

California's Tax System

Sales and Use Tax Weakness & Possible Remedies: The Tax Base is Too Narrow

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Introduction

One of the weaknesses in California's sales tax is that the tax base is too narrow. A sales tax is a consumption tax, yet many types of consumption of individuals are exempted from the sales tax for a variety of reasons. For example, the California sales and use tax does not apply to the following consumer purchases: grocery store food, theater tickets, haircuts, storage fees, pet care, legal services, and software and music purchased and downloaded online.

Some of the exempted consumption today is a digital substitute for taxable tangible personal property. For example, if a consumer buys a CD at a music store, sales tax is owed. If the consumer instead downloads the same music from a computer, no sales tax is owed. Since the sales tax was enacted in the 1930's, consumption of intangibles (such as digital items) and services has increased while the consumption of tangible personal property has decreased. This leads to a shrinking tax base for the state. It also creates another form of a digital and class divide in that consumption of non-taxable services and intangibles is more significant for higher income consumers while consumption of taxable tangible personal property can be more significant for lower income consumers.

It is not the intent of this report to call for the taxation of all types of consumption as there may be policy reasons to make some items (such as basic medical care) tax exempt. Instead the purpose is to point out and explain tax base weaknesses with the sales and use tax, describe the advantages and disadvantages of broadening (updating) the tax base, and note ways this can be accomplished. For example, broadening the

sales tax base would not only make the system more equitable, it would also allow for California's high tax rate to be lowered (which would also make the tax more equitable). If desired, there is also revenue potential in this weakness. The revenue might serve to address state needs such as in the health care and education areas where often, solutions call for rate increases for taxes where rates are already quite high.

Data is provided to explain the tax base weakness. Information on a few other states is provided as well to provide some context in understanding ways that California's sales and use tax is out of sync with states that have made changes to modernize their sales and use tax. Recommendations for change are provided and a tax policy analysis is included to indicate how addressing the tax base weakness would help the sales tax to better meet the principles of good tax policy.

Weakness: The sales and use tax base is too narrow in that many consumption items are exempt.

Remedy: Broaden the base, lower the tax rate, and address issues of compliance and adverse impact to low-income individuals.

Brief History of the California Sales and Use Tax

California's sales tax was created in 1933 with the Retail Sales Act. The tax was to be imposed on retailers for the privilege of selling tangible personal property. In 1935, the use tax was enacted to complement the sales tax to ensure that in situations where a retailer was not

obligated to collect sales tax (such as because it was not located in California), the California consumer would be obligated to pay use tax at the same rate. While the sales tax is imposed upon the retailer (although they can add it to what the buyer pays), the use tax is legally imposed upon the purchaser.

In the 1940's, some cities began assessing a local sales tax. By 1954, about half of California cities imposed a sales tax which produced significant revenue for them. Each city administered its sales tax on its own. In response to complexity concerns raised by businesses, the legislature enacted the Bradley-Burns Uniform Local Sales Tax Act in 1955. The Act allowed counties and cities to impose a sales tax with a base similar to that of the state and administered at the state level.

The combined state and local sales tax rate in California is 7.25% (January 2003). Some areas also have district sales tax(es), with the result that the rate varies among counties from 7.25% to 8.75%. The 7.25% California sales tax rate is composed of the following elements:

Rate	Jurisdiction
5.00%	State (General Fund)
0.25%	State (Fiscal Recovery Fund)
0.50%	State (Local Revenue Fund)
0.50%	State (Local Public Safety Fund)
1.00%	Local (County/City) (City and county operations + County transportation funds)
7.25%	Total Statewide Base Sales/Use Tax

District taxes range from 0.125% to 0.50% per district. A county may have more than one district within it or it may have no districts. For example, the tax rate in Santa Clara County is 8.25%, comprised of the standard 7.25% and two district taxes of 0.50% each.

The Tax Base and Exemptions

Because the California sales and use tax rules specifically apply to tangible personal property, sales and purchases of services and intangibles are exempt from the tax. However, there are a few exceptions. If the service is embedded in the

goods or if an intangible (such as a film) can be viewed as tangible, it will likely be taxed. The California Revenue & Taxation Code has many rules that explain taxable tangible personal property. For example, where the consumer directly or indirectly provides materials to a business that fabricates an item from them, that labor is included in the sales price and taxable (R&T Section 6006). Similarly, a restaurant's prices may not be separated between services and food; instead, the entire restaurant bill is subject to sales tax.

In addition to items or services that are not subject to the sales and use tax because they are not tangible personal property, California law provides many exemptions where an item of tangible personal property is not subject to tax. The law may address a specific item, such as ice used to pack food for transportation (R&T Section 6359.7). Or, the exemption benefits a seller such as because they are a charitable organization (for example, R&T Section 6360 provides that a charitable organization selling certain prisoner of war bracelets is not subject to sales tax on the bracelets).

