Sales Taxation of Business Purchases: A Tax Policy Distortion

by Alan D. Viard

The retail sales tax is a prominent feature of the state and local tax landscape. Forty-five states and the District of Columbia have broad sales taxes, with only Alaska, Delaware, Montana, New Hampshire, and Oregon lacking such a tax. According to Census Bureau data for fiscal 2007, general sales taxes account for 32 percent of state tax revenue and 12 percent of local tax revenue.¹

One might think that the prevalence of the sales tax would be good news for citizens and economists who support efficient taxation. The retail sales tax is commonly viewed as a proportional consumption tax, a description that also appears in public finance textbooks.² Economic analysis generally supports the efficiency of consumption taxation, which avoids the penalty on saving and investment imposed by income taxes.³ Of course, a proportional consumption tax imposes burdens on households of limited economic means, suggesting a need for measures to address distributional concerns. But such a tax raises relatively few efficiency problems.

Unfortunately, as most tax practitioners are aware, actual state and local sales taxes diverge dramatically from the popular and textbook vision of the tax. One major flaw is the exclusion of a wide range of consumer services from taxation, which renders the consumer tax base much narrower than the textbook description suggests. The other crucial flaw, which is the focus of this article, is the imposition of tax on a wide range of business purchases; taxes on those purchases account for roughly 40 percent of nationwide sales tax revenue. The taxation of business purchases impedes economic efficiency and hides the true tax burden from the public.

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Reform can be pursued within the sales tax context through the adoption of broader exemptions for business purchases and more expansive interpretation of existing exemptions. Alternatively, the problem could be addressed more comprehensively by replacing state and local sales taxes with value added taxes, an option previously discussed by Richard Bird. The VAT option would, however, present significant challenges, particularly regarding the treatment of interstate and international sales.

Extensive Taxation of Business Purchases

The divergence of actual sales taxes from the consumption tax ideal is not an oversight. Instead, the divergence is built into the foundations of sales tax legislation. Rather than defining taxable sales as sales to consumers, the typical sales tax statute begins with a definition that encompasses sales of tangible personal property in general and then provides a limited set of exclusions that shelter only some business purchases from taxation. The leading

casebook on state and local taxation, authored by Walter Hellerstein, Kirk Stark, John Swain, and Joan Youngman, describes the situation:

Despite the theoretical premise that the sales tax is a single-stage levy on consumer expenditures . . . it is important to recognize from the outset that the sales tax in practice falls far short of that goal . . . the retail sales tax often treats a business purchaser as the ultimate consumer of property or services it purchases, even though the price of that property or those services will be reflected in property or services that are subsequently sold and taxed.4

Hellerstein et al. provide a survey of leading state cases interpreting exemptions for business purchases.5 Their survey notes the following limitations of the exemptions:

- Some states deny the resale exemption for firms’ purchases of items subsequently conveyed to customers when customers pay no separately stated charge for the items. In some states, therefore, a restaurant may be taxed on its purchases of napkins, utensils, and cartons that it provides to consumers with their meals; a travel agency may be taxed on its purchases of travel brochures that it distributes to its customers, a baseball team may be taxed on its purchase of bats and jackets that it distributes to fans; and a hotel may be taxed on its purchases of beverages that it provides to guests on a “complimentary” basis.

- Some states disallow the resale exemption if the resale occurs in another state.6 Although this practice is (in my view) a glaring violation of interstate trade neutrality, state courts have ruled that this practice does not violate the dormant commerce clause of the U.S. Constitution and the U.S. Supreme Court has declined to review their decisions.

