base may widen the types of businesses that local governments want to attract. For example, if the sales tax base only focuses on tangible personal property, cities are more interested in having big box retailers locate in their jurisdictions rather than service providers or sellers of digital goods. Broadening the base to more personal consumption would make more companies attractive for the sales tax they can generate for a municipality.

7. Improve Neutrality of the Sales Tax

Varying state sales tax exemptions can affect a vendor's decisions on where to locate and expand, which violates the neutrality principle that tax rules should not affect decision-making. Removing business purchases from the sales tax base would also eliminate this tax from decisions on how vertically integrated a business needs to be — leaving that decision to be based on costs and other factors.

Repealing most if not all exemptions for personal spending would also eliminate the sales tax rules from some personal spending decisions. For example, for states with back-to-school sales tax holidays, the system encourages households to purchase the products during the holiday period. Tax bases that either exempt or do not include specific consumption can also affect decisions. For example, if a state does not tax digital goods, students may decide to purchase digital textbooks rather than tangible ones to reduce the cost. With these distinctions removed for personal consumption, however, those purchase decisions can be better focused on which version best helps the student's learning.

Some sales tax exemptions apply based on the type of seller. For example, a tax-exempt entity like an animal shelter might be exempt from charging sales tax, while a pet store is required to charge tax on the same product sale.[30] While this rule may exist to help the nonprofit and eliminate compliance burdens, it violates the neutrality principle. It also violates the transparency principle in that buyers likely do not understand why application of sales tax depends on whom they purchase a product from. As part of base broadening, these special rules should be removed. Administrative simplifications can be created, as discussed in the fourth section of this article, to aid the nonprofit with compliance.

8. Have a Simpler Sales Tax

Because they must be drafted to know what is not subject to the tax, sales tax exemptions for some manufacturing equipment or for food other than hot food to go are among the special rules that make a tax system more complex. A broader base eliminates the need for so many special rules. What's more, exempting all or nearly all business purchases eliminates the need for special rules — although it will require states to define clearly what is a business purchase versus a personal purchase, which can be an issue for self-employed taxpayers.

Exempting business purchases also eliminates the need to determine where a transaction should be taxed. For example, if a business purchases software with licenses to be used by employees in 20 states, the seller (and perhaps the buyer) needs to calculate the sales tax for each state. Similar issues exist for services provided from multiple states to multiple locations of the buyer. Removing business purchases from the sales tax base eliminates these difficult rules, special recordkeeping, and audits.

[29] Arkansas Department of Finance and Administration, "Candy, Soft Drinks, and Digital Products," undated.

[30] Nellen, "Pets Unite — 'No Taxation Without Representation,'" *State Tax Notes*, July 3, 2017, p. 93. This article provides several examples of sales tax exemption oddities that help illustrate the need to fix the base flaw, including the application of sales tax based on who the seller is.

Further, broadening the sales tax base to most personal consumption eliminates the need to define what food is and is not subject to sales tax, how any sales tax holiday works, and how special exemptions — such as for children's clothing and college textbooks — operate. Repealing these breaks also removes the need to verify entitlement to the exemption, which may require the buyer to timely and properly complete some forms.[31]

9. Improve Transparency and Accountability To Taxpayers

Removing most business purchases from the sales tax base eliminates pyramiding. Helping taxpayers understand this concept will assist them in appreciating why the current base flaw needs to be fixed and the benefits to the system of doing so. Similarly, explaining how the cost of exempting necessities and high-end consumption — such as entertainment and personal services — makes the tax system less progressive and provides tax breaks to people who do not need them can help taxpayers better understand the benefit of addressing this base flaw.

Moreover, one can increase understanding of the system by making it simpler without questionable policies such as sales tax holidays and exemptions for food other than food to go. Similarly, some states define tangible personal property to include software even if it is acquired without tangible media (meaning it is not actually tangible personal property). Connecticut's definition of tangible personal property includes digital goods and canned software electronically accessed or transferred — even though none of these items are tangible personal property.[32] Eliminating the sales tax base flaw eradicates the need for those contorted definitions and workarounds that attempt to expand the base less than transparently — such as by legally stating that an intangible (which has no mass) is tangible.

10. Be VAT Ready — Just in Case

A sales tax base without the flaws is more in line not only with how a consumption tax is supposed to work, but also with how a VAT works (assuming a VAT without base flaws). If we someday have the federal VAT that has been suggested for many years,[33] it is likely to look more like the flawless sales tax model than states' current sales tax bases. As the federal debt jumps higher to address the pandemic, a VAT suggestion is likely to return to future tax and budget reform discussions. A state with a base more in line with a VAT base will be less confusing to its taxpayers, and perhaps it will experience greater compliance and administrative simplicity.