The Board of Equalization (BOE) administers the sales and use tax. It has categorized the reasons underlying exemptions and exclusions to the sales and use tax in its Publication 61, *Sales and Use Taxes: Exemptions and Exclusions* (<http://www.boe.ca.gov/pdf/pub61.pdf>). The categories used are:

1. Necessities of life (including food and certain medicines)
2. General public benefit (including certain sales to museums and certain charitable items, such as the bracelets mentioned earlier)
3. Industry benefit (including certain sales of transportation items for interstate use, custom computer programs, certain racehorse breeding stock, and certain periodicals)
4. Exclusions by definition (such as cash discounts, intangibles, admission charges, and lodging)
5. Other exclusions, exemptions and credits (such as occasional sales, sales for resale, and the first \$400 of tangible personal property purchased outside of

the U.S. and brought in by an individual within 30 days)

The categories and some examples from each are listed in the chart below. The chart also includes other BOE information on the revenue that is “lost” (as estimated by the BOE) due to the exclusion or exemption.

Exemption/Exclusion Examples	Estimated Annual Revenue Loss (in millions)*
Necessities of Life	
Food products**	\$4,990.1
Candy, snack foods, bottled water	\$318.8
Food sold in vending machines	\$13.9
Prescription medicines	\$1,829.5
Professional health services	Not measured
Gas, electricity, water, steam delivered through pipes to homes	\$2,344.4
Other	\$464.6
General Public Benefit	
Various	\$1.8
Most items in this category are not measured. They include certain alternative energy projects, items sold by charitable organizations and schools (such as school meals or items sold by the PTA).	Not measured
Industry Benefit	
Fuel sold to air common carriers	\$51.0
Rentals of linen supplies	\$46.2
Other	\$113.9
Most of the items in this category are not measured. They include certain fuel sold to air carriers, master records in the entertainment industry, and certain vehicles in the leasing industry.	Not measured

Other Industry or General Business Exemptions and Exclusions	
Certain farm equipment and machinery	\$86.0
Periodicals	\$24.9
Printed sales messages	\$43.0
Custom computer software	\$77.2
Worthless accounts	\$74.8
Other	\$35.5
Exclusions by definition	
Intangible personal property in form of technology transfers	\$75.3
Diesel and use fuel tax	\$40.0
Again, most of the items in this category are not measured. ⁱ	Not measured
Other Exemptions, Exclusions, and Credits	
All items in this category are not measured. They include interstate and foreign commerce, occasional sales, sales for resale and vehicles sold to a family member.	Not measured
Total of the <i>measured</i> revenue loss	\$10,630.9

* The revenue loss refers to revenue that is not realized by state and local governments due to an exemption or exclusion. Data is based on the latest available to the Board of Equalization as of June 2005 (the date of Publication 61).

** When the California sales tax was enacted in 1933, food was not exempt. The exemption for food was added in 1935.ⁱⁱ

Context: The *measured* revenue loss from exemptions and exclusions in the California sales and use tax law totals \$10.6 billion annually. If some of these exemptions and exclusions were to be removed, the tax rate could be lowered and relief for low-income taxpayers provided through other means, such as a refundable income tax credit. The specific changes in base and rate that could be made would be within the purview of the legislators and governor, as would the decision as to whether the changes would be made to not

only broaden the base and reduce the tax rate, but to also generate additional annual revenue. To give this revenue loss figure some context, consider the comparisons in the following chart.

Budget (1/07); available at http://www.lao.ca.gov/2007/budget_overview/07-08_budget_ov.htm.

Item	Amount	Revenue Loss as % of the Item	
		Tax rates used in Pub 61	75% of tax rates used in Pub 61 ^a
2005/6 CA state and local sales tax revenue ^b	\$32.2 billion	32.9%	24.7%
2005/6 CA corporate income tax revenue ^b	\$10.3 billion	102.9%	77.2%
2005/6 CA personal income tax revenue ^b	\$51.2 billion	20.7%	15.5%
Cost of providing health insurance to CA's uninsured ^c	\$842 million	1262.5%	946.9%
2005/6 General Fund spending on K-12 ^d	\$34.6 billion	30.6%	23%

^a Thus, if the rate used to measure the revenue loss in Pub 61 was 8%, then the rate used in this column would be 6% (75% of 8%).

^b Source: Legislative Analyst's Office, *California's Tax System: A Primer* (2007); available at http://www.lao.ca.gov/2007/tax_primer/tax_primer_040907.aspx.

^c Source: Kominski, et al, *Cost of Insuring California's Uninsured*, May 2005, published in UCLA Center for Health Policy Research; available at <http://www.healthpolicy.ucla.edu/pubs/publication.asp?pubID=141>.

^d Source: Legislative Analyst's Office, *2007-08: Overview of the Governor's*

Observations: Caution should be exercised in reviewing the revenue loss figures. They do not realistically represent revenue that could be raised if the exemption or exclusion were removed. For example, if the exemption for food were to be repealed, there would need to be some type of relief provided for low income households which would use some of the revenue generated from the base broadening. Also, a broadening of the base should be accompanied by a reduction in the tax rate to avoid an unneeded revenue windfall to the state and a significant tax increase to all taxpayers. In addition, application of the sales tax to currently untaxed items might lead to some drop in purchases or price reductions by sellers.

The revenue loss of many of the items in the list of exemptions and exclusions was not measured by the BOE. For example, most services were not measured. Many states, do tax personal services, such as haircuts and lawn care. Also, entertainment services, such as theater and movie tickets were not measured and several states today tax these items. Thus, if the list of exemptions and exclusions is used to identify revenue sources, it is important to consider the items not measured.