- In many states, materials purchased by manufacturers are taxable if they are “consumed” in the manufacturing process rather than becoming an ingredient or component of an article that is resold. An iron and steel producer may therefore be taxed on its purchases of coke that is consumed to produce heat to fire the furnaces, but not its purchases of coke that is infused into the iron.7

- Because equipment exemptions are often limited to equipment “directly used” in “manufacturing,” they are unavailable in some states for the purchase of equipment used to transport manufactured goods, newspapers and printers’ purchases of printing and photofinishing equipment, purchases of incubators to hatch eggs, or manufacturers’ purchases of climate control equipment.8

Hellerstein et al. report that other state courts have upheld exemptions for business purchases in some of the situations listed above, reflecting differences in state statutes or in judicial interpretation of ambiguous statutory terms. As they observe, the reason that courts have found it difficult to sensibly answer the question of which business purchases should be taxed is because the question should not be asked in the first place.9

A recent Tax Foundation report, drawing on CCH data, documents the state-by-state variation in taxation of business purchases in 2009. Of the 20 types of business purchases examined, Hawaii taxed 18; South Dakota 17; New Mexico 16; and the District of Columbia 15; while Virginia taxed only 5 and Kentucky, Maryland, Missouri, Rhode Island, South Carolina, and Vermont each taxed only 6.10 It’s unclear why some states tax business services to

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5Id., at pp. 646-678.


8Wisconsin Department of Revenue v. Milwaukee Brewers Baseball Club, 331 N.W.2d 383 (Wis. 1983); Minnesota Twins Partnership v. Commissioner of Revenue, 587 N.W.2d 287 (Minn. 1998).


11Granite City Steel Co. v. Department of Revenue, 198 N.E.2d 507 (Ill. 1964); see also, Kaiser Steel Corp. v. State Board of Equalization, 593 P.2d 864 (Calif. 1979) (steel producer taxed on its purchases of materials that became part of slag byproduct that it sold at minimal price to have removed from its premises).

12West Lake Quarry & Material Co. v. Schaffner, 451 S.W.2d 140 (Mo. 1970).

13Western Paper Co. v. Qualls, 615 S.W.2d 369 (Ark. 1981); Colorcraft Corp. v. Department of Revenue, 493 N.E.2d 1066 (Ill. 1986).

14Peterson Produce Co. v. Cheney, 374 S.W.2d 809 (Ark. 1964).


16Hellerstein et al., supra note 4, at p. 612.

a greater extent than do other states. Analyzing the above numbers, I found essentially no correlation between the number of types of business purchases taxed by a state and the state’s statutory sales tax rate, per capita income, or vote in the 2008 presidential election. I did find, however, that business purchases were taxed to a somewhat greater extent in the western states, confirming an observation previously made by John Mikesell. In particular, the 21 western sales tax jurisdictions taxed an average of 10.6 types of business purchases, while the 25 eastern sales tax jurisdictions taxed an average of 8.6 types, a statistically significant difference. Moreover, three of the four jurisdictions that taxed the most types of business purchases were western while six of the seven jurisdictions that taxed the fewest types were eastern.18

Several studies have estimated the volume of sales taxes imposed on business purchases. An early study by Raymond Ring Jr. estimated that purchases by resident consumers accounted for only 59 percent of nationwide sales tax payments in 1979, with most of the remaining 41 percent falling on business purchases (some taxes were levied on purchases by tourists, nonprofit organizations, and governmental units).19 In a later study looking at 1989 data, Ring again found that only 59 percent of the tax was imposed on purchases by resident consumers.20 A study undertaken for the Council On State Taxation estimated that $100 billion of sales taxes, equal to 43 percent of total sales tax revenue and three times larger than state corporate income taxes, were collected on business purchases in fiscal 2003.21 A recent study estimates that $127 billion of sales taxes were collected on business purchases in fiscal 2009.22

Sales taxation of business purchases is a hidden tax that disguises the true cost of government. Aside from that political flaw, however, the tax also has adverse economic consequences.

**Economic Consequences**

A wide range of authors have discussed the economic distortions arising from taxation of business purchases.23 The following sources of inefficiency have been noted:

- The tax on inputs pyramids into the price of the final goods in an uneven manner, causing effective tax rates to vary across goods subject to the same statutory tax rate, which can distort consumers’ choices between different goods.

Evidence from statistical studies and simulations of economic models suggests that the taxation of business purchases significantly impedes economic efficiency. In particular, the evidence suggests 21,22,23,24

18[See John L. Mikesell, “Sales Tax Incentives for Economic Development: Why Shouldn’t Production Exemptions be General?” National Tax Journal, 54(3), Sept. 2001, pp. 557-567, at p. 563. My computations are available on request; western states are those in the Mountain, Pacific, West North Central, and West South Central regions defined by the Census Bureau.]


that such taxation is more likely to reinforce other economic distortions than to offset them.

