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# THE EVERYDAY TAX

## Sales Taxation in Utah



# THE EVERYDAY TAX

## SALES TAXATION IN UTAH

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**“No taxes can be devised which are not more or less inconvenient and unpleasant.”**

- George Washington, Farewell Address, 1796

## INTRODUCTION

Since the creation of Utah’s sales tax in 1933, both the state population and the scope of the tax have changed substantially. More changes could be on the way. The run-up to the 2018 Utah Legislative Session was full of discussion about the sales tax, and the 2019 session promises even more discussion on the matter.

The sales tax is paid almost every day by most people who set foot in Utah, residents and visitors alike. It is one of the legs of Utah’s “three-legged stool” of tax revenues, along with property and income taxes. In 1975, it became the largest revenue-generator of the three – and by a substantial margin.<sup>1</sup> However, during the past two decades its importance has diminished.

In 2016, the tax generated \$3.4 billion.<sup>2</sup> The majority of these funds go to the state, while the remainder goes to local towns, cities and counties. Due to dedications of other revenues, the state’s sales tax revenues form the backbone of its General Fund, providing 84% of its dollars.

## HISTORY OF SALES TAX IN UTAH

The sales tax was first introduced in Utah in 1933, just two years after the introduction of the income tax. These new taxes were meant to offset losses from property taxes due to the Great Depression. Beginning with a rate of 0.75%, the sales tax was initially set to expire after two years. However, the Utah Legislature reconvened that same year to repeal the sunset date and raise the rate to 2.0%.<sup>3</sup>

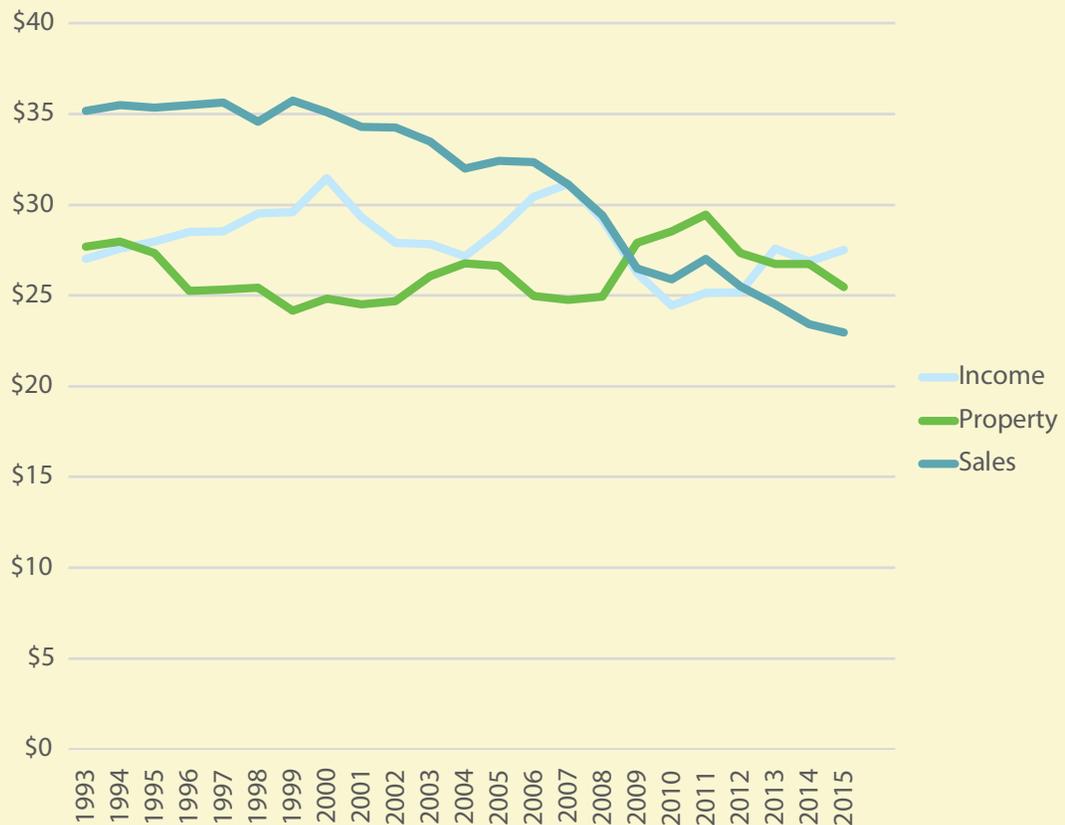


### KEY FINDINGS OF THIS REPORT

- During the past 45 years, Utah has seen the nation’s second biggest decline in taxable sales as a proportion of consumer expenditures.
- Beginning in 1975, Utah’s sales tax imposed a larger tax burden than income or property taxes. During the past two decades it has trended downward to impose the smallest burden of the three.
- Utah had essentially the same real per capita sales tax revenue in 1978 as in 2016 – meaning that, as costs climb, the state is losing purchasing power from this revenue source.
- More than 20% of the state’s sales tax revenues are earmarked – meaning the expenditures lack standard annual legislative oversight, and the government’s flexibility to meet changing needs is constrained.
- Among the nine western continental states that collect sales taxes, Utah has the lowest sales tax burden.
- If Utah broadened the sales tax base to include all personal consumption transactions, the state could drop the effective rate to 2.1% (from 6.2% currently) and generate the same amount of revenue.
- Sales taxes on services are supported by economists and policy analysts across the ideological spectrum. However, expanding sales taxes to capture services can face intense pushback from industries to be affected and from citizens who fear the change will result in net tax increases.

**The sales tax burden – historically higher than income and property taxes – has declined since the 2000s.**

**Figure 1: Utah’s Sales, Individual Income and Property Tax Burdens (Revenues per \$1,000 of Personal Income), 1993-2015**



Source: U.S. Census, Bureau of Economic Analysis.

A companion tax was introduced in 1937: the use tax. It is imposed on items purchased out of state but brought into the state for use. The use tax is charged at the same rate as the general sales tax.

The local option sales tax was introduced in 1959, giving cities and counties the ability to levy a 0.5% tax and providing a source of income to local governments beyond property taxes. The Utah Legislature also expanded what was subject to the sales tax. Initially, the sales tax was limited to retail sales, utilities, food and admissions, but in 1959 the legislature expanded it to include repairs of property, short-term accommodations like hotels and laundry services.

In 1975, the Utah Legislature allowed for an increase of the standard local option from 0.5% to 0.75%. That same year, the legislature introduced a dedicated local tax for public transit systems. Since 1975, the state has added 16 local sales taxes in addition to a general local option. Local governments adopting these taxes are responsible for nearly all of the net increase in the real per capita sales tax revenue since 1978.

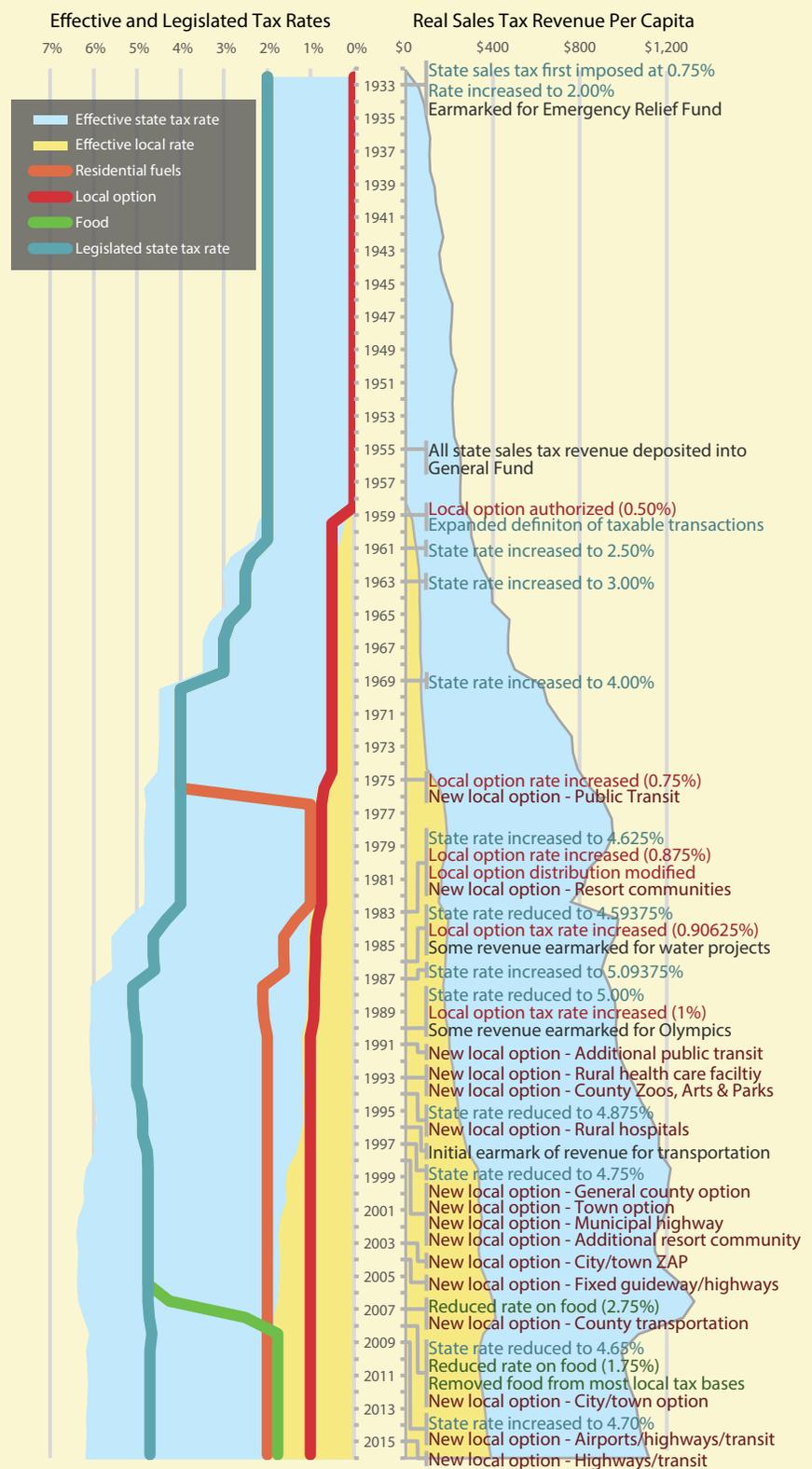
Differential sales tax rates started in 1977, when the legislature lowered the residential fuel rate (for natural gas, electricity, etc.) to 1%. Residential fuel still has a differential tax rate, which today is 2%.