Also, in reviewing how the sales tax base could be broadened to include more types of personal consumption, it is important to note that several of the items listed by the BOE are ones that arguably should not be in the base, even a broadened one. For example:

- The Board's list of exemptions and exclusions includes cash discounts offered by the seller. Arguably, these are really not part of the sales price of an item. When a cash discount is given, the tax should be imposed on the discounted price since that is the true retail price.
- The list also includes items that are not sourced to California under California's destination approach. That is, if the item is sold to a person

residing outside of California, the California sales tax would not apply. Instead, the sales tax of the jurisdiction where the buyer resides (the destination) would apply.

- Another listed exemption is on the local and district sales tax imposed on an item. This is a decision to be made in designing the law – should the state tax be imposed on the tax inclusive or tax exclusive price of the item. To avoid imposing a tax on a tax, it is likely that most people would argue for not imposing the state sales tax on the retail price with the local sales tax included.
- There are often transactions where the cost of collecting the tax may outweigh the revenue collected. For example, assume a small non-profit school organization generates funds by selling t-shirts to students at the school. If it were required to collect sales tax and complete the forms, the compliance cost might outweigh the funds raised. If the non-profit is required to pay sales tax when it buys the t-shirts (rather than treating them as a non-taxable sale for resale), the lost tax revenue would only be on the mark-up, and likely, minimal. This is a policy decision for lawmakers: should certain organizations with a specified amount of minimal sales be allowed to sell tax exempt or should a simplified compliance method be created to aid them?

Changes in Consumption

In the 1930's when California's (and most other state's) sales taxes were created to be imposed on tangible personal property, that was the significant consumption item. Consumption of digital items did not exist and consumption of personal services was likely less than it is today. The closing of Tower Record stores in 2006 is a good example of changed consumption patterns as digitally downloaded music becomes the preferred way to purchase music.ⁱⁱⁱ The ability and convenience of downloading software programs via the Internet rather than purchasing

them on tangible media is also leading more of this consumption item to move from the taxable personal property category (off-the-shelf software on a CD) to a non-taxable category even though, like the music, the consumer ends up with the same result – the ability to listen to their favorite music or use software. In addition, changes in technology have created some new products and services that didn't even exist a decade ago, such as ring tones for mobile phones, or the ability to play a game with people who are not in the same room with you. The following data illustrate some of the changed and changing consumption patterns. Data on broadband deployment is also included since that type of powerful Internet access is needed to enable more types of consumption to occur digitally (such as software, music, games, and movies). Greater use of broadband will lead to a further decrease in taxable tangible personal property consumption and an increase in non-taxable consumption.

- Changes in consumption have led to a drop in sales that are subject to the California sales tax. The Center on Budget and Policy Priorities reports that from 1990 – 2003, the percentage of sales subject to sales tax in California dropped by 13.4 percentage points. The median decline in the U.S. was only 8 points.^{iv}
- The Legislative Analyst's Office (LAO) noted that in 1981, 48% of consumption represented items subject to the California sales tax, but that amount dropped to 38% by 2005.^v
- A 2002 legislative research study in Minnesota reported that in 1967, about 40% of personal consumption was of services and in 1999 that percentage had increased to 60%.^{vi} The Center on Budget and Policy Priorities reports that from 1970 to 2001, consumption of tangible personal property minus groceries dropped from 39% of household consumption to 33%. In addition, from 1970 to 2001, consumption of services increased from 31% of household consumption to 44%.^{vii}
- In the 1990's, spending in the U.S. on media and information services increased from \$365 to \$641 per person.^{viii}

- The growth in micropayment revenue from 2003 to 2009 is estimated to be 23%. Micropayments are defined as under \$5 per transaction. Researchers estimate that growth will take place not so much because the technology for handling small payments has advanced, but that the number of opportunities for low-cost online transactions, such as music or information, will grow.^{ix}
- Adoption of broadband in U.S. households increased 40% from March 2005 to March 2006 which was double the growth rate from the prior year.^x
- In March 2006, 21% of households with income below \$30,000 had broadband access while 68% of households with income over \$75,000 had such access.^{xi}
- A 2004 press release by Nielsen//NetRatings was entitled, “Affluent Americans Power Internet Growth.” The report noted that at the income level of \$150,000 or more, 69% of Internet users used broadband while 31% used narrowband. In contrast, in households with income under \$25,000, broadband use was 25% which narrowband use was 75%.^{xii}
- It has become more common to use certain software tools, such as those for tax preparation and bookkeeping, online rather than purchasing the software on a CD and loading it on a personal computer. This marketing technique tends to make the transaction more of a service rather than a distribution of goods.^{xiii}
- Jupiter Research reports that in 2006, downloads of digital music increased more than 30%. They estimate that spending on digital music in the U.S. will be \$2.5 billion by 2011. They also estimate that by 2011, 22% of music spending by U.S. consumers will be digital, and ring tones will represent 12% of such spending.^{xiv}
- In April 2007, Apple Computer’s sales of iPods reached 100 million (sales started in 2001). Apple also reported that its iTunes Store has sold downloads of over 2.5 billion songs, 50 million TV shows and 1.3 million movies.^{xv}
- In June 2007, Apple’s iTunes Store became the third largest music retailer in the U.S. with almost 10% of the market. The largest music retailer was WalMart (15.8%) followed by Best Buy (13.8%).^{xvi}
- There is increased use of computers to play video games, rather than using game consoles and purchasing games on tangible media. A 2004 report indicated that revenues from online games would triple by 2008 to \$1.1 billion. The study also expected revenues from multi-player online games to more than double from 2004 to 2008.^{xvii} The ability to play games online without purchasing a tangible product (other than the computer) has generated a market that consists of both digital items, as well as services – connecting people across the globe to play together (“massive multiplayer online role-playing game” or MMORPG) and creation of tournaments that people can pay a fee to enter and play. The fee structure and revenue models vary such that it may look like the purchase of a game, an entry fee, or a subscription fee.