11. Lower the Tax Rate

Finally, a promising benefit of fixing the sales tax base is a lower tax rate. A reduced rate makes base broadening more attractive despite the base expansion that households would experience. A rate reduction is undoubtedly challenging when, as noted, about 42 percent of today's sales tax collection stems from business purchases that should be removed to address the base flaw. Yet there is significant revenue in many of the personal consumption exemptions and items not currently in many states' bases. For example, the cost of Nevada's sales tax exemption for food for human consumption was $489 million for fiscal 2018.[34] Sales tax collections for that year were $1,189 million[35] — meaning that the food exemption was 41 percent of the sales tax base.

Elimination of this significant exemption should enable some degree of rate reduction. Of course, part of the revenue generated is needed to create more targeted relief measures for low-income households to alleviate the sales tax that will newly be imposed upon food and other necessities of life. The level of difficulty of obtaining a lowered tax rate will vary among states.

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[31] For example, to obtain the sales tax exemption for textbooks in New Jersey, the buyer must complete Form ST-16, listing each textbook and its price and certifying that the buyer is a student and the books are required for school purposes.

[32] Conn. Gen. Stat. section 12-407(a)(13).

[33] See, for example, Congressional Budget Office, "Options for Reducing the Deficit 2019 to 2028 — Impose a 5 Percent Value-Added Tax" (Dec. 13, 2018). *See also*, William G. Gale, "How a VAT Could Tax the Rich and Pay for Universal Basic Income," Brookings (Jan. 30, 2020).

[34] Nevada Department of Taxation, "2017-2018 Tax Expenditure Report," at 229.

[35] Nevada Fiscal Analysis Division, "Revenue Reference Manual" (Jan. 2019), at 5.

IV. How to Implement an Improved Base and Related Reforms

As noted, fixing the sales tax base flaw will be difficult but not impossible. The approach to achieving the benefits described earlier must include a thoughtful plan for how to help the public understand the rationale; how to transition taxpayers in to help the tax agency, consumers, and businesses that may become new sales tax collectors; and how to provide reliable estimates of the revenue changes. Further, the tremendous financial challenges the COVID-19 pandemic presents for consumers, businesses, states, and localities must also be factored into the planning to achieve a better sales tax system. Here are suggestions to eradicate the sales tax base flaw and improve the sales tax system.

A. Educate Taxpayers

States will need to find ways to increase understanding of the sales tax among taxpayers. Information provided should cover the nature of this consumption tax, its role in providing state and local revenues, what is taxed and what is exempt, the cost of exemptions and legal exceptions, the significant tax savings enjoyed by higher-income individuals who use sales tax breaks they do not need, and the adverse effects to the tax and budget systems of not improving the base. Information about changes in consumption patterns over the past few decades should also be provided.

B. Transition in the Changes Per a Specific Plan

Changes should not be made all at once. The base should be broadened over a period of years to allow taxpayers to adjust to the changes and for the state tax agency to adequately assist businesses now subject to sales tax collection and filing responsibilities. However, to aid both businesses and consumers, the plan to fix the base flaw should be enacted in a single bill, but with effective dates spanning a period of one to a few years.

The base broadening to more types of personal consumption can start with industries that already collect sales tax. For example, many hair salons sell tangible property, like shampoo, and already file sales tax reports. Adding hair styling services to the base would be relatively painless for the vendor and the tax agency — and arguably simpler because tax applies to the entire bill.

C. Consider Administrative Convenience

Removing business purchases from the tax base would involve both simple and more challenging changes. For example, items only purchased by businesses — such as factory equipment — would be easily removed. But removing business purchases of meals and entertainment would be more challenging. For example, how would a restaurant know if the customer is a business or an individual? In many cases, a business luncheon is paid for using an employee's personal credit card — followed by the employer reimbursing the payer. Also, the buyer is not identified in many meals paid with cash.

The time and costs of separating these sales between personal and business, or for a business to seek a sales tax refund from the revenue department, are likely not a good use of time.[36] And there is a personal element in these transactions even if paid by a business, in that everyone eats regardless of who is paying for it. Thus, it is likely best to include restaurant meals and prepared food purchased at a grocery store in the tax base for all consumers.

Entertainment is typically not in most states' sales tax bases, but adding it for consumers is necessary to address the base flaw. For administrative convenience and the personal element that exists with this type of purchase, including all entertainment in the base is appropriate and administratively convenient.