One of the most significant sales tax changes occurred in the early 1980s, when the legislature changed the distribution formula. Since the inception of the local sales tax, revenues had been distributed solely on a point-of-sale basis. Accordingly, local sales tax revenues stayed in the town, city or county where they were collected. This created an unfair advantage to certain communities, particularly in the view of predominantly residential communities with limited retail activity. In 1983, the Utah Legislature passed a law to share a portion of the local sales tax revenue statewide according to population, helping to support the coffers in communities with low retail activity.

The other big change, which remains controversial, was the introduction of the reduced tax rate on non-prepared food purchases. The legislature lowered the state sales tax rate for non-prepared food to 2.75% in 2007 and to 1.75% a year later. While non-prepared food was exempted from many of the local taxes, the general county and local options continued to apply to non-prepared foods, leading to a current combined state and local rate of 3%. The change remains a topic of debate among legislators. Discussions range from eliminating the tax on food entirely to reinstating the full rate.

## Even as sales tax rates have generally trended upward, real per capita revenue from the tax has fluctuated.

**Figure 2: A Timeline of Sales Tax Rates, Real per capita Revenues and Notable Changes**



Source: Utah State Tax Commission and the Utah Office of Legislative Research and General Counsel.

## STRENGTHS AND WEAKNESSES OF THE SALES TAX

The sales, income and property taxes together make up the “three-legged stool” of Utah tax revenues. Each has comparative strengths that help counterbalance the weaknesses of the others. For example, the instability of the sales tax can be offset by the stability of the property tax; and the regressivity in the sales tax can be offset through progressivity in the income tax.

Among the strengths of the sales tax:

- It is paid in small portions, making it financially manageable for taxpayers. Compare that to lump sum payments in the thousands of dollars taxpayers can face if their property taxes are not collected by their mortgage holder or if they miscalculate their income tax withholdings.<sup>4</sup>
- The sales tax is collected by businesses, reducing the regulatory burden on taxpayers and easing the administration of the tax. There are more than 63,000 businesses in Utah, and not all of them collect sales tax.<sup>5</sup> Compare that to the 1.2 million individuals who file annual income tax returns.<sup>6</sup>
- Payment of the sales tax by consumers is straightforward and easy to understand.
- The tax is considered fair from a certain point of view because everyone pays the same amount on the same transaction.
- To a degree, consumers can control the amount of sales tax they pay by controlling their spending.
- To some extent, the sales tax reflects an individual’s ability to pay the tax. Their level of consumption provides a reasonable index of economic ability to carry the cost of government services.
- Sales tax revenues are generated not only by residents of a jurisdiction, but also visitors and commuters who benefit from the services and infrastructure provided by that jurisdiction. This can be particularly beneficial for jurisdictions with significant tourism.

There are also drawbacks to the sales tax, which include:

- The sales tax is regressive. Low-income individuals will spend more of their income on consumption and less on sales-tax-free saving when compared to higher income individuals.
- This regressivity is even worse when the predominant consumption taxed pertains to goods, since lower-income households spend a larger share of their income on goods than services when compared to higher-income households.
- The sales tax is not transparent; because it is collected in small portions on a daily basis, few individuals understand how much they pay in sales taxes overall.
- Large purchases, which are often a substantial component of the sales tax, are subject to economic cycles. As a result, sales tax revenues will often fall or stagnate during economic downturns.

## WHAT IS TAXED – AND AT WHAT RATE?

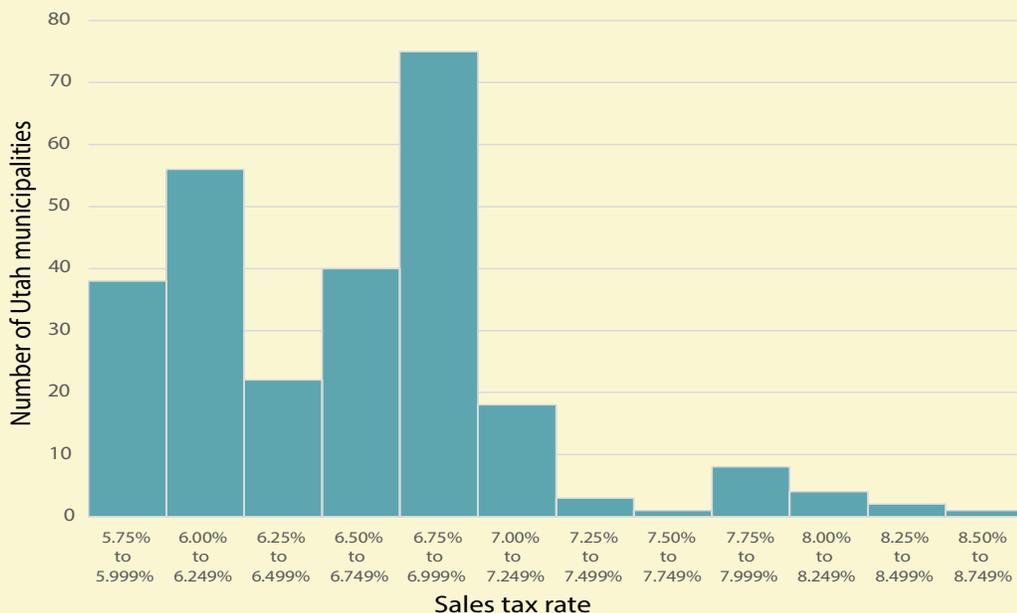
Sales taxes and sales tax rates vary by local jurisdiction, as authorized by the Utah Legislature. Moab has the highest total sales tax rate, at 8.6%, while 38 cities and towns are tied for the lowest total tax rate, at 5.95%. Based on revenues and the imputed tax base, the average effective sales tax rate in Utah is 6.2%. Figure 3 illustrates the distribution of tax rates among municipalities.

Sales and use taxes are applied to financial transactions. The Utah Legislature includes the following in the state’s sales tax base:

- Sale, lease or rental of tangible personal property.
- Repair or renovation of tangible personal property.
- Residential and commercial use of natural gas, fuels oil, coal, heat, and electricity.
- Prepared food and unprepared food.
- Admissions (such as movies, sports, museums, performances and skiing).
- Hotel and motel accommodations and services (if less than 30 consecutive days).
- Sale or repair of products transferred electronically (such as downloaded music, movies or software).
- Certain telecommunication services.
- Certain cleaning services (such as laundry, dry cleaning, pet cleaning).
- Motor vehicle rentals.<sup>7</sup>

### Most combined tax rates fall between 6.2% and 6.85%.

**Figure 3: Tax Distribution of Combined State and Local Tax Rates Among Municipalities, 2018**



Source: Utah State Tax Commission.

Rates can vary based on the type of product purchased. Residential fuels are taxed at 2%. Cities and towns can impose up to an additional 6% on electricity and natural gas. Unprepared food is taxed at 3% (1.75% by the state and 1.25% by local entities). Most counties levy an additional 1% tax on food prepared by restaurants.<sup>8</sup> Motor vehicles are taxed by the state at 2.5%, and depending on the county, local governments



### THE TRANSIENT ROOM TAX

The transient room tax, also known as the hotel tax, is levied on the rental of temporary lodging for stays of not exceeding 30 consecutive days. This includes hotels, motels, inns, trailer courts, campgrounds, tourist homes and similar accommodations.<sup>10</sup> The transient room tax levied by various local entities raised \$68 million in 2016. Salt Lake County generated \$21.7 million. Utah's 28 other counties generated \$36.7 million. Cities and towns brought in \$9.6 million collectively, \$3.1 million of which was generated by Salt Lake City.<sup>11</sup>

Salt Lake City has a combined (state and local) transient room tax of 12.6%, ranking 109th among the top 150 urban centers, and 13th among the 18 top urban centers in Utah and the surrounding states.<sup>12</sup>

can levy an additional 3% or 7%. Transient rooms are taxed by the state at 0.32%, counties can levy an additional 4.25%, cities and towns can levy an additional 1.5%, and Salt Lake County can levy an additional 0.5%. Cities and towns can levy 3.5% beyond the state rate on telecommunication services, and the state collects 3.3% on prepaid phones and their usage.

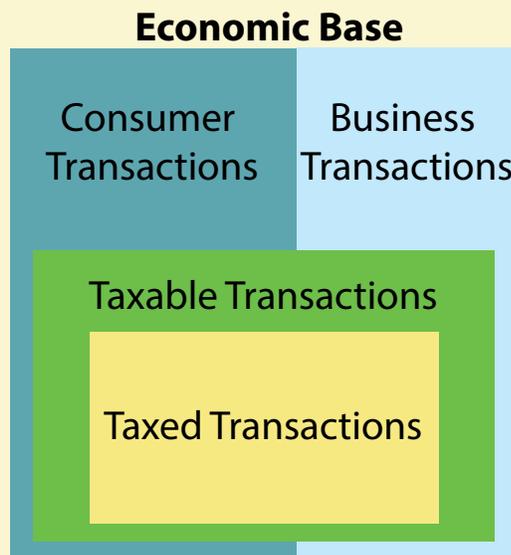
Certain transactions are excluded from taxation, including numerous services. Examples of excluded services are health care, legal and accounting, advertising, maintenance, data processing, and many personal services such as landscaping, haircuts, service on real property (such as that provided by electricians or plumbers), storage and personal instruction.<sup>9</sup>

In addition, Utah grants specific exemptions to items that would otherwise generally fit within the tax base. There are 91 such exemptions. Figures 4 and 5 outline some of these exemptions. Figure 5 (on the next page) details different types of exemptions and examples of the exemption types.<sup>13</sup>

There are some broad reasons why products might be exempt from the sales tax. Many products are considered input components to more advanced products. In these cases, it is considered economically inefficient to tax business inputs. The primary reason for 48 of the state's 91 sales tax exemptions is because they are considered business inputs.

### Taxed transactions make up only a small portion of Utah's economic base.

**Figure 4: Approximate Representation of Taxed and Taxable Transactions Compared to Economic Base of All Transactions in Utah**



	Consumer Transactions	Business Transactions
<b>Taxed</b>	Personal vehicles, retail purchases, admissions, services on personal property, etc.	Office furniture, office supplies and other personal property
<b>Exempt (taxable, but not taxed)</b>	Newspapers, water piped to a residence, prescription drugs, etc.	Items purchased for resale, locomotive fuel, etc.
<b>Excluded (not taxable)</b>	Health care services, housing services, real property, etc.	Advertising services, accounting services, business consulting and legal services etc.