Why Broaden the Tax Base

Reasons for broadening the sales and use tax base include the following.

1. The California sales tax rate is already high (roughly 8%, but varies from county to county). Broadening the base would enable the rate to be lowered.

California’s state rate of 6.25% is the 8th highest among state tax rates, as of January 1, 2007. The highest state rate is 7% and the lowest (not counting the few states that do not impose a sales tax) is 4%. Selected state sales tax rates:^{xviii}

Massachusetts	5.0%
Michigan	6.0%
Mississippi	7.0%
Nevada	6.5%
New Jersey	7.0%
New York	4.0%
Washington	6.25%

It is not uncommon to have proposals to increase the sales tax rate to raise revenue. Given the already high sales tax rate in California and the changes in consumption from taxable goods to non-taxable intangibles and services, a rate increase is not the ideal technique to generate more sales tax. (This is further explained in the tax policy analysis at the end of this report.)

2. Economically, there is no rationale for taxing some forms of personal consumption while exempting others. That is, there is no reason to tax laundry detergent, but not dry cleaning services. Similarly, there is no reason to tax a game in a box but not one played only on the Internet. The current exemption for intangible and services seems to be primarily based on history in that when the sales tax was created in 1933, tangible personal property was the key consumption area.
3. Some exemptions reach beyond the intent of the exemption. For example, the exemption for food includes milk and vegetables, but also a \$30 block of cheese purchased at a gourmet grocery store, candy, and bottled water. Assuming the food exemption is to benefit purchases that are necessities of life (as described by the BOE), it is too broad. Another option is to tax all food but then provide relief to low-income individuals through other means such as a refundable income tax credit. The exemption for utilities has the same flaw – it is not targeted to provide relief to individuals who most need it. Instead, everyone, regardless of income level does not have to pay sales tax on their utility bills.
4. As consumers have increased their consumption of services and intangibles (such as digital downloads) and decreased their consumption of tangible personal property (see data above), the sales tax base becomes outdated and generates less tax revenue.
5. As noted in the data presented earlier, some changes in consumption patterns are not consistent across income groups. For example, consumption of digital goods and services are more significant for higher

income individuals than for lower income individuals raising issues of fairness and equity with the current narrow tax base.

6. A broader base can make a tax more stable (less volatile). For example, in an economic downturn, people may purchase fewer tangible goods, such as cars and household appliances. However, consumption of food and some services may not drop as quickly enabling tax collections to not be as severely affected as could happen with a narrower tax base.
7. Other states tend to have a broader sales tax base than does California. A majority of states tax off-the-shelf software whether transferred on tangible media or electronically. These states include Arizona, Massachusetts (effective 4/1/06), Michigan, Minnesota, New York, North Carolina (effective 7/15/03), Ohio, Texas, Washington, and Wisconsin. In addition, other states tend to take more types of services relative to California.

Starting in 1990, the Federation of Tax Administrators (FTA) has studied the sales tax treatment of 160 services by the states, with periodic updates. Changes in some states expanded the FTA’s list of services tracked in the survey to 168 in 2004. Hawaii and New Mexico tax the greatest number of services. Of the 168 types of services studied, at 6/1/04, the FTA found the following:^{xix}

State	# of services taxed
California	23
Florida	62
Hawaii	160
Massachusetts	19
Minnesota	67
New Mexico	156
Nevada	15
New York	56
Texas	81

8. California cities tend to be fairly dependent on the sales and use tax. Today, one

technique for increasing local revenues is to bring large retailers into the city or a corporate sales office in order to generate sales tax. A broader base would likely lead cities to be more equitable in decisions regarding business growth by also making it desirable to have businesses that do not sell tangible personal property.

9. Exemptions and exclusions for any tax should be reviewed periodically to determine whether the original reason for their creation remains valid.
10. A broader tax base can improve the ability of a tax to meet the principles of simplicity, efficiency and fairness. Tax laws are complicated whenever something is exempt from the tax or subject to a special rule. Exceptions require special definitions which are not always easy to write or enforce. For example, several years ago, California started taxing snack food but then found it was very difficult to define a snack and the tax was later repealed. A tax base with few exceptions not only allows for a lower rate, it can also improve compliance and administration, and lead people to view the tax as more fair (because everyone is paying the tax or all consumption items are subject to the tax). Application of the sales tax to all non-real property consumption of individual consumers can also simplify the law by eliminating the need for defining exemptions. Relief for necessities of life can be provided through other means, such as a refundable income tax credit or a special medical deduction or credit for sales tax on health care (if that consumption item were included in the sales tax base).