An empirical study by Timothy Bartik found that sales taxes on equipment had a negative, and statistically significant, effect on small-business start-ups, even as some other tax variables had statistically insignificant effects. A 2005 study by Benjamin Russo reported simulations of an economic growth model in which he found that removing the tax on business purchases, while increasing the tax rate to maintain revenue neutrality, would increase real output by 0.5 percent in the long run. To be sure, much of the long-run gain would be because of increased capital accumulation financed by a short-run reduction in consumption. Even so, the reform would yield a net gain in economic well being equal to 0.05 percent of consumption. Russo found that sales taxation of business capital reinforces the inefficient reduction in business capital use caused by the presence of monopoly power in the market to produce capital goods.

In a 1992 paper, U.S. Treasury Department economists David Joulfaian and James Mackie considered how sales taxes affect firms' choices between different kinds of capital. Sales tax is generally imposed on business equipment, but not business structures, although structures bear some burden because of sales tax imposed on building components. Joulfaian and Mackie estimated 1987 average sales tax rates of 4.2 percent for equipment and 1.6 percent for structures. Interestingly, they found that the sales tax reduced distortions in the choice among different types of capital before the Tax Reform Act of 1986 because the sales tax's bias in favor of structures helped offset the federal income tax system's bias in favor of equipment. (Of course, that does not necessarily mean that the sales tax on business purchases advanced overall efficiency, given its other distortions.) After the Tax Reform Act of 1986, however, when the federal tax system was more neutral, the sales tax's bias in favor of equipment increased distortions in firms' choices between different capital assets.

Similarly, the net effect on the efficiency of consumers' choices appears to be negative. In principle, if business inputs used to produce consumer services were taxed more heavily than business inputs used to produce consumer goods, the taxation of business inputs could help offset the distortion resulting from states' exemption of consumer services from sales tax. As Mikesell notes, however, the states with broader taxation of business purchases also tend to have broader taxation of consumer services, suggesting little scope for such an effect.

Unsurprisingly, many observers have described sales taxation of business purchases in harsh terms. In 2002 Charles E. McLure Jr. identified the taxation of business purchases as one of many "nutty" features of state and local tax systems. Hellerstein et al. list the taxation of business purchases as a "structural flaw" of state sales taxes. State Tax Notes contributing editor David Brunori noted the "near unanimity among public finance scholars" against the practice and nominated it as one contender for the most egregious flaw of state tax systems.

Exempting all business purchases from tax would reduce sales tax revenue by about 40 percent. One way to offset the revenue loss would be to raise the statutory tax rate. If that were the only option, reform would still be worthwhile. A sales tax on consumer purchases with a 10 percent statutory rate would be more efficient, and therefore less burdensome, than a tax with a 6 percent statutory rate that featured a 10 percent effective rate because of the taxation of business purchases. (As noted above, Russo's simulations confirm that result.) The higher statutory rate would actually have the salutary effect of making the true size of the tax burden more transparent.

A common fallacy holds that low statutory tax rates are inherently good. In reality, however, economic distortions and tax burdens depend on effective, not statutory, tax rates. The statutory tax rate is a number that has no intrinsic significance apart from its role as one determinant of effective tax rates. Proposals to create a more neutral and efficient tax system should be supported, whether they result in higher or lower statutory tax rates. For example, as I have observed elsewhere, the proper goal of revenue-neutral corporate tax reform is to level the playing field across different types of capital; that leveling is desirable whether it involves base broadening that permits a reduction in the

28Mikesell, supra note 18, at p. 565 n.3.
30Hellerstein et al., supra note 4, at pp. 611-612.
statutory tax rate or base narrowing that requires an increase in the statutory tax rate.32

