To: Members of the Committee on Revenue

From: Mary Jane Egr Edson
Legal Counsel for the Committee

RE: LR 572 (Hadley) – Composition and Expansion of Sales and Use Tax Base[1]

Date: December 9, 2014

Nebraska's sales tax was originally established by passage of three separate bills in the 1967 Legislature. The tax focused on the final sale, at retail, of any item of tangible personal property or goods. Sales of certain services were specifically made subject to the tax by law. Services sold to the final consumer are not taxed unless specifically stated in the sales tax law. This structure is similar to that used in most of the other 45 states that have a retail sales and use tax. Nebraska was one of the last states to implement a sales tax, and its original structure appears to be the result of implementing what was well established policy in other states. Nebraska's sales tax contains the same exemptions and structure as most other