Challenges

Change in general: While in theory, it may seem simple to broaden the sales tax base and lower the tax rate, in reality, such a change is complicated and politically challenging. First, any change is difficult in that people are very used to what they currently know. Consumers are likely to view any change as a tax increase (even if the rate is lowered) if something they did not pay tax on before, such as digital downloaded items, becomes taxable. Businesses will also face challenges of learning new rules to

determine what is taxable and what is not taxable. Also, some businesses that currently have no sales tax filing obligations will have increased compliance costs of filing returns. Of course, businesses that have been collecting sales tax and filing returns are unlikely to be sympathetic to such concerns.

Also, once an exemption exists, it is difficult to remove. As President Bush noted in 2007: “It’s much easier to get something in the code than get it out of the code.”^{xx} A comprehensive study of California taxes in 1964 also noted the challenge of removing exemptions, noting that what usually happens is the exemption grows once in the law.

“Once an exemption is adopted, efforts are made to enlarge its scope. Experience has produced the expression “exemptions beget exemptions.” When individuals and businesses can choose between items subject to tax and those not subject to tax, manipulations result which invite pressures from others for broadening of exemptions to eliminate unfair competition.”^{xxi}

Finally, there are likely some consumption items people will strongly object to paying tax on, particularly those in the “necessity of life” category such as food and health care. Yet, change is possible, and perhaps even required given economic and societal changes that have occurred since the 1930’s. Many states have broadened their sales tax base from what it was when first created decades ago and there are ways to transition in changes to alleviate concerns. In addition, emphasizing the benefits of a modernized sales tax system may encourage many taxpayers to embrace changes and progress.

Concerns about taxing services: Any talk about applying sales tax to services will lead many to raise the past instances in Florida and Massachusetts, and more recently – Michigan, as to why it cannot be done despite the reality that several states successfully tax many types of services. In 1987 and 1990, respectively, Florida and Massachusetts began to tax some services and soon thereafter, repealed that tax. Issues that arose are ones that can be addressed, as evident by the application of taxes on some services in other states today.^{xxii}

Effect on businesses: Businesses that become subject to sales tax collection under a broadened sales tax will need to start filing sales tax returns and implementing accounting systems to enable them to assess and collect the tax properly. The state can help by offering refundable tax credits and training.

Concerns are also likely to be raised that the burden of taxing services will fall more on small business than larger ones because larger businesses may start to hire more employees rather than pay sales tax on outside or contracted services. This is unlikely in all cases in that businesses often need certain services on a sporadic schedule or need an independent service provider (such as for accounting or legal services).

Another concern likely to be raised is that businesses will find it cheaper to contract for taxable services with providers located outside of California who are not required to collect the sales tax, thus leading to a drop in business for California service providers. However, California taxpayers would still be required to self-assess and pay use tax on such services. In addition, for many of the services, such as theater admission, haircuts, lawn care and veterinary services, taxpayers will not obtain the service from out of state to avoid the sales tax.

Effect on local governments: Broadening of the sales tax base accompanied by a rate reduction intended to achieve revenue neutrality, will result in winners and losers among local government. For example, some cities have a strategy of attracting retailers that generate sales tax for the city. A drop in the tax rate may lead to a greater decrease in tax collections from the retailers than will be made up by the taxes collected on items newly subject to the sales tax. This issue can be addressed by gradually expanding the tax base and lowering the rate rather than doing it all at once. Other transitional relief might include measuring city sales tax revenue for the three years preceding the change. If the tax change results in reduced collections of a certain percentage, the city would be compensated from a pool of funds gathered for this purpose. The percent of compensation would be phased out over a few years to give cities time to adjust to sales tax revenue changes.

Legal constraints: The California Constitution, Article XIII A, Section 3 provides: “any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed.” In addition, to increase revenue from a general tax, a local jurisdiction needs to obtain a majority vote of the group affected by the tax. Also, Article XIII A, Section 4 provides that cities, counties and special districts may only impose special taxes (except for taxes on real property) if there is a 2/3 majority vote of qualified electors in the jurisdiction.

Because the sales tax is both a state and local tax, to broaden the tax base (even perhaps with a rate decrease) a majority vote of the electorate would be needed along with a 2/3 vote of the legislature.

Implementation Recommendations

To be viable and effective, the California sales and use tax needs to be brought into the 21st century. One significant change is to address the changed consumption patterns from the 1930’s to today. Broadening the tax base would also enable the high tax rate to be reduced and would also provide opportunities for revenues to address state and local needs, if desired. No doubt, changing the base would be a major change.

Other states have acted: California would not be alone in broadening and modernizing its sales tax base. Several states already tax more consumption items than does California and several states are broadening their base to include digital items (particularly where they are substitutes for tangible items, such as music). For example, starting October 2006, New Jersey’s expanded its sales tax base to include more services and intangible/digital property. One new category of taxable items includes “digital property” defined as “electronically delivered music, ring tones, movies, books, audio and video works and similar products, where the customer is granted a right or license

to use, retain or make a copy of such item. Digital property does not include video programming services, including video on demand television services, and broadcasting services, including content to provide such services.” The base was also extended to prewritten software delivered electronically unless used directly and exclusively in the conduct of business.^{xxiii}

Ways to make base broadening workable: Listed below are some recommendations for implementing changes to the sales and use tax base.