An increase in the statutory tax rate would not, however, be the best way to offset the revenue loss from exempting business purchases. It would be far better to obtain revenue by extending the tax to consumer services, which most states largely exempt. As various authors have noted, the exemption of consumer services is the other major structural flaw of state sales taxes.33 In his simulations, Russo found that the combination of fully exempting business purchases and fully taxing consumer services would yield a net revenue gain that could be used to lower the statutory tax rate. He also found that the gain in economic well being from that policy was four times greater than the gain from a policy that offset the revenue loss by increasing the statutory tax rate.34

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More broadly, bringing consumer services into the tax base and removing business purchases from the tax base are complementary strategies. So long as sales of consumer services are exempt, it is difficult to formulate and implement the proper tax treatment of business purchases. Exempting business purchases that are inputs into the production of exempt consumer services would reinforce the distortion of consumer choices from the exemption of consumer services and would likely be seen as abusive. But continuing to tax those business purchases would be a highly flawed substitute for direct taxation of consumer services, because it would preserve several of the current distortions. Also, distinguishing purchases that are inputs into the production of exempt services from those that are inputs into the production of taxed goods would be administratively difficult. If both consumer goods and consumer services are taxed, then inputs into both types of production can be exempted.

The complete exemption of business purchases could increase enforcement challenges arising from buyers’ false claims that their purchases are for business use. As discussed by George Zodrow, one way to combat fraud would be to borrow a feature of the VAT. It would be possible to impose sales tax on all purchases of products that are readily susceptible to consumer use while allowing business purchasers of those products to claim credit for the tax on separate tax returns. Although that approach would raise some complications, it would permit greater scrutiny of the claimed business use.35

Prospects for Reform

Given policymakers’ attitudes, reform may not be easy. Mikesell describes the fundamental reasons why state legislatures do not exempt all business purchases from sales tax even as they eagerly adopt other, less well-designed, measures to promote economic activity. He concludes that legislators prefer hidden taxes on business purchases to visible rate increases, prefer to tax “business” rather than individuals, prefer to impose taxes that they think will fall on nonresidents, and do not understand the logical case against the taxation of business purchases.36

Those attitudes have even led a few states to adopt turnover, or gross receipts, taxes that apply to the full value of the product at each stage of production. Bird, in words that would be echoed by public finance economists everywhere, comments that a “turnover tax is by far the most distorting form of sales tax economically.”37 Unfortunately, the historical movement away from those taxes is being reversed, at least to a limited extent. In the last several years, Ohio has adopted a gross receipts tax and Kentucky and Texas have adopted corporate tax changes that give firms the option of being taxed on their gross receipts.38

Within the sales tax context, the exemption of business purchases is often viewed as a form of preferential treatment, even though business purchases are already taxed because they contribute to the cost of the final product. Mikesell reports that some states classify sales tax exemptions for business purchases as tax expenditures.39 Similarly, some state courts adopt a policy of narrowly construing tax exemptions for business purchases.40 Those

33Hellerstein et al., supra note 4, at p. 606; McLure, supra note 29, p. 845.
34Russo, supra note 26, at pp. 451-452.
35Zodrow, supra note 23, at pp. 436-437.
36Mikesell, supra note 18, at pp. 565-566.
37Bird, supra note 23, at p. 811.
39Mikesell, supra note 18, p. 566.
40Minnesota Twins, 587 N.W.2d, supra note 8, at 289 (stating that burden of proving exemption lies with taxpayer); Western Paper, 615 S.W.2d, supra note 13, at 370 (saying that exemption is strictly construed and that to doubt is to deny exemption); Blackmon, 205 S.E.2d, supra note 15, 205 S.E.2d at 499 (saying that all doubt in interpreting exemption is resolved in favor of taxing authority).
practices reflect the attitude that the exemptions constitute preferential treatment.

Despite that bleak environment, incremental reforms can be pursued. Legislatures can clarify that the resale exemption applies to out-of-state sales and to the conveyance of items to customers without a separately stated charge and that materials consumed in the manufacturing process are exempt. Courts can give exemptions a broad or fair, rather than a narrow, construction.