While there are many other types of common consumption for businesses and consumers, such as newspapers and software, the method of purchase with the buyer's name and location provided makes it simpler to tax the consumer but not the business buyer. Alternatively, vendors

[36] Allowing business buyers of meals and entertainment to file for a refund is a preferred approach over states requiring the vendor to determine if the buyer is a business or not — with potential liability for making the wrong determination. This approach is also used for a credit invoice VAT by over 120 countries. A business must prove to the government that it is indeed a business before it is entitled to any refund of VAT paid.

can be required to charge all customers — with the business buyers then allowed to request a refund from the tax agency per specified procedures, including claiming it on the sales tax forms filed by the business buyer.

D. Identify Necessities of Life and Effectively Target Relief

As noted, poorly designed financial relief efforts for purchasers of items that the state deems necessities of life result in significant revenue omitted from the sales tax. Much of this relief goes to those not in need because they tend to spend more on these items. Targeted relief measures must be identified to fix the base flaw by including more personal consumption in the sales tax base. The nature of this relief will vary by type of expenditure and the state's other taxes that might serve as vehicles for the relief such as a refundable income tax credit.

Some purchases might be easily structured to provide targeted relief. For example, utility charges can automatically exempt the standard fees for a specific size dwelling, such as a 1,200-square-foot home. Monthly charges above this amount would be subject to sales tax. Thus, individuals incurring costs below what it takes to heat or air condition and supply water to a 1,200-square-foot, or smaller, home would get sales tax relief, while those using utilities to service a larger home would pay sales tax on the utilities beyond the necessity-of-life amount. A residence of a specific size — perhaps 4,000 square feet and larger — could be treated as not warranting relief.

Alternatively, all utilities could be subject to tax — with a refundable income tax credit for low-income taxpayers. One downside to this approach, however, is that the relief would not be obtained until the income tax return is filed, even though it would offer greater assistance if provided with each monthly utility bill.

To modify the base by removing some or all necessities of life while adding previously excluded personal consumption such as entertainment and personal services, a state will need to have an informed discussion about what is a necessity of life. Consumer spending such as education and medical care can pose challenges because they can be expensive and include varying degrees of necessity. While education should be viewed as an investment rather than consumption, defining it will present obstacles. For example, high-end personal services, such as hiring a personal trainer, should be added to the tax base, but they could easily be renamed a fitness class if education is tax exempt. Thus, states will need to find workable and realistic definitions.

Again, the latter is difficult but not impossible. Education could mean programs of study that grant a degree. Federal tax law's definition of education — such as qualifying for the American opportunity and lifetime learning credits — already defines higher education. Use of existing definitions will also provide uniformity among states. Courses taken to maintain active business licenses should be exempt as business purchases.

Imposing sales tax on medical care will cause financial difficulty to many individuals. But what about elective procedures such as cosmetic surgery, which are more likely to be obtained by affluent residents? Some states have already dealt with similar issues when exempting prescription drugs from sales tax and deciding whether all, including Botox, should be exempt. States will need to evaluate the best approach while measuring the costs of broad exemptions that include high-cost elective procedures and medicines versus finding ways to easily tax the elective procedures.

As with education, looking to existing rules — such as whether a procedure is covered by health insurance — might help separate necessities from elective procedures. Revenue projections and a goal of lowering the tax rate along with base broadening should be considered in these decisions. For instance, lawmakers may decide that all procedures performed by licensed medical professionals should be exempt for simplification purposes, with other currently exempt or excluded consumption modified instead.

E. Don't Make the Flaw Worse

Though the temptation to expand the sales tax base for business purchases is great, particularly when states need revenue, they must resist — because doing so would only exacerbate the base flaw and make future reform more difficult. Imposing new tax obligations on the private sector is often favored because voters might think businesses do not pay enough taxes. Individuals, however, may not consider that the new tax likely will be passed onto them through increased prices, or that it will worsen a long-standing systemic flaw.

Similarly, adding new exemptions for items of personal consumption should be avoided. While reducing a tax base is uncommon when a state needs funds, California's fiscal 2021 budget included a one-year extension of the relatively new exemptions for baby diapers and menstrual hygiene products (A.B. 85), at a cost of $76 million.[37] Not only is this a significant cost for an item still under study per the implementing legislation (S.B. 92, enacted in 2019), but the longer a provision is in the law, the more people get accustomed to it and the harder it is to repeal it or to let it expire.

F. Assist New Sales Tax Collectors and Focus on Simplified Compliance Options

Some businesses would become sales tax collectors if the base were broadened to more personal consumption. Opponents of base broadening may raise this issue and the burden it places on a group that likely includes small businesses such as personal trainers. Yet many small businesses now sell tangible personal property and collect sales tax. However, there are costs involved with getting ready to collect the tax such as new software, training, and perhaps hiring someone to handle compliance. State tax agencies need to be ready to assist these businesses.