## Utah sales tax exemptions may apply to specific types of entities, items used for specific purposes or specific products.

**Figure 5: Examples of Sales Tax Exemption Types**

Entity-Based Exemptions	Use-Based Exemptions	Product-Based Exemptions
Public transit authorities	Items purchased for resale	Prescription drugs
Nonprofit organizations	Components of more advanced products	Newspapers
Governmental agencies	Machinery purchased for manufacturing with a lifespan of more than three years <sup>14</sup>	Hay
Local agencies on aging		
Senior citizen centers that work with aging agencies and/or are owned by governments		

Some exemptions are justified as strategic for economic development, such as energy produced from alternative energy sources or airplanes built in Utah.

Other items are exempt because it would be difficult and burdensome to collect sales tax on these items. Some examples might be sales of personal property through classified ads or purchases from coin-operated amusement devices.

Many products associated with health care services are exempt for public health purposes, such as prescription drugs and prescribed medical equipment. Other exemptions relate to the perception of a public benefit, such as exemptions for nonprofits, non-bottled water, college textbooks or newspapers.<sup>15</sup>

### HOW ARE SALES TAXED?

Utah requires sellers to collect the sales tax on all taxable goods and services. In instances where the seller is not required to collect the tax, the buyer is subject to a use tax for the same amount.

Sales tax rates are based on the seller's location if selling only taxable goods, or the buyer's location if the seller sells only taxable services. When sellers sell both taxable goods and services they have the option to choose the location on which to base the rate. If a Utahn purchases a taxable good or service from outside the state or from a remote seller, the applicable sales tax rate is based on the buyer's location.<sup>16</sup>

When sellers do not have nexus (generally thought of as a physical presence of stores, merchandise or workers), they are not required to collect sales tax to remit to the state, although they can do so voluntarily. Again, if the sellers do not collect sales tax on taxable goods and services, then the buyer is required to remit the equivalent amount in use taxes.

Sellers are required to keep the taxes they collect in trust, meaning the money cannot be used for any other purposes. Depending on the size of the sales tax

liability, sellers must file taxes annually, quarterly or monthly. Those who file monthly (generally sellers who collect \$50,000 or more in sales tax annually) can keep for themselves 1.31% of the sales tax they collect on non-grocery items and of the standard tax rate on grocery items. (See the sidebar for more details.)

### WHO PAYS?

Both residents and non-residents pay sales taxes in Utah. In some states with a high volume of tourism, the sales tax is used to shift the tax burden from local residents to non-residents making purchases in the state. Indeed, many jurisdictions in Utah rely on tourism to provide local government revenues. For tourism-heavy communities (those that have transient room capacity that is at least two-thirds the size of the permanent population), the Utah Legislature has authorized a resort community sales tax of 1.1% and has authorized voters to approve an additional 0.05%. As of 2016, 17 communities had adopted some level of tax, bringing in an additional \$22 million annually. Park City alone generates \$13 million in resort community tax revenue. Moab and Springdale are the only other communities that generate more than \$1 million with this tax.<sup>17</sup> Moab is one of seven municipalities in the state that collects no municipal property tax.<sup>18</sup> This is because they can “export” much of the residents’ tax liability to tourists.

Businesses also pay sales taxes on many items, such as office supplies, personal property and even taxable services. Traditional economic theory would indicate that business’ inputs should not be subject to sales tax because that results in tax stacking – whereby taxes are imposed several times on the same goods or portions of goods.<sup>19</sup> In many cases, the state’s sales tax exemptions reflect this philosophy as the Utah Legislature has exempted many types of business inputs from the sales tax. However, when products are broadly used by both businesses and consumers, exemptions become less feasible.

### THE CHALLENGE OF CREDIT CARD FEES

High-volume sellers – those collecting \$50,000 or more in sales taxes annually – may keep 1.31% of the sales tax they collect. On \$50,000 in sales tax, that is \$655. This helps defray the cost of collecting taxes. However, most high-volume sellers collect payments through credit cards. Depending on the card, transaction fees can be 1.5% to 2.5% of the total transaction, including the sales tax portion. That means when a local grocery store collects sales taxes, and the buyer uses a credit card, the grocery store will pay a transaction fee for the sales tax amount – which may be greater than the 1.31% of the sales tax revenues collected that high-volume sellers may keep. This may result in retailers losing money in transaction fees simply because they are required to collect sales tax.



At times, especially for large purchases, consumers cross state lines to reduce their tax liability. With online sales, consumers might choose to purchase from sellers that lack a physical presence in Utah and therefore are not required to collect sales taxes. In both situations, residents are subject to the use tax, which applies to the same transactions as the sales tax and at the same rates. With vehicle purchases, the state has some enforcement mechanisms; for instance, owners are required to pay sales or use tax when first registering their vehicle in Utah. For many other purchases, there is limited compliance with the use tax.

**When sales tax money comes in, the Utah State Tax Commission sorts the funds out into the following accounts.**

**Figure 6: Accounts that Receive Revenue from the Sales Tax, Fiscal Year 2017**

State Sales Tax	\$ 1,856,753,521
<b>County and Local</b>	
County Option Fixed Guideway Tax	21,110,310
County Option Sales and Use Tax	142,152,579
County Option Sales/Use for Highways/Public Transit Tax	27,525,028
County Option Zoo, Arts Parks	43,490,906
Local Sales and Use Tax	568,616,649
Municipal Energy Sales & Use Tax	6,130,069
Town Option Sales & Use Tax	9,508,850
<b>Roads and Highways</b>	
Highways Sales and Use Tax	14,537,212
Centennial Highway – 8.3% Vehicle Related Products	202,695,708
Critical Highway Needs Fund	64,000,000
Critical Highway Needs Fund – 0.025% Diversion	25,235,351
Transportation Investment Fund – 30% Sales Growth Diversion	195,579,581
Transportation Investment Fund – 1/16% Sales Diversion	35,659,525
<b>Other</b>	
Water & Wastewater Projects – Sales	31,333,954
Admin. Allowance Service Charge – Sales Tax & Misc.	11,968,715
Dedicated Credits – DNR Plants/Animal Protection – Sales	2,450,000
Other, non-transportation earmarks	\$ 77,072,000

Source: Utah State Tax Commission, TC-23: FY2017.

**WHERE DOES SALES TAX REVENUE GO?**

In addition to the state sales and use taxes, there are many different county and local sales taxes. They generally are distinguished either by their purpose or the transactions to which they apply. Others are more general. The County Option Sales & Use Tax, for example, is directed at a wide variety of uses, from county jails to parades. Figure 6 lists Utah’s 18 funds that receive sales tax revenue.

## Sales taxes produce 88% of state general fund revenues. Here's where general fund revenues go.

Figure 7: Breakdown of All General Fund Expenditures, Fiscal Year 2017

Governmental service	Allocation	Share of general fund allocation
Social services – health	\$ 482,061,000	20%
Social services – human services and youth corrections	442,905,000	18%
Higher education – colleges and universities	317,821,000	13%
Adult corrections and Board of Pardons	296,594,000	12%
Courts	129,638,000	5%
Business, economic development and labor	94,737,000	4%
Public safety	92,794,000	4%
Other capital budgets	84,726,000	3%
Higher education – Utah Education Network	78,800,000	3%
Debt service	68,736,000	3%
Social services – workforce and rehab. services	60,065,000	2%
Elected officials	59,953,000	2%
Natural resources and energy development	43,414,000	2%
Agriculture, environmental quality and public lands	29,588,000	1%
Legislature	26,376,000	1%
Administration and technology services	21,481,000	1%
Higher education – buildings	20,000,000	1%
Higher education – applied technology colleges	18,885,000	1%
Heritage & arts	18,525,000	1%
Higher education – state administration	16,205,000	1%
National Guard & Veterans' Affairs	11,101,000	<1%
Capitol Pres. Board, Dept. of Human Res. and Career Services	5,254,000	<1%
Public education – state administration and agencies	4,502,000	<1%
Transportation	\$ 3,000,000	<1%

Source: Utah Office of the Legislative Fiscal Analyst.

### State Sales Tax

The statewide sales tax is the primary funding mechanism for the Utah Legislature. The sales tax generated \$2.5 billion for the state, \$1.9 billion of which went into the Utah General Fund in fiscal 2017. These funds are used for post-secondary education, transportation, health care, corrections and more (see Figure 7). This spending is at the discretion of the Utah Legislature through the appropriations process.

## Counties can levy an array of additional sales taxes.

**Figure 8: Optional County Taxes**

Tax Name	Percent	Source	Usage Examples
Public Transit	0.25 or 0.3	80% of taxable sales (countywide in Davis, Salt Lake, Utah, and Weber; 23 other areas in the state)	Public transit
Additional Public Transit/Airport/Highways	0.25	65% of taxable sales (Davis, Salt Lake, Summit and Weber counties; Brigham City, Perry and Willard)	Airports, highways and public transit
Public Transit/Fixed Guideway/Highways	0.3	15% of taxable sales (Utah County)	Transit and highway funding within Utah County
County Option Transportation	0.25	59% of taxable sales (Cache, Millard, Salt Lake, Summit, Weber)	Transportation funding
Airport, Highway, Public Transit, or Other Transportation Purpose within Counties of Second Class	0.1 or 0.25	15% of taxable sales (Utah County)	Transportation and airport funding within Utah County
County Option Highway or Public Transit	0.25	21% of taxable sales (Carbon, Davis, Duchesne, Grand, Rich, San Juan, Sanpete, Sevier, Tooele, Weber)	Highway or transit funding within named counties
County Botanical, Cultural, Recreational, & Zoological (ZAP tax in Salt Lake)	0.1	66% of taxable sales (Cache, Salt Lake, Summit, Uintah, Washington, Weber)	Used to fund organizations that provide cultural or scientific benefit to the community
Rural Health Care Facilities	1.0	0.6% of taxable sales (Daggett, Garfield, Kane, Grand)	Used to fund health care initiatives in rural areas
Supplemental State Sales & Use	0.3	16% of taxable sales (Davis & Weber counties)	Distributed to public transit within the counties

Source: Legislative Research and General Counsel.

### County Sales Taxes

Every county in the state collects a 0.25% sales tax for the counties' general funds. Counties may also levy additional sales taxes. These optional sales taxes are listed in Figure 8.<sup>20</sup>

### Local Sales Taxes

Every town and city in the state collects a 1% sales tax, providing support to their governments' funding. There are also additional taxes some cities levy, which are listed in Figure 9.<sup>21</sup> (See the next page.)