1. Find ways to increase understanding of the sales and use tax among California taxpayers. Information provided should cover the nature of the tax (a consumption tax), its role in providing state and local revenues, what it applies to and what is exempt, the cost of exemptions and exclusions, and the adverse affects to the economy of not updating the base. In addition, information about changes in consumption patterns over the past few decades should be provided.
2. Be sure that base broadening is accompanied by a tax rate reduction.
3. Do not make all changes at once. The base should be broadened over a period of years to provide an opportunity for taxpayers to adjust to the changes and for the BOE to be able to provide the necessary assistance to businesses that become subject to sales tax collection and filing responsibilities.
4. Start with areas where consumers are already used to paying sales tax, such as on digital items that are the equivalent of the tangible item.
5. To broaden the coverage of services, start with ones that are primarily used by consumers rather than also businesses. This will lessen the pyramiding problem that already exists in the sales tax system. In addition, these types of services are ones that are unlikely to pose use tax collection problems because they are obtained from California-based providers. Examples of

personal services include pet grooming, shoe repair, car washes, hair styling, diaper service, health clubs, dry cleaning, parking, bowling alleys, admission charges to entertainment events, self storage fees, personal instruction, and veterinary services.

6. If consumption items added to the base are ones likely to impact low-income taxpayers, also enact a refundable income tax credit (or similar type relief) for such taxpayers (use targeted relief).
7. Implement simplified compliance techniques for small businesses of under a certain amount of gross receipts. For example, instead of quarterly filing, consider annual filing and provide paper and online recordkeeping tools to businesses. The use of technology should be included in the compliance and administration of the broadened sales tax to improve compliance and reduce vendor costs.^{xxiv}
8. Base expansion will cause more businesses to be subject to sales tax compliance. California should provide a refundable tax credit to alleviate start-up costs for these businesses and ideally, provide compensation for all businesses that collect sales tax.
9. Federal and state rulings should be reviewed for help in properly defining the expanded tax base. A 1987 Florida ruling provides insights on reducing the likelihood of legal challenges. Among other findings, the court noted that imposition of sales tax on legal services was permissible. Per the court, states have flexibility and discretion in selecting items to be taxed “provided that the classification is reasonable, nonarbitrary, and rests on some ground of difference having a fair and substantial relation to the object of the legislation.” (*In re Advisory Opinion to the Governor*, 509 So 2d 292, 303 (FL 1987))

Case law should also be reviewed to aid in drafting rules on nexus and determining the tax on services

performed and/or delivered to more than one state.

lessons can be learned from these states as well.

10. Learn from other states, such as Minnesota and New Jersey, on how to broaden the sales tax. In addition, most states tax off-the-shelf software regardless of the delivery mode and

11. Avoid creating or exacerbating other weaknesses in the tax system. For example, the revenues should not be earmarked for special purposes.^{xxv}

Tax Policy Analysis^{xxvi}

The following chart explains how a sales tax with a broadened base would satisfy the principles of good tax policy. The rating in the last column indicates whether base broadening would improve the current system.

Principle	Application and Analysis	Rating
Fairness		
<p>Equity and Fairness Similarly situated taxpayers should be taxed similarly.</p>	<p>Broadening the sales tax base will make the system fairer because all taxpayers would have their consumption subject to tax regardless of whether it is tangible personal property, intangible or services. Some of the currently untaxed consumables, such as digital items and personal services, are more significant consumption items to higher income individuals than for lower income individuals. Thus, broadening the base will lead to higher income individuals paying their “fair share.”</p> <p>“Experience demonstrates that generally broad-based taxes using lower rates tend to be more equitable than narrow-based taxes with higher rates. Exemptions reduce the base. Consequently, higher rates are required to produce a given amount of revenue.”^{xxvii}</p> <p>Any adverse effects base broadening (with a rate reduction) has on low-income individuals can be compensated through a refundable income tax or similar transfer.</p>	+
<p>Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.</p>	<p>Broadening the base should have no appreciable effect on transparency. Assuming the sales tax continues to be separately indicated on invoices, taxpayers will know it exists and its amount.</p>	No effect
Operability		
<p>Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.</p>	<p>Broadening the tax base should improve the ability of the sales tax to meet the principle of certainty. Exemptions require detailed definitions so it is clear what is taxable and what is not. However, the rules can become outdated with changes in transactions. When all items transferred to individual consumers are taxable, there is no uncertainty as to whether something should be taxed. Also, even if a few broad categories of items, such as perhaps basic medical care, remained exempt, there would be fewer rules and more certainty as to whether something was subject to sales tax.</p>	+