To alleviate this new burden, transitioning in the base broadening across industries can help. Also, some of these businesses — such as veterinary clinics and gardeners — are likely already collecting sales taxes on the tangible personal property they sell but not on the services. The base broadening will make sales tax apply to the entire purchase — with its application dependent only on whether the customer is a household or a business.

Base broadening will simplify compliance by removing the complexity of often hundreds of special, narrowly defined sales tax exemptions that states often have. For example, a landscaping business, veterinarian, pet food store, or grocery store won't have to identify which tangible property items are taxable versus exempt and ensure that any exempt services are truly for services. Rather, the entire charge to the household customer would include sales tax.

A further simplification would be to charge sales tax to all customers, with business customers obtaining the sales tax refund from the tax agency on their own — such as with a line on the sales tax forms used to report and remit what they collect. This would also put the verification of business status on the party with the relevant information: the buyer rather than the seller. Moreover, the approach avoids the challenges a vendor can face if required to determine if a self-employed person is making a personal or business purchase.

A further compliance simplification to consider is to allow small businesses below a specified level of gross receipts to file sales tax forms annually rather than monthly or quarterly. The taxes collected could be included with quarterly estimated income tax payments. The final reporting and reconciliation could be done on the income tax form with a special sales tax schedule. Improved use of technology must also be considered, including having the sales tax collected and remitted at the same time the vendor is paid.

Also, to make changes and new compliance burdens more palatable and assist businesses, an income tax credit could be considered to help cover a percentage of any start-up costs incurred to get ready to collect sales tax for the first time.

When base broadening results in once-exempt nonprofit sellers being required to collect tax on sales to consumers, simple approaches should be established where appropriate. For example, assume a nonprofit decides to generate funds by charging for car washes or by selling books. The entity should be able to obtain a one-time sales tax collection packet from the state revenue department's website. This packet would explain the collection procedures and tax rates and allow for a simple, online reporting form to transfer the sales tax from the entity to the agency via various

[37] The estimated tax expenditure for 2020-2021 for baby diapers is $52 million and $24 million for menstrual hygiene products. Tax Expenditure Report 2019-2020, *supra* note 24, at 9.

options — including digital ones. For nonprofits that regularly sell goods or services, the usual sales tax compliance rules should apply.

G. Run and Rerun Projections

In creating a plan to eliminate — or at least greatly reduce — the sales tax base flaw, lawmakers will need lots of information and projections. Beyond the tax expenditure reports that already measure the cost of exemptions, items legally excluded from the base yet representing personal consumption — such as personal services — need to be measured. Also, the amount of sales tax revenue currently derived from business purchases is needed in order to plan for how to gradually reduce that amount while broadening the base with exempt and excluded personal consumption purchases. Identifying true necessities of life and how to provide tax relief to low- and middle-income taxpayers will also require measures of the costs of that relief. Figures that predate changes stemming from the pandemic — which has altered spending patterns — will be needed, along with regular updating.

H. Consider New, Potentially Better Consumption Tax Approaches

This article has focused on improving the sales tax by removing long-standing and significant base flaws. But the resulting consumption tax is still in the form of a sales tax charged per purchase transaction. There are other approaches for consumption taxes. For example, a formula approach for taxing consumption could be used. In simple terms, consumers would calculate their annual consumption using a formula: Consumption = Income less Savings. True, there are complications, but not impossibilities.

There are advantages of the formula approach — including a broad base comprising only personal consumption (businesses would not pay this tax), an option to remove consumption desired to be exempt such as medical care, use of a progressive rate structure if desired, and an exemption for low-income taxpayers by having the tax only apply to those above a specified income level.[38] Given this article's bold and challenging base suggestions, it is also worth exploring other forms of consumption tax that can reach the same goals and perhaps even more to improve the state's tax system.

V. Moving Forward

These suggestions are major ones involving a significant revenue source for the states with sales taxes. The problems with the long-standing flawed base have been known for decades and are usually made worse by an annual stream of new exemptions for consumers and base broadening for businesses. Continually worsening the flaws is not a sustainable model for effective taxation. Different consumption patterns have eroded the sales tax base, and adding business purchases to that base increases the system's complexity because of definitional and sourcing issues.

The financial challenges posed by the COVID-19 pandemic already require difficult tax and budget decisions. Including a plan to finally eliminate sales tax base flaws should be part of the current decision-making and, at a minimum, should be considered by not making the flaws worse. ■

[38]For a description of a formula approach to sales tax, see Fred E. Foldvary, Colleen E. Haight, and Nellen, "An Analysis of a Consumption Tax for California," prepared for the California Senate Office of Research (2016). *Also see* Nellen, "More Than One Way to Tax Consumption," 21st Century Taxation blog (Feb. 11, 2017).