Prepared for Indiana Tax Competitiveness and Simplification Conference

June 24, 2014

Reforming the Indiana Retail Sales Tax: Lessons Learned from Florida and Pitfalls to Avoid

Sheldon H. Laskin
Acting General Counsel
Multistate Tax Commission

"One danger in making the reasonable reform of expanding the tax base to encompass service purchases is that services purchased as business inputs will get included in that expansion. If they are, all the problems associated with including business purchases of tangible property will be encountered."

Professor John L. Mikesell

Professor Mikesell is absolutely right. If the sales tax base is not expanded to include services, the sales tax will increasingly become obsolete in the service-based 21st century economy in which we live. And as he points out, to the maximum extent possible business service inputs should be excluded from the tax base. But in addition to the economic arguments he makes in favor of excluding business service inputs, there is also a strong political argument in favor of excluding them; including them in the tax base could well result in a reform that is stillborn.

Florida's 1986 attempt to expand its sales tax base to services remains to this date the most ambitious and comprehensive attempt of any state to do so. Although political opposition from local Florida businesses ultimately killed the reform effort, Florida actually had a number of legal, political and demographic factors in its favor in making its attempt.

First, Florida had a law that required periodic sunset of business regulations. Relying on this statute, in 1986 the legislative leadership proposed that numerous sales tax exemptions be repealed, including the exemption for "professional, insurance, or personal service transactions."

For a number of reasons, there was little organized opposition to the proposal. First, the legislative leadership had popularized the notion that there were numerous loopholes from the sales tax that needed to be closed. In addition, Florida's rapid population growth had increased demand for government services and infrastructure improvements, in a state that lacks a personal income tax. Finally, the very fact that the repeal was rooted in a general sunset provision made it very difficult for political opposition to coalesce. There was no specific industry group that could claim that it was being singled out for unfair or discriminatory treatment. This put lobbyists in the position of having to argue that their clients deserved special, favorable tax treatment as compared to other service providers. This in turn made it possible for legislators to respond to any request to be excluded by asking, "show me why your client should be excluded while other businesses are included?"

To be sure, as the proposal was refined its scope was significantly narrowed. Ultimately, only 33.4% of previously exempt services would have been taxed. And only 45% of the potentially new service tax base would be taxed. In comparison, 68.4% of the potential goods tax base was subject to sales tax. Nevertheless, the proposal represented an opportunity for a significant modernization and reform of the sales tax to reflect the shift to a service-based economy that was then in its early years. What ultimately killed the reform effort, however, was the tax treatment of business inputs.

Prior to the 1986 reform effort, 25% of Florida sales tax revenue was derived from business purchases. Perhaps for this reason, the legislature never considered whether business service inputs should be subject to sales tax in the first instance. Instead, the only debate was about which of two alternative versions of the *existing* resale exclusion for business purchases should apply to services. Ultimately, only services directly received by the ultimate consumer were subject to the resale exclusion. A service purchased for use by the service provider was subject to tax if the ultimate consumer did not directly receive the purchased service.[1] This would obviously have led to pyramiding of the tax.

But it was not the pyramiding problem that doomed the Florida reform. The issue that stoked local business opposition was the treatment of the use tax on taxable services purchased by a multistate business doing business in Florida. Imposing such a tax would require importing the income tax concept of apportionment in order to avoid constitutional issues under the due process and dormant commerce clauses. This would have been a radical departure from the sourcing rule – place of first use – for tangible personal property under the use tax. Out-of-state companies objected to the compliance costs of designing and implementing programs to apportion their use tax on services received in Florida. Instead, they proposed a sourcing rule based on the state of commercial domicile of the purchaser.

The legislature did not agree to the commercial domicile rule. But the very fact that it had been proposed aroused local Florida businesses. Under a commercial domicile rule, they would be the only purchasers liable for the use tax. This might not have mattered all that much if a large number of states imposed use tax on business service inputs. But since only Florida would be imposing the tax, the argument that local business would be put at a competitive disadvantage to out-of-state service purchasers doing business in Florida resonated with the legislature, and the reform effort died.

Professor Mikesell has made a solid economic case for not including business inputs in an expanded Indiana sales tax base. The Florida reform attempt illustrates the political costs of including them – it might doom the entire enterprise.

[1] An example would be court reporting services purchased by a law firm. Although the client would ultimately benefit from the court reporter's service, nevertheless the law firm would be liable for the tax because the client would not ordinarily directly receive the court reporter's services.