<p>Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.</p>	<p>The basic operation of the sales tax will not change with a broader base. The sales tax would continue to be imposed on the seller who can collect it from the buyer. When this process is followed, the buyer knows the total cost of the purchase before finalizing that purchase.</p>	<p>No effect</p>
<p>Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.</p>	<p>While a broadened sales tax base will lead to more businesses with sales tax compliance obligations, it should be possible for the BOE to implement techniques to keep compliance costs low for taxpayers. However, administrative costs for the BOE will increase with more taxpayers in the system although the additional costs should be minor relative to the amount of tax collected.</p>	<p>Not significant</p>
<p>Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</p>	<p>Broadening the base of a tax and removing exemptions and exceptions should make the law simpler because fewer definitions are needed. Compliance tools and techniques can be created by the BOE to keep compliance costs down for taxpayers, particularly small businesses.</p>	<p>+</p>
<p>Minimum Tax Gap A tax should be structured to minimize non-compliance.”</p>	<p>Base broadening will result in more businesses that have sales tax collection and return filing obligations. The addition of more taxpayers will likely lead to a greater amount of tax that is not collected. On the other hand, a lower rate tends to reduce non-compliance. In the early years of implementing base broadening, it is likely that some portion of the tax on the expended consumption items will not be collected due to confusion about the change, some taxpayers looking for loopholes and perhaps some tax protesters.</p>	<p>+ / -</p>
<p>Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.</p>	<p>A broadened sales tax base should not pose any problems for the government in determining its tax collection amount because it already has data on consumption by individuals. A broadened base can reduce volatility in the tax which will benefit governments.</p>	<p>+</p>
<p>Appropriate Purpose and Goals</p>		
<p>Neutrality The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p>Broadening the tax base to impose sales tax on digital or intangible items that are the equivalent of a taxable tangible item will better enable the sales tax to meet the neutrality principle. For example, today, a taxpayer may be inclined to obtain software or music or a movie online rather than on a CD in order to avoid paying sales tax on the transaction. Broadening the sales tax to include all or several types of services may lead businesses to hire employees to do work that otherwise would have been contracted out; such action will avoid sales tax on the transaction. Taxation of services might affect the decision of some businesses as to how they hire some workers (employees or contractors). This issue would be lessened though if businesses were exempt from paying sales tax which is necessary to avoid pyramiding where a tax is paid on a tax.</p>	<p>+ / -</p>
<p>Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.</p>	<p>The growth of the Internet and the many new possibilities for businesses to generate revenue did not lead to an increase in sales tax collections. This is because many types of new products and services possible with the Internet are not the types of consumption subject to the California sales tax. An expanded tax base that includes consumption in various forms (rather than only tangible personal property) would allow sales tax revenues to track better with economic growth.</p>	<p>+</p>

	<p>Application of the sales tax to more types of personal consumption along with a rate reduction could benefit industries that today seem to bear the full brunt of the sales tax if they sell tangible personal property. Spreading the sales tax out among more types of consumption should make the tax more efficient.</p>	
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Additional Reading

California Board of Equalization, Staff Legislative Bill Analysis, AB 9, 4/18/05; available at <http://www.boe.ca.gov/legdiv/sutleg/pdf/ab0009-1ss.pdf>.

California Commission on Tax Policy in the New Economy, Final Report (Dec. 2003); recommendations for broadening the sales tax base (pp12 – 21) and background on the sales and use tax (pp 115 – 119 and 132 – 136).^{xxviii}

California Legislative Analyst’s Office (LAO), *California’s Tax System: A Primer* (April 2007); available at <http://www.lao.ca.gov/laoapp/PubDetails.aspx?id=1649>.

Mazerov, Michael, “Expanding Sales Taxation of Services: Options and Issues,” *State Tax Notes*, 7/21/03. Also available at <http://www.cbpp.org/3-24-03sfp.htm>.

Oklahoma League of Economists, *Sales Tax on Services* (Spring 2000); available at <http://www.busn.ucok.edu/ole/Spring%202000/Taxes%20on%20Services.htm>.

More Information on California Tax System Weaknesses and Possible Solutions

http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm

This site has reports, short articles, links and the *21st Century Taxation Blog*. Please take a look.

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- i Services are in the category of exclusions by definition (since services are not tangible personal property). In its 4/22/05 analysis of AB 9 (2005-2006), the Assembly Revenue & Taxation Committee noted that for fiscal year 2005-06, “sales tax on legal services alone would generate approximately \$2.1 billion in total sales tax revenue.” Available by search at <http://www.leginfo.ca.gov/bilinfo.html>. The BOE analysis of this bill included an estimate that taxing the 11 specified services would generate \$4.693 million in revenue. It did not specify how much of this revenue would be generated by businesses (which reflects pyramiding – a problem area). BOE, Staff Legislative Bill Analysis, AB 9, 4/18/05; available at <http://www.boe.ca.gov/legdiv/sutleg/pdf/ab0009-1ss.pdf>.
 - ii Assembly Interim Committee on Revenue and Taxation, *The Sales Tax – A Major Tax Study*, Part 4, written by Dr. Harold M. Somers, December 1964, published in *Journal of the Assembly*, 1964 Session, Vol. 1, p. 13 (hereinafter *1964 Report*).
 - iii The closing of record stores is likely not due only to sales of digital music, but also to overall drop in music sales, music piracy, and increased competition from low-cost stores, such as WalMart. Ethan Smith, “Sales of Music, Long in Decline, Plunge Sharply,” *Wall Street Journal*, 3/21/07, p. 1; available at <http://online.wsj.com/article/SB117444575607043728.html>.
 - iv CBPP, report on California; available at <http://www.cbpp.org/states/5-17-05sfp-fact-ca.pdf>.
 - v Analysis of AB 9 (2005-2006), the Assembly Revenue & Taxation Committee (4/22/05); available by search at <http://www.leginfo.ca.gov/bilinfo.html>.
 - vi Minnesota House of Representative, *The Minnesota Sales Tax Base* (Nov. 2002); available at <http://www.house.leg.state.mn.us/hrd/issinfo/ssmstb.htm>.
 - vii Mazerov, “Expanding Sales Taxation of Services: Options and Issues,” *State Tax Notes*, 7/21/03; also available at <http://www.cbpp.org/3-24-03sfp.htm>.
 - viii Horrigan, Pew Internet and American Life Project, *Consumption of Information Goods and Services in the United States*, (Nov. 2004), page 1; available at http://www.pewinternet.org/pdfs/PIP_Info_Consumption.pdf.
 - ix As reported by Emarketer, 8/4/04 at <http://www.emarketer.com/Article.aspx?1002971>.