Interestingly, other kinds of taxes appear not to be affected by the misconception that exemption of business inputs is an unjustified preference. In the income tax context, for example, business expenditures are routinely deducted, either immediately or through depreciation, while personal expenditures are generally not deducted. Similarly, VATs routinely allow firms to claim a deduction (under the subtraction method) or a tax credit (under the credit invoice method) for their purchases. One broad solution to the problem would therefore be to exempt from sales tax any purchase that gives rise to a business deduction for income tax purposes. A bolder option, which Bird discussed several years ago, would be for states to replace their retail sales taxes with VATs.

The choice between a VAT and a retail sales tax is often understood as a trade-off between administration and compliance. The VAT has the drawback of requiring tax filing and payments by a larger number of firms, while the retail sales tax has the drawback of being more difficult to enforce. At low tax rates, compliance is less important and the retail sales tax is thought to have an advantage; at high tax rates, compliance is more important and the VAT is thought to be superior.41

As Bird observes, a more powerful argument for the VAT is that it offers an opportunity to end the taxation of business purchases. Moreover, the VAT diminishes the associated enforcement challenges because sellers are not responsible for determining whether purchasers are businesses; instead, purchasers must claim offsetting deductions or credits on returns that also report their own business receipts.42 The VAT also addresses the sales tax’s failure to tax consumer services. The broad exemption of services, which is ubiquitous in the sales tax context, is generally absent in the VAT context (although some services, such as financial services, are difficult to tax under either system).43

Although switching to a VAT would increase the number of firms in the tax system, it is unclear that this is a major problem. As Bird notes, a large number of firms make some retail sales, even if those sales are not their primary business.44 Other firms that make no sales to consumers are subject to sales tax today, precisely because current law taxes many business purchases. States could also reap some offsetting administrative savings if they used the VAT to replace, not only their sales taxes, but part of their income taxes. Even if progressivity concerns may militate against a complete replacement, the VAT could be used to replace income taxes on lower- and middle-income taxpayers.45

One argument against a VAT is that it is an invisible tax that hides the true cost of government and can therefore function as a money machine. If the VAT was listed on customer receipts, however, it would actually be more visible than current state and local sales taxes, because the VAT liability shown on the receipt would be the full tax liability. In contrast, the state and local sales tax shown on receipts today reflects only the sales tax burden imposed at the retail stage and omits the 40 percent of the tax imposed at intermediate stages of production. Tax Notes contributing editor Martin A. Sullivan, reviewing the experience in Canada where the VAT is listed on receipts, found that it has not fueled the overall growth of government.46 Bird, Jack Mintz, and Thomas Wilson have reached a similar conclusion about the Canadian experience.47

Despite its appeal, a well-functioning state VAT might be difficult to impose in the absence of a federal VAT. A crucial difficulty is how to tax interstate and international transactions. Bird discusses some of the possibilities and challenges of implementing a destination-based VAT at the state level.48 The existing state VATs, or facsimiles thereof, in Michigan and New Hampshire rely on the much less satisfactory approach of apportioning the tax base across states in a manner similar to the apportionment of state corporate income taxes; the California tax reform commission’s September 2009

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41For a discussion, see Zodrow, supra note 23.
42Bird, supra note 23, at pp. 816-817.
43Id., at pp. 817-818.
44Id., at p. 820.
45At the federal level, Michael J. Graetz suggests the use of a VAT to replace the income taxes paid by low-income and middle-income households, 100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States (New Haven: Yale University Press, 2008).
The proposal also featured apportionment. Unfortunately, that approach would transform the levy into a variable rate tax on the apportionment factors and also make the tax far less transparent to consumers.

The feasibility of a state-level VAT in the absence of a federal VAT was recently discussed at a session of the American Bar Association Section of Taxation meeting. Some observers questioned the feasibility of such an arrangement, although Prof. Linneu Mello noted that Brazil has a subnational VAT without a corresponding national tax. State VATs will obviously be more feasible if and when some type of VAT is adopted at the federal level.

**Conclusion**

Despite their image as consumption taxes, state and local retail sales taxes are actually imposed on a large volume of business purchases, resulting in significant economic inefficiency. Whether reform is pursued within the sales tax context or outside it, a reduction in the taxation of business purchases should be a high priority in efforts to improve state and local tax systems.

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