## Cities and towns can levy an array of additional sales taxes.

**Figure 9: Optional Local Taxes**

Tax Name	Percent	Source	Usage Examples
Municipal Highway/Public Transit	0.3	11% of taxable sales	Highways and transit funding
Rural City Hospital	1.0	0.1% of taxable sales (Beaver City)	Used to help fund rural health care initiatives
City or Town Botanical, Cultural, Recreational & Zoological / ZAP	0.1	15% of taxable sales (30 cities/towns)	Funds organizations providing cultural or scientific benefit to community
Resort Community/MIDA*	1.1	3% of taxable sales (17 cities/towns)	Used to help fund resort communities
Additional Resort Community	0.5	0.8% of taxable sales	Used to help fund resort communities
Town Option	1.0	0.01% of taxable sales (Snowville)	Used to help fund town initiatives
City or Town Option	0.2	5% of taxable sales (Murray, Naples, South Salt Lake, Riverdale, Vernal)	Used to help fund town and city initiatives

\* Military Installation Development Authority.

Source: Legislative Research and General Counsel.

## COMPARING UTAH TO OTHER STATES

### Utah Tax Burden Comparison

There are numerous ways to compare states' sales tax rates. Often, state comparisons look at the state sales tax rates alone. As of 2017, Utah's rate of 4.7% was lower than average. It ranked 36<sup>th</sup> highest in the nation and 7<sup>th</sup> highest among 11 western states.<sup>22</sup> Five states nationally, including two western states, do not collect sales taxes – Alaska, Delaware, Montana, New Hampshire and Oregon. That said, Alaska does allow some of its local governments to impose sales taxes, Montana allows resort communities to collect sales tax, and Delaware levies a gross receipts tax, which is similar in many ways to a sales tax.

When accounting for state and local sales taxes (weighted by population) Utah's tax rate looks a bit higher. Utah has the 30<sup>th</sup> highest sales tax rates in the nation and is seventh highest among 11 Western states. Among Utah's six surrounding states, only Idaho and Wyoming have lower rates.

However, looking at rates alone can obscure the true impact of the tax. Another key component when comparing sales tax is to consider what share of transactions is subject to the tax, as illustrated for Utah in Figure 4. In many states, groceries and clothing are exempt from the sales tax. Most states do not tax professional and personal services, and many states exempt items that are sold business-to-business.

Utah's sales tax base (or taxable sales) is equivalent to 34% of the personal income generated in the state. The median state has a sales tax base that is equivalent to

35% of the personal income generated in the state. Hawaii is an excellent example of why both the base and the rate must be considered. While Hawaii has the 6<sup>th</sup> lowest rate in the nation, its sales tax base represents 104% of the personal income in the state. As a result, it has one of the highest sales tax burdens in the nation. Wyoming tells a similar story. While it has the 7<sup>th</sup> lowest sales tax rate, its sales tax base represents 62% of personal income, which means it also has historically rated in the top 10 states in terms of sales tax burden.

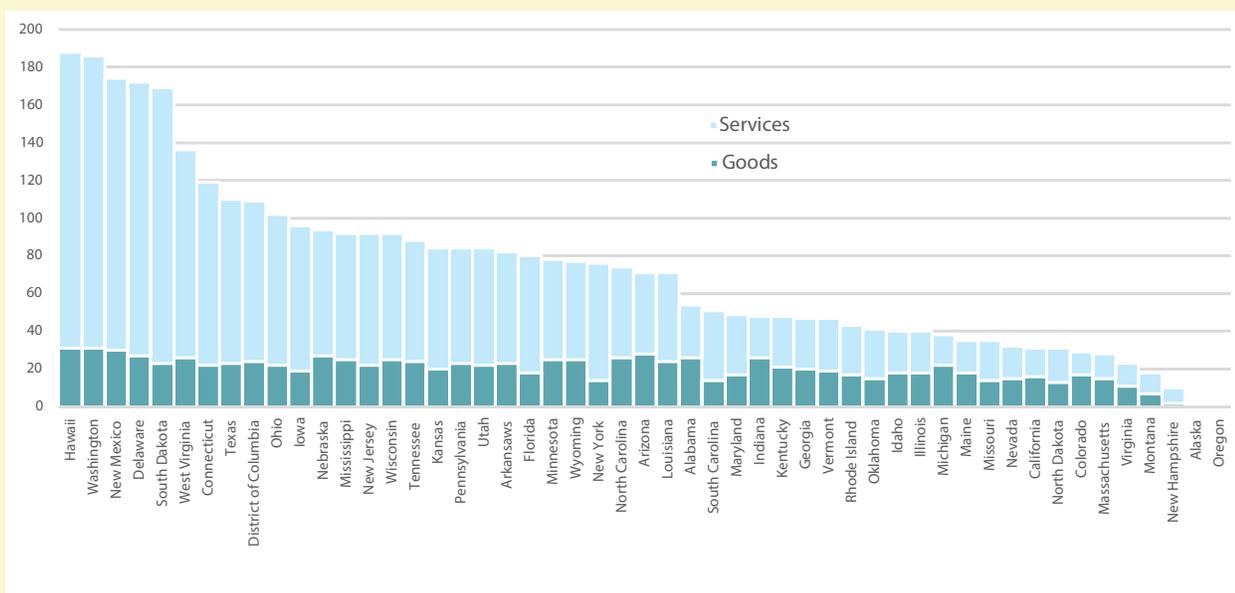
When analyzing the sales tax burden among states, both sales tax rates and the share of transactions applicable to the sales tax are considered. Utah’s sales tax burden is \$22.97 for every \$1,000 of personal income. That is the 28<sup>th</sup> highest sales tax burden nationally. But among the 11 continental Western states it is 9<sup>th</sup> highest; only Montana and Oregon, which lack sales taxes, have a lower tax burden. However, during the 1990s and 2000s, Utah was ranked between 4<sup>th</sup> and 6<sup>th</sup> among Western states. It is only since 2013 that Utah’s sales tax burden has fallen to the lowest among the Western states that collect sales tax.<sup>23</sup> This shift occurred as Utah’s sales tax burden fell faster than the sales tax burdens of California, Colorado and Idaho.

### Comparing the Reach of Utah’s Sales Tax

Given the wide variation in tax codes, compiling data on what is taxable and what is not among 50 states is a difficult task. However, the Federation of Tax Administrators, an association of state principal tax revenue agencies, administered a survey asking states whether businesses paid taxes on a series of services and commonly exempted or excluded goods. The survey does not provide a comprehensive list of all possible services and goods, but it offers some basis for comparison.

### The reach of Utah’s sales tax is near the mid-range among the states.

Figure 10: Number of 195 Goods and Services that are Applicable to the Sales Tax, by State



Source: Federation of Tax Administrators.

The survey asked states about 31 goods and 164 services.<sup>24</sup> Responses separate the states into several categories. The five states with the most taxed transactions levy a gross receipts tax. This type of tax includes nearly all transactions. Some of the few items that escape taxation tend to be water, travel services and fees for financial services.

Utah is 19<sup>th</sup> highest in the number of goods and services surveyed applicable to sales tax, meaning that the majority of states have more exemptions and exclusions.

The next group are 10 states that tax a majority of the goods and services surveyed. However, they largely have excluded or exempted professional services such as advertising, accountants, architects, attorneys and engineers. They also have exempted or excluded health care services and financial services, but they still tend to tax labor charges for repair as well as entertainment services.

Then next group, consisting of 12 states, is squarely in the middle. They tax fewer than half of the listed goods and services, but still a fair amount. Utah is one of these states. In addition to the exemptions and exclusions in the previous two groups, these states also tend not to tax labor charges on real property and many computing services.

After a noticeable cut off, the next group of 12 states tax only 45 to 56 of the surveyed goods and services. These states tend to add exemptions or exclusions for labor charges on personal property and some entertainment services, although usually not for entertainment that charges an admission fee such as amusement parks, circuses or professional sports.

The last group are those that tax the fewest services. This group includes states that do not have sales tax or a gross receipts tax. Oregon, New Hampshire, Montana, Alaska and eight other states tax fewer than 38 of the surveyed goods and services. All of these states (even those that do not technically have a sales tax) still have some sort of tax on transient lodging such as hotels and motels. Many of these states still tax telecommunication services and the sale or rental of personal property, while exempting or excluding most other transactions. While Alaska and Oregon appear to tax none of the surveyed services, Alaska localities can levy a tax on transient rooms, and Oregon levies a statewide transient room tax, as do several of its local governments.

States clearly take a variety of approaches of taxing services, goods that may seem like a service, or goods that are attached to a service. Utah tends to fall in the middle of the pack when it comes to the array of goods and services surveyed.

## **SALES TAX ISSUES IN UTAH**

As legislative committees have discussed the state's tax system during the past three years, several topics have received significant attention. These include the regressive nature of the sales tax and options to mitigate this concern. Earmarks have also come up, as their rapid rise during the past 15 years has reduced money that would otherwise be available in the state's General Fund by 20%.

Not only have earmarks reduced funding flexibility, but taxable transactions as a share of personal consumption have been shrinking. There are two primary drivers of this trend: the increasing number of exemptions and changing consumer expenditure patterns.

## Lower-income households spend a much larger share of their incomes on taxable items.

Figure 11: Share of Income and Expenditures Spent on Taxable Items by Quintile

	Quintile 1	Quintile 2	Quintile 3	Quintile 4	Quintile 5
Average income	\$11,587	\$29,414	\$51,379	\$84,924	\$188,676
Average expenditures	\$26,144	\$38,187	\$48,543	\$66,532	\$112,845
Average expenditures on taxable items	\$11,656	\$16,757	\$21,159	\$27,906	\$44,347
Share of income on taxable items	101%	57%	41%	33%	24%
Share of expenditures on taxable items	45%	44%	44%	42%	39%

Source: Consumer Expenditures Survey, Bureau of Labor Statistics.

### Regressivity

Because a larger portion of their income goes toward purchasing necessities such as food and clothing, lower-income households are likely to spend a larger portion of their income on taxable transactions. Higher-income households, on the other hand, are more likely to place income into savings, investments and services not subject to sales tax. For this reason, the sales tax is well-known for being regressive.

Applying the Utah sales tax to the National Consumer Expenditures Survey clearly demonstrates that those in lower income households pay substantially more of their income on taxable services than higher income households do.

Those in the lowest quintile, on average, spend more in taxable transactions than they earn. This is possibly because many individuals in this income category are spending down savings or going into debt. They are also a group whose post-tax income is slightly higher than pre-tax income due to tax credits.

When looking at the share of income spent in taxable transactions among quintiles, the differences are quite stark. The lowest quintile spends 101% of its income in taxable transactions, the second lowest quintile spends over 50% of its income in taxable transactions, while the highest quintile spends less than a quarter of its income in taxable transactions.

However, when comparing the share of households' expenditures on taxable goods, the difference is much smaller. This difference is likely because lower-income households are more likely to spend their money on goods rather than services compared to higher-income households. If all services and goods were taxed, then this would become at least somewhat more proportional. However, the sales tax system overall would continue to be regressive because individuals in the lowest quintile spend more than twice their income while individuals in the highest quintile spend less than 60% of their income (the rest remains unspent in some form of savings).

To help mitigate the regressive nature of the sales tax, many states reduce or exempt the tax on necessary items such as water, food and clothing. Some states also provide some sort of credit or rebate to low-income households.

Utah exempts water, along with most other states, and Utah is one of six states that has a reduced tax rate for unprepared food; only three states tax unprepared food at the full amount, while 32 states exempt unprepared food completely.<sup>25</sup> Clothing is exempt in a handful of states, and another handful offer sales tax holidays on clothing when families are preparing to send their children back to school.

Some economists consider these exemptions to be inefficient tools for directing support to lower-income households. While few doubt that the sales tax is regressive and that food exemptions can give relief to lower-income households, middle- and higher-income households also benefit from the exemption.<sup>26</sup>

Some states accept the tax as regressive and find ways to offset the sales tax in other ways, such as a progressive income tax structure or income tax credits. Hawaii, Idaho, Kansas and Oklahoma offer rebates or credits for the sales tax paid for necessary items provided solely to lower-income families.<sup>27</sup> In addition, the federal government, 29 states and even some municipalities offer an earned income tax credit. These credits are often designed, in part, to offset the regressive nature of sales tax.<sup>28</sup>

In Utah, the state's taxpayer income tax credit reduces the tax liability of lower and middle-income households, adding a level of progressivity that offsets the regressive nature of the sales tax.

### **The Impacts of Earmarks**

Most of Utah's budget is appropriated by the state government each year. However, sometimes the legislature chooses to place a portion of those appropriations in a special class known as earmarks. Earmarks, also known as dedications or set-asides, are essentially auto-pilot appropriations. Earmarked funds proceed directly to designated accounts. Account administrators have various levels of control over those revenues, dependent on the fund. These earmarked revenues are then excluded from the revenues the legislature deliberately appropriates each legislative session.

In 1939, all of the sales tax revenue was dedicated to the Emergency Relief Fund. The fund was largely under the discretion of the governor to mitigate the devastating impact of the Great Depression. When Utah Foundation analyzed the sales tax 13 years later in 1946, it highlighted some interesting impacts of earmarking the sales tax for public aid. Wartime spending in Utah created unprecedented economic growth in the state. As a result, the state saw an unexpected increase in tax revenues, including those from the sales tax. However, those funds were all earmarked for public aid, but the dire need for public aid funds to address the devastation of the Great Depression was no longer there.<sup>29</sup>

At that time, earmarks across revenue sources made up 80% of governmental funds. That means for every \$100 collected, only \$20 were subjected to legislative oversight – \$80 was automatically sent to administrative accounts where unelected government administrators could spend it how they pleased with little or no legislative oversight.<sup>30</sup>

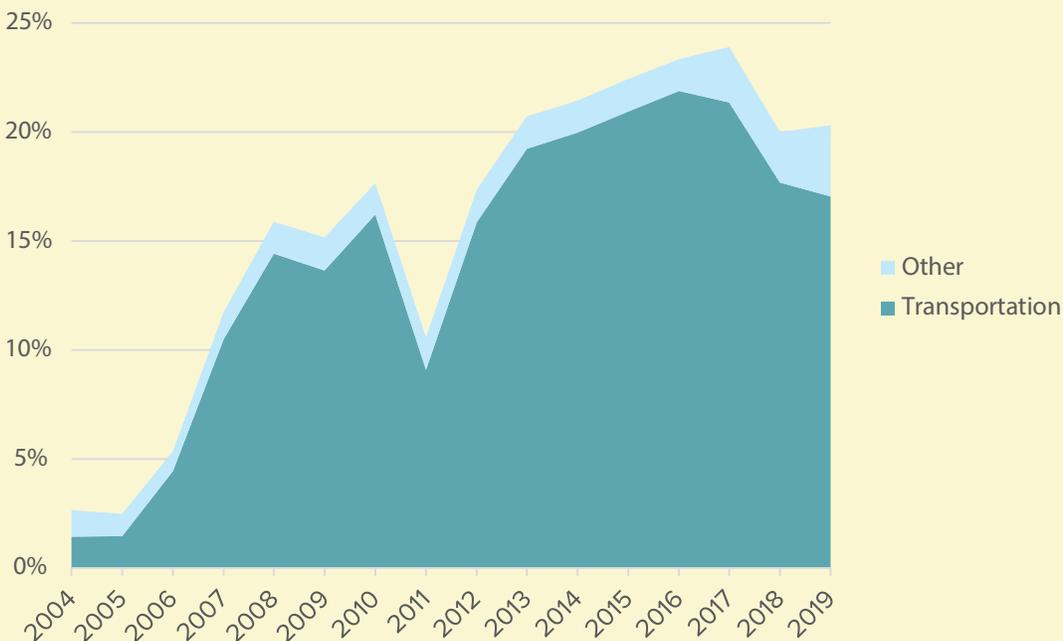
While earmarks help to guarantee stable revenues to meet various needs, there are potential problems with earmarking. First, earmarks may create an “out of sight, out of mind” effect, and agencies receiving earmarks may not have to demonstrate the wise spending of those funds in order to justify their continuing appropriations for the next year.

Second, economic conditions can rapidly change and earmarks tend to make budgets less adaptable. For instance, legislators in 1939 allocated a revenue source that provided \$3.5 million. By 1946, that revenue source was generating more than twice as much (\$8.4 million), all of which was still dedicated to public aid. This issue can become even more problematic when other needs are left unfunded.

Third, earmarks can become dissociated from their need. For instance, the sales tax was initially linked to meeting the need of public welfare. During the war and post-war years, Utah’s booming economy and rapidly climbing personal income substantially decreased the need for public aid, even while generating more than twice the amount of money originally allotted to meet the need. But because those funds were allotted for that purpose, Utah saw average contributions to public aid recipients double in many instances. This led to Utah Foundation’s conclusion in a 1946 study that “A study of public aid reveals that Utah’s public assistance program is the most liberal among the 48 states, based upon ability to pay as measured by per capita income.”<sup>31</sup>

### The share of potential earmarked general fund revenues has increased rapidly during the past 15 years.

Figure 12: Earmarks as a Share of Potential General Fund Revenue, by Fiscal Year



Source: Economic Report to the Governor, 2016.

During the past 15 years, earmarks have been consuming a growing portion of sales tax revenues, with most of the funds being dedicated to transportation projects.

In 2015, the Utah Tax Review Commission, which consists of legislators, appointees from the Governor's Office and citizens, was reorganized after a four-year hiatus. They were tasked with investigating Utah's sales tax earmarks. In November of the same year, after studying the earmarks for eight months, they recommended to the Revenue and Taxation Interim Committee that nearly all of these earmarks should be repealed.

## A DIMINISHING ROLE FOR SALES TAX REVENUES

The base of a tax determines which transactions are taxable. Over the past several decades taxable transactions as a share of personal consumption have been shrinking nationwide. There are two primary ways this occurs. The state can choose to alter the sales tax base by choosing to exclude or exempt additional items, or consumer patterns can change such that a greater share of their consumption goes toward purchases that are exempt or excluded from sales tax.

North Dakota and South Dakota are the only states where the 2015 taxable base as a share of consumer spending was greater than the median rate between 1970 and 2010. Another 16 states have seen a decrease between 3% and 20%, while 27 states have seen a decrease of 20% to 44%. Utah's tax base was one of the most impacted. The state's 2015 taxable base as a share of consumer spending has decreased by one-quarter compared to the median from 1970 to 2010.

That has had an impact on state funding. Since 1978, Utah's state real sales tax revenue per capita produced essentially as much as it did in 2016 – meaning that, as costs climb, the state is losing purchasing power from this revenue source. The local sales taxes have continued to grow, but primarily because of rate increases or a wider adoption of local options by local entities.

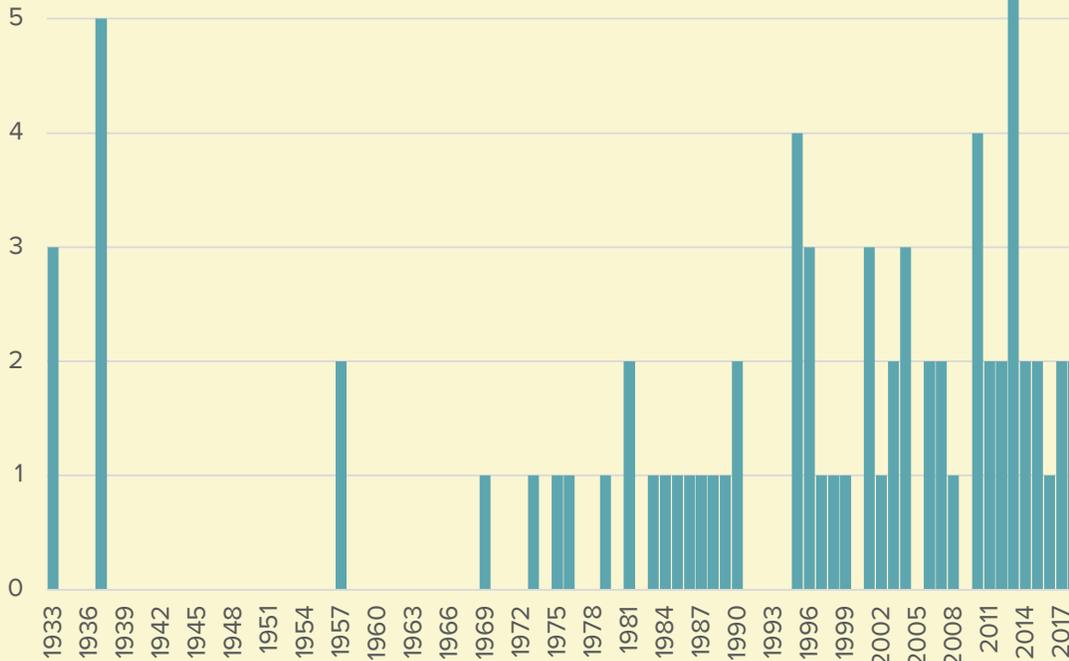
In contrast to the state's real sales tax revenue per capita, real consumer expenditures per capita grew by 65% during the same time period.

It is not necessarily a bad thing for real per capita sales tax revenues to remain stable over the long term. Such a measure of revenue accounts for population growth and inflationary costs. However, the two largest programs historically reliant on state sales tax revenues, Medicaid and secondary education, are well known for outpacing inflation.<sup>32</sup> As a result, Utah has found ways to deal with the decreased purchasing power of sales tax revenues. One way it has done so is by shifting income tax revenue toward secondary education. Before 1995, the general fund was responsible for nearly all non-tuition secondary education funding. In 2018, among appropriated funds, only 30% of non-tuition secondary education funds came from general fund revenues. See Utah Foundation's recent report, *The Education Tax: Income Taxation in Utah*, for further discussion of this change.

There are two primary reasons the state's real per capita sales tax revenues have remained stable while per capita consumer spending has nearly doubled: an increase in exemptions and changing consumer preferences.

## The rate of exemptions added to the sales tax has increased over time.

Figure 13: The Number of New Exemptions Per Year



Source: State Tax Commission, Office of Legislative Research and General Counsel.

### Exemptions

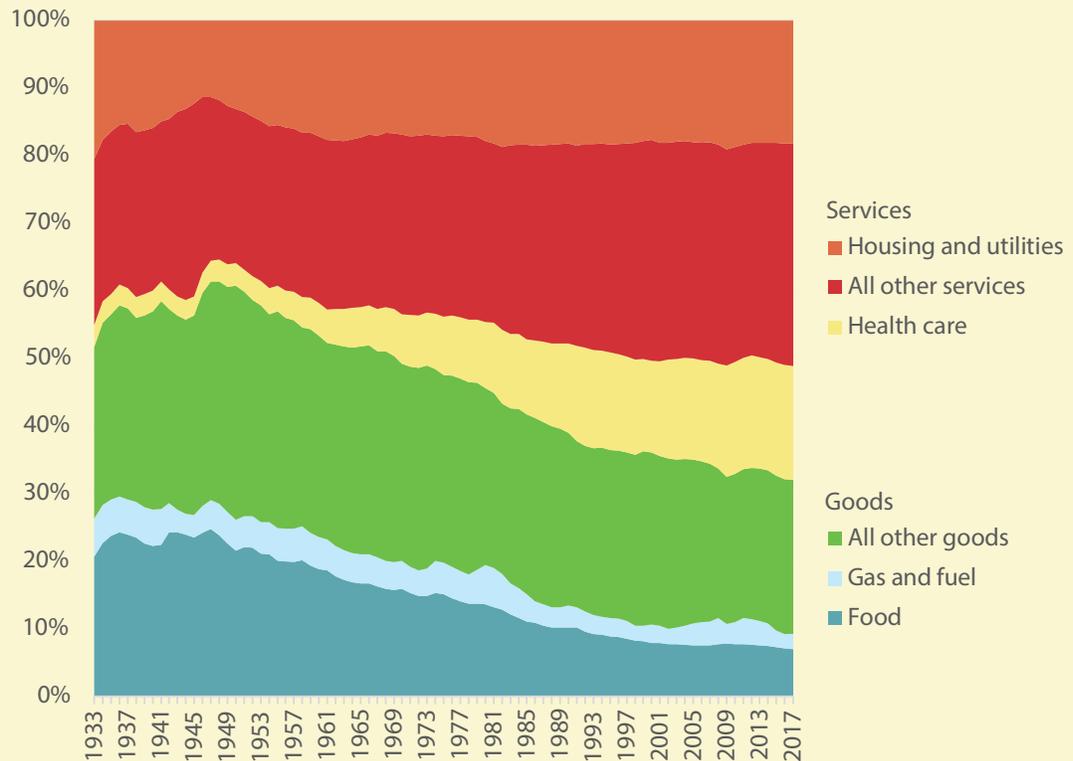
The Utah Legislature has steadily added to the number of products exempted from the state sales tax.

Each exemption chips away at the revenue base. The Utah State Tax Commission has estimated the impact of 69 of the 91 exemptions is nearly \$650 million per year, or about one-fifth of all current potential sales tax revenues. While this represents the best data available, it is flawed. The Commission cautions that 25 of those estimates are based on poor data, and only nine estimates are based on high-quality data.

Many of these exemptions have robust arguments in their favor. However, exemptions can create economic distortions and unfairly benefit specific industries over others. For example, there is an exemption on electricity purchased by ski resorts for ski lifts, but not electricity for other entertainment and leisure venues such as amusement and water parks. However, whether deserving or not, the increasing rate at which legislators are granting sales tax exemptions is contributing to the shrinking sales tax base.

## Services have grown from 48% to 68% of consumer expenditures.

Figure 14: Personal Consumption Expenditures, U.S.



Source: U.S. Bureau of Economic Analysis.

### Changing Consumer Patterns

Consumption patterns have changed in various ways over the past 80 years. These changes include a transition toward services (especially medical services) and economic shifts wrought by technological advancements. As a result, consumers have shifted a greater proportion of their expenditures to non-taxable transactions and away from taxable transactions.

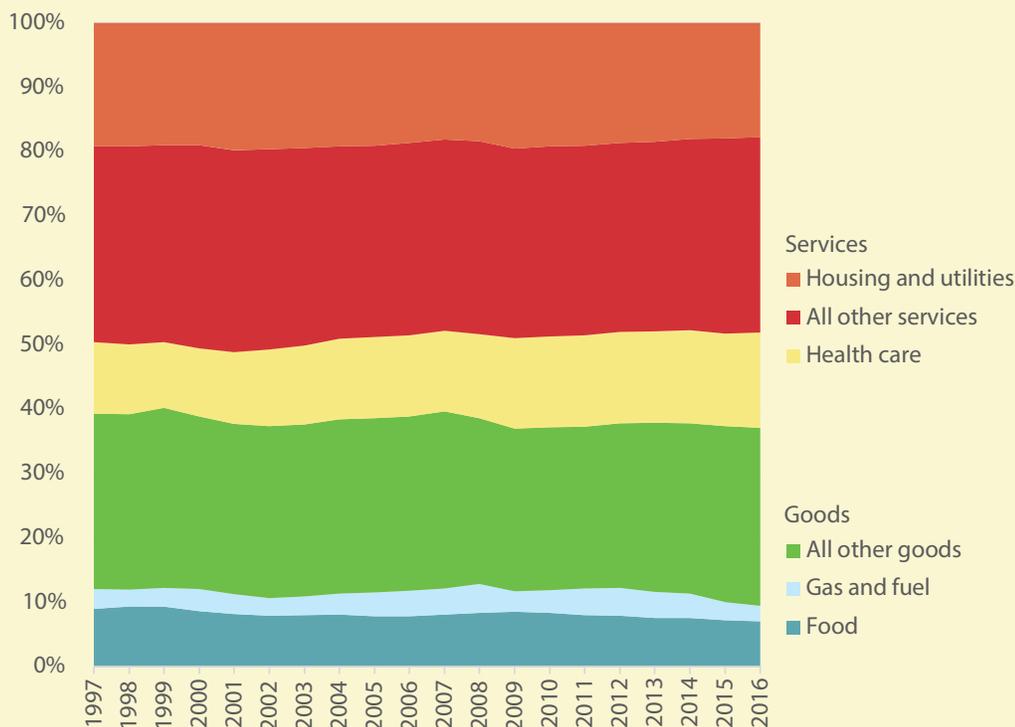
*A Shift Toward Services.* Services, which are much less likely to be taxed than physical goods, have become an increasingly dominant part of the economy. When the sales tax was first introduced in 1933, 52% of the nation's personal consumption expenditures were spent on goods. By 2017, that number had decreased to 32%.

Personal consumption expenditure data for Utah go back only as far as 1997, but still demonstrate the gradual shift toward services and away from goods. In 1997, 39% of personal consumption expenditures were on goods. By 2016, it had gradually eroded to 37%. While it might seem like a small change, keep in mind this is a shorter time scale than the national decline.

Both nationally and in the state, the increase in consumer expenditures on health care services has been a major part of the story. Utah Foundation's recent report,

## Led by health care, Utah's personal consumption expenditures on services continue to grow.

Figure 15: Personal Consumption Expenditures, Utah



Source: U.S. Bureau of Economic Analysis.

*Bills of Health: What's Driving Medical Service Costs in Utah*, identified price and rate increases for medical services, advanced technology and prescription drugs as the primary drivers of rising health care costs.<sup>33</sup> Growth in health care prices has outpaced total inflation in 62 of the past 71 years.<sup>34</sup>

Part of the reason more personal expenditures are shifting toward medical services is the aging population. Nationally, individuals 65 and older are spending 13% of their personal income on health care expenditures, while those under the age of 65 spend 5% of their income on health care expenditures.<sup>35</sup> Utah has a lower share of individuals over 65, but population projections suggest that the share will double by 2065, growing from 9% to 20% of the population. With the aging of the population and health care cost increases consistently trending above inflation, health care services will probably continue to take an expanding portion of consumer expenditures.

Some reports have attempted to tie more recent movements toward services to the consumer preferences of Millennials (those born between 1981 and 1996).<sup>36</sup> They posit that Millennials are prioritizing experiences (often non-taxed services) over goods. However, when comparing national consumer expenditures for those 34 and under to those 35 and over, both groups spend around 34% of their income on Utah's taxable transactions. That said, if a consumer expenditure shift among

younger generations were to occur, the changes would be magnified in Utah because the state has one of the youngest populations in the country.

*Technological Changes.* There are a number of technological changes that affect the sales tax base across the nation. One example might be the software as a service (SAAS) business model. In the past, individuals and businesses purchased software editions, and with each purchase, they paid sales tax. Personal and business services, however, are not taxed. Another example is media such as music and movies, which were previously sold in physical form from record and video stores. Such media are usually now acquired online.

Utah has been assertive in addressing many of these items. Pre-programmed software and downloaded media are now taxable. However, the Utah State Tax Commission has been requesting legislative action on streaming media, which is not yet taxed.

Another factor driven by technological change has been the growth in non-store retail establishments, which are often located outside the state.

## THE SALT LAKE CITY TAX INCREASE

Many counties, cities and towns seek to meet their communities' changing needs by increasing the sales tax rate. Several jurisdictions have increased sales tax revenue through referenda as recently as 2015. More recently, Salt Lake City approved an increase through its City Council.

In 2015, the Utah Legislature gave Salt Lake City the right to increase its sales tax by 0.5% under the Impacted Communities Taxes Act.\* This was part of a deal between the legislature and the city to relocate Utah's state prison from Draper to a location west of the Salt Lake International Airport.

The tax, passed by the Salt Lake City Council on May 1, is expected to generate \$25 million in 2019 and \$33 million thereafter. Mayor Biskupski's fiscal 2019 budget recommendation for the new funding is as follows:

- **\$7 million** to double the number of roads maintained by the city each year and implement and develop other road and sideway improvements.
- **\$6 million** to hire and train 27 additional police officers, hire support staff and provide pay increases.
- **\$5 million** to increase the frequency of bus service on major routes, develop transit infrastructure and provide other improvements.
- **\$4 million** to fund an increase in the supply of and access to affordable housing.
- **\$3 million** for a rainy-day fund.\*\*

\* Utah State Legislature "HB 454: Prison Development Amendments," 2015, <https://le.utah.gov/~2015/bills/static/HB0454.html>.

\*\* Salt Lake City, "Funding Our Future," 2018, <http://fundingour-futureslc.com/critical-needs-dashboard/>.



In 1992, the U.S. Supreme Court ruled in *Quill v. North Dakota* that companies without a presence in a state could not be required to collect sales tax for that state.<sup>37</sup> At the time, most remote sales occurred by catalog. In 2018, remote sales through online companies accounted for 9% of all retail purchases (more than double the 4% just 10 years before).<sup>38</sup> Estimates of the impact of remote sales on Utah's sales tax revenues vary. A 2016 estimate put it in the large range of \$80 million to \$350 million.<sup>39</sup> In his 2017 State of the State address, the Governor quoted an estimate between \$150 million and \$200 million.<sup>40</sup> This is an issue not only because of foregone revenue, but because out-of-state entities that do not collect taxes gain a competitive advantage over entities within Utah that do. (That said, Utah entities selling out of state enjoy this advantage in other states.)

States have responded in various ways to attempt to capture these sales taxes. Some states like South Dakota have specifically created laws violating the ruling in *Quill v. North Dakota* as a part of an effort to return the issue to the Supreme Court. Other states have broadly defined the presence needed to create nexus. Massachusetts, for instance, extends nexus to include tracking cookies placed in users' web browsers.<sup>41</sup> Utah has addressed the issue by attempting to create voluntary agreements with major online retailers, with some success. In

2017, Utah's taxable sales from "non-store retail" more than doubled the amount from the previous year. This 119% growth far outpaces both the growth in other retail revenue streams and the growth over previous years, indicating that Utah has begun collecting previously foregone revenues.<sup>42</sup>

Utah's quickly growing non-store retail tax revenues illustrate what many see to be a broader trend. In oral arguments in *Wayfair v. South Dakota*, U.S. Supreme Court Chief Justice John Roberts recently pointed out that data suggests "that this is a problem that has peaked in the sense that the bigger e-commerce companies find themselves with physical presence in all 50 states. So they're already covered. And the work-arounds that some of the states have employed are also bringing more in."<sup>43</sup> While policymakers in the recent past have pointed to sales taxes on e-commerce as a potential source of more revenues, Utah, like many other states, has already found ways to capture much of the foregone revenue. The Supreme Court is expected to issue a related ruling on this case by the end of June 2018.

Another change allowed by technology is peer-to-peer transactions. Peer-to-peer transactions happen daily. Historically, such transactions have been exempted from the Utah sales tax as isolated or occasional sales from individuals or entities that are not regularly engaged in business.<sup>44</sup> The sharing economy was a \$14 billion industry in 2014, and one estimate suggests it will grow to \$335 billion by 2025.<sup>45</sup>

The sharing economy generally centers around a platform that aims to connect buyers and sellers. Because the platform is not itself selling anything, it is generally not liable to collect sales tax on the transactions that occur over the platform. Many sellers on these platforms are engaged only in occasional or isolated sales and would not be responsible for sales tax. Others, however, are regularly involved on these platforms, but due to unfamiliarity with tax laws they might not be collecting sales tax even when required by law. In many cases, states and localities are so focused on the platforms' right to operate in the locality that developing applicable sales tax regulations becomes an afterthought.<sup>46</sup>

Occasionally, platforms offer the ability to collect and remit sales taxes, but such services are intermittent and infrequent. The impact of these types of sales on state revenues is unclear. However, there has been explosive growth in the sharing economy among various industries, likely contributing to the expansion of spending on untaxed goods and services.

It should be noted that there are ways to address exemptions, and trends in consumer behaviors are potentially reversible. Legislators could remove exemptions, and it is possible that future changes to consumer preferences could increase the share of consumer expenditures spent on taxable goods. The current base of transactions will likely generate an increasing amount of revenue well into the future, though perhaps at a rate substantially slower than personal expenditures. One option is to do nothing, but should the state choose this option, the revenues from the sales tax will probably not be able to support the same state services they did in the past, prompting the state to rely more on other revenue streams to make up the difference.

## POSSIBLE ACTIONS TO SHORE UP THE BASE

If tax revenues fail to rise in proportion to the needs of the state, Utah has several options. It can scale back public services, find other sources of revenue, raise the sales tax rate or expand the base. Shoring up the base could take different forms, including a gross receipts tax, a value added tax, taxing more services or merely rolling back some exemptions.

### Gross Receipts Tax

On the face of it, a gross receipts tax bears many similarities to a sales tax, but there are some key differences. While sales tax is paid by the buyer, a gross receipts tax is paid by the seller. Gross receipt taxes are essentially a tax on all businesses, whereby they are required to pay a designated percentage of all their receipts – everything they sell. In the 1930s, as states were searching for new revenue, many initially chose a gross receipts tax instead of a sales tax. However, most gross receipt taxes were replaced by sales taxes or other taxes by the 1960s.<sup>47</sup>

While gross receipt taxes often have exemptions and exclusions similar to a sales tax, they tend to apply to a broader array of transactions. Generally, all receipts (sales) are taxed regardless of whether a company sells a service or a good, and regardless of whether the company sells to a private consumer, a business or a nonprofit. Delaware, Hawaii and Washington have gross receipt taxes that apply to nearly all transactions.

If Utah were to replace its sales tax with a gross receipts tax and capture a base that was 100% of personal income, it could potentially reduce the effective rate of the tax from 6.2% to 2.1% and generate the same amount of revenue.

*Benefits and Drawbacks.* A gross receipts tax would also mitigate several of the trends currently eroding the sales tax base. It would not matter whether the economy shifted from goods to services or to some other future sector, because all state companies would be taxed on their receipts, regardless of what they sell.

By capturing expenditures on services, a gross receipts tax would reduce the regressivity that stems from higher-income households spending more on untaxed services while lower-income households spend more on taxed goods.

A gross receipts tax would also reduce the level of administrative complexity. Current sales tax law outlines 91 exemptions and differential rates. Gross receipt taxes are generally much simpler.<sup>48</sup> All companies would simply be liable for the legislated percentage of their gross sales, whether it be non-prepared food, personal property, or a previously untaxed service.

**If tax revenues fail to rise in proportion to the needs of the state, Utah has several options. It can scale back public services, find other sources of revenue, raise the sales tax rate or expand the base.**

However, there are several downsides to the gross receipts tax. Because it includes business-to-business sales, it results in tax stacking, which economists generally discourage. To illustrate, consider the following: One company extracts raw materials from the ground and sells them to a refinery. The refinery extracts the valuable resource from the raw materials and sells the refined good to a manufacturer. The manufacturer uses the refined material to create a good which they in turn sell to a retailer which in turn sells it to a consumer. Under a gross receipt tax, that material was taxed four times, each time it was sold. As a result, gross receipt taxes can create economic inefficiencies by encouraging firms to integrate vertically. In the case of this example, the manufacturer may realize it gains a competitive advantage if it expands to extract, refine, manufacture and sell the product. Its product would then be cheaper since it would only be taxed once, while competing products not vertically integrated would remain subject to the tax four times.

Stacking has a particularly negative competitive impact on small businesses that find themselves less able to integrate vertically.<sup>49</sup> That said, a gross receipts tax might offset other economic distortions associated with a sales tax.

Under the current system, services receive preferential treatment and distort individual actions when a comparable good is taxed while the service is not. For instance, hiring a tax firm to file your income tax return is a sales-tax free service, but purchasing software to file the return is taxed. Taking a skiing lesson is not taxable, but renting skis is. Hiring a landscaping service to mow your lawn would not be taxable but purchasing your own lawn mower would be. Ideally, economists would encourage as little distortion as possible by taxing all the various options at the same rate. A gross receipts tax would reduce this distortion, but the corrective effect might be offset by the distortions associated with tax stacking.

A gross receipts tax could diminish a state's competitiveness. Tax stacking could increase the price for local goods and services, encouraging consumers to look outside the state for options. The impact could be particularly influential on companies where physical location is not important, such as companies in business consulting or technological industries. However, if the state lowered the tax rate as it expanded the base, the impact might be mitigated.

A gross receipts tax would increase the number of necessary items taxed. Many items of necessity in Utah such as water, food, and residential fuel are exempted or taxed at a differential rate. Extending a tax to include necessary services such as medical services or housing services would cause similar concerns to the taxation of food and other basic necessities and likely remain quite unpopular among the public.

Gross receipt taxes also do not account for the profitability of a business. Certain industries, while selling a lot of product, have narrow margins.<sup>50</sup> As a result, their effective tax rate as a share of net income would be higher than for high-margin businesses under a gross receipts tax.

## Taxing All but B-to-B Transactions at the Same Rate

Utah could avoid much of the distortion associated with the gross receipts tax by shifting to a sales tax that taxes all non-business-to-business transactions. Taxing all non-business-to-business transactions expands the sales tax base to include all goods and services, while avoiding the economic distortions of tax stacking.

Based on 2012 estimates (the latest data publicly available), approximately 34% of sales tax revenues came from businesses.<sup>51</sup> If businesses were excluded from the tax base while at the same time expanding the sales tax to all final-consumption transactions, Utah's average combined state and local sales tax could be reduced to 2.1% from 6.2% and still produce the same amount of revenue.<sup>52</sup> The policy of sales tax applying to goods but not services is generally considered a reflection of the time in which sales taxes were first created. In the first half of the 20th century, the purchase of goods made up a more dominant portion of the economy. There is no broadly embraced economic or technical reason to exempt non-business-to-business services.

*Benefits and Drawbacks.* If a sales tax includes all transactions, it would be imperious to many of the trends of purchases shifting from goods to services currently eroding the state sales tax.

A sales tax, as opposed to a gross receipts tax, is much more transparent for the consumer. The amount paid in tax is clearly marked on the receipt or proof of purchase rather than hidden in the final cost.

A sales tax on all final consumption transactions also eliminates the current incentive to purchase a service over a similar good. Individuals would pay sales tax on both golf lessons and golf clubs, and on both a landscaping service and lawnmowers.

Potentially, taxing services can reduce the regressivity of the sales tax. If all non-business-to-business transactions are taxed, then individuals who tend to spend a greater share of their income on goods (generally those with lower incomes) will have a similar burden to those who tend to spend a greater share of their income on services (generally those with higher incomes). However, some difference in tax burden will remain based on the ratio of expenditures to income.<sup>53</sup>

Under this taxation regime, there would be more administrative complexity in some respects and less in others. There might be potential difficulty in separating out business transactions from consumer transactions. However, the state already has an exemption certificate system in place to cover exempt transactions and a sales tax refund program to reclaim sales taxes paid on exempted transactions.<sup>54</sup> One or both of these programs could be expanded to exempt business-to-business transactions.

While this might increase the regulatory burden on business, they would not need to pay a sales tax on business purchases. There would likely be a learning curve for businesses that provided previously untaxed goods and services. However, this group is likely limited to some degree. Many businesses that provide untaxed goods or services also provide taxed goods or services and would be familiar with the process.

Excluding business-to-business transactions from the sales tax base eliminates the distortions caused by tax stacking. In many ways, the state already attempts to

limit taxation of business-to-business transactions. A number of the products exempted from Utah's sales tax are the result of lawmakers attempting to ensure that taxes were not stacked. However, by exempting a product entirely, it means that end-consumers of that product might also not pay sales taxes. This contributes to the erosion of the sales tax base. Exempting all business transactions will eliminate the distortion while not providing tax benefits inefficiently.

Taxing services could leave Utah with certain competitive disadvantages in comparison with other states. If services in Utah were taxed, but none of the surrounding states had a tax on services, Utah consumers could change some of their service providers to other states. Haircuts are not an easy service to obtain from someone outside the state, while financial services can readily flow across borders. Such a competitive disadvantage could hurt Utah businesses as their customers seek tax-free out-of-state solutions.<sup>55</sup> The use tax should in theory require those buyers purchasing from out of state to pay the tax, but compliance with the use tax is low.<sup>56</sup>

There are a number of factors that could mitigate this impact. If Utah could effectively exempt or exclude business-to-business transactions, many companies would have lower operating costs, allowing them to keep prices competitive. In addition, if the broadening of the base were accompanied by a significant reduction of the overall sales tax rate, that competitive disadvantage for purchasing services would be at least partially mitigated. It might also be the case that a substantially lower rate might create a competitive advantage in terms of selling goods.

Again, extending taxes to include basic necessities such as health care and housing services would likely raise significant concerns among the general public. Including all non-business-to-business services in the tax base might also raise widespread resistance among the companies that were previously able to sell their services tax free. There are also potential complications of non-state businesses selling previously untaxed services in Utah. If exempted, it would provide an incentive for businesses to relocate outside of the state and sell their services into the state. If included in the tax base, compliance might be low due to unfamiliarity of state sales tax laws and not understanding that they would be required to collect sales tax.

One issue that would likely arise from excluding business-to-business purchase would be the individual use of businesses to purchase products or services for personal use. This might not include just the misuse of business exclusions but could include practices like the rise in company vehicles that allow individuals to sidestep the sales tax. The state might need more vigorous auditing practices to make sure business tax exclusions are not misused.

### **Taxing Services Piecemeal**

Another alternative is expanding the taxation of services on a piecemeal basis. This might allow services that are predominantly business-to-business to be excluded or exempted while including services that are more focused on the end consumer. Additionally, it might allow lawmakers to avoid services that would be quite unpopular to tax, such as housing or health care services.

*Benefits and Drawbacks.* Expanding services piecemeal might allow legislators

## The state could theoretically broaden its tax base by expanding taxation of services.

Figure 16: Estimated Increase Over Current Sales Tax Base

Sector	Base Expansion
Financial services	21%
Health care	44%
Housing and utilities	47%
Recreation services	14%
Other services	16%

Source: U.S. Bureau of Economic Analysis.

to expand the sales tax base in phases, choosing which services would be reasonable to tax and excluding services that are predominantly used in business-to-business transactions (such as advertising). This method might also face a lower level of political opposition because the tax would apply only to certain portions of the business community.

However, singling out certain services and leaving others untouched raises issues of fairness. It also keeps the door open to eroding the base through future exemptions.

Most of the benefits and drawbacks highlighted in the previous section stand true for this section. But to the degree that not all final consumption

services are taxed, many of the benefits mentioned above would be scaled back or non-existent.

Massachusetts and Michigan attempted to expand their taxable services in this fashion but ran into problems figuring out how to classify which services would be taxed and which would not. Both states relied on industry codes that normally classify types of businesses rather than the services they provide.

### Value Added Tax

In recent years, there has been increasing discussion about the U.S. adopting a value-added tax, or a VAT. This tax, rather than exempting business purchases, requires a business to pay a tax only on a fraction of the business input – the value added by just the seller. Another way of looking at the VAT would be to call it a fractional sales tax. The buyer pays sales tax only on the value added by the seller.

The VAT has been adopted by 160 countries. Europe countries employed it as a means of addressing the tax-stacking problems in previous tax systems. There are few examples of states adopting a VAT as a replacement or partial offset of the sales tax. The most prominent example is that of Michigan, which adopted and repealed the VAT twice, from 1953 to 1967 and from 1976 to 2006. Michigan used it specifically to replace the corporate income tax, which generated much more volatile revenue.

*Benefits and Drawbacks.* A VAT provides a broad base for revenue. The broader the base of any VAT, gross receipts tax or sales tax, the more stable revenues will be. Furthermore, the more that services are taxed under a VAT, the less regressive the system will be. Similarly, a broad-based VAT would provide many of the benefits and drawbacks of a broad-based sales tax that excludes all business-to-business transactions. Products would be taxed similarly, whether they be goods or services. As a result, goods could become more competitive in Utah while services could become less competitive.

One reason Michigan's VAT was unpopular among business owners was because of its administrative complexity. Eliminating unnecessary complexity is critical for any state considering a VAT.

The biggest drawback to a state-adopted VAT pertains to interstate commerce. Businesses, often unfamiliar with the VAT, protest what they understand to be a net income tax or a tax on labor costs, and have challenged the state apportionment methods. Michigan found itself subject to constant litigation along these lines.<sup>57</sup>

## **BENEFITS AND DRAWBACKS OF A BROADER BASE**

The primary benefit of taxing services is that it allows a broader tax base. A broad tax base generally provides a more stable source of revenue over the long term and allows a lower tax rate which tends to reduce the amount of economic distortion caused by taxes.<sup>58</sup> In addition, policies that extend the sales tax to all non-business-to-business transactions help “future-proof” the sales tax base. Future shifts from goods to services or vice-versa would not impact the sales tax base because both would be included.

There are concerns that levying taxes on services could lead to a higher overall tax burden for consumers.<sup>59</sup> In fact, that is one of the primary reasons behind a 2018 voter initiative campaign in Arizona proposing a constitutional amendment prohibiting the government from levying a sales tax on services.<sup>60</sup>

This concern may be warranted. When Massachusetts and Michigan expanded their sales tax base to include services, the primary reason was to raise revenue.<sup>61</sup> However, it is not necessarily the case that taxing services would lead to higher taxes. Naturally, if the government just included services as part of the sales tax base without lowering the rate, it would be a tax increase. However, legislation could easily be designed to make the change revenue-neutral or even provide a tax break by adjusting the sales tax rate accordingly.

Nonetheless, there is some truth to the argument that residents might end up paying more than they otherwise would have, even if the state passed revenue-neutral legislation. This would be a result of individuals’ tax liabilities slowly shifting toward previously untaxed service transactions as they become a larger part of consumer spending. In other words, it is not so much that taxes would increase, but the fractional tax reductions inherent in the current system would be removed.

Economists and organizations across the political spectrum promote broadening the taxable base.<sup>62</sup> The sticking point is that the expansion of taxes tends to be unpopular with the public. Proposed expansions of the tax base would also probably face significant opposition from industries not previously subject to the tax.<sup>63</sup>

**Economists and organizations across the political spectrum promote broadening the taxable base. The sticking point is that the expansion of taxes tends to be unpopular with the public. Proposed expansions of the tax base would also probably face significant opposition from industries not previously subject to the tax.**

## CONCLUSION

Utah's sales tax is the largest pool of unrestricted funds the Utah Legislature has to cover state-provided services. Starting in 1975, the sales tax revenues overperformed income and property tax revenues. However, that is changing with the increase in sales tax exemptions and shifts in consumer spending.

To address these changes, Utah has several choices. It can find ways to do more with less, scale back state-provided services, look to other revenue sources, repeal exemptions, raise the tax rate, or include more in the tax base.

If the state chooses to include more services in the tax base, it should recognize the change as a tax increase or lower the sales tax rate to produce the same amount of revenue. Expanding the sales tax to include all non-business-to-business transactions comes with a number of benefits, including removing economic distortions, future-proofing the sales tax base, reducing the level of regressivity of the sales tax, and making Utah's goods more competitive when compared with other states. It would also come at the cost of making Utah's services less competitive and increasing the amount of regulatory burden for businesses as they avoid paying the tax. Economists and policy experts on both sides of the aisle are in favor of including services in the sales tax base, but many states seem to be having a hard time implementing the change due to the political pressure of those who would incur the burden of the new taxes.

In the short term, keeping exemptions in check and looking for opportunities to reduce them might be the most manageable approach to shoring up the sales tax base. While arguments can be made for any exemption, the more they expand, the more upward pressure will come to bear on sales tax rates. Broadening the base, on the other hand, opens the possibility for governments to reduce the tax rate. This offers potential competitive benefits for Utah as a whole, but it is a matter of particular interest for lower-earning households, since they tend to spend a greater proportion of their income on taxable goods.

**This is the third report in Utah Foundation's Tax Policy Series. Part 1 examined property taxes; Part 2 examined the income tax. Find the whole series at [utahfoundation.org](http://utahfoundation.org).**

## ENDNOTES

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