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- ^x Horrigan, Pew Internet and American Life Project, *Home Broadband Adoption 2006*, (May 2006), page 1; available at http://www.pewinternet.org/pdfs/PIP_Broadband_trends2006.pdf.
- ^{xi} Horrigan, Pew Internet and American Life Project, *Home Broadband Adoption 2006*, (May 2006), page 3; available at http://www.pewinternet.org/pdfs/PIP_Broadband_trends2006.pdf.
- ^{xii} Nielsen//NetRatings, “Affluent Americans Power Internet Growth,” 4/19/04; available at http://www.nielsen-netratings.com/pr/pr_040419.pdf.
- ^{xiii} For example, in 2007, Intuit announced a 400% increase since 2004 in the number of customers using QuickBooks®: Online Edition; press release of 5/29/07; available at http://web.intuit.com/about_intuit/press_releases/2007/05-29.html.
- ^{xiv} David Card, Jupiter Research US Digital Music Forecast, 1/8/07; available at <http://weblogs.jupiterresearch.com/analysts/card/archives/2007/01/jupiterresearch.html>.
- ^{xv} Apple, “100 million iPods sold,” 4/9/07; available at <http://www.apple.com/pr/library/2007/04/09ipod.html>.
- ^{xvi} Reuters, “Apple now third largest music retailer: survey,” 6/22/07; available at <http://www.reuters.com/article/companyNewsAndPR/idUSWEN893120070622>.
- ^{xvii} CNET, “Study: On-line game revenue to skyrocket,” 7/12/04, based on a report from the Yankee Group; available at http://news.com.com/Study+Online-game+revenue+to+skyrocket/2100-1043_3-5266062.html.
- ^{xviii} Information is from the Federation of Tax Administrators at http://www.taxadmin.org/fta/rate/sale_vdr.html.
- ^{xix} FTA data available at <http://www.taxadmin.org/fta/pub/services/services.html>.
- ^{xx} White House news release, 8/9/07; <http://www.whitehouse.gov/news/releases/2007/08/20070809-1.html>.
- ^{xxi} *1964 Report, supra*, p. 13.
- ^{xxii} For an overview of Florida’s prior tax on services and the issues that led to its demise, see Hellerstein, “Florida’s Sales Tax on Services,” *National Tax Journal*, Vo. 41, No. 1, March, 1988, pp. 1 – 18.
- ^{xxiii} See <http://www.state.nj.us/treasury/taxation/salestaxbase.htm>. Due to revenue needs, New Jersey also raised the sales tax rate from 6% to 7%. Such a change is contrary to broadening the base which should call for a rate decrease.
- ^{xxiv} For example, the BOE could give online vendors the option of including a payment link on their website that would enable the credit card of California buyers to be charged by the seller for the cost of the item and by the BOE for the associated sales tax. This would eliminate the vendor’s compliance obligations and reduce costs for vendors because they would not bear the costs incurred through additional credit card fees for the assessed sales tax. Such a system might only be appropriate for small online vendors.
- ^{xxv} For example, AB 9 (2005-2006) proposed to broaden the sales tax to include “specialized services” that included marina services, custom computer software, charter of a plane or limousine, accounting and bookkeeping services, legal services, security and detective services, and various consulting services. Challenges with this bill included that it primarily covered services used by businesses as well as individuals so it expanded the pyramiding problem. In addition, revenues were earmarked for a specific purpose exacerbating another weakness in California’s tax and budget system.
- ^{xxvi} This analysis uses a document prepared by the American Institute of Certified Public Accountants (AICPA) Tax Division and altered to the above format by Joint Venture: Silicon Valley Network. The AICPA document, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001) is available at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>. The Joint Venture workbook is available at <http://www.jointventure.org/PDF/taxworkbook.pdf>. The principles laid out in these documents are frequently used tax policy analyses ones. For more information see Nellen, *Policy Approach to Analyzing Tax Systems*; available at http://www.cob.sjsu.edu/facstaff/nellen_a/Policy%20Approach%20to%20Analyzing%20Tax%20Systems.pdf. Note: The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.
- ^{xxvii} *1964 Report, supra*, p. 13.
- ^{xxviii} Note: Author of this report (Annette Nellen) was the lead author of the Commission’s report at pages 115 – 119 and 132 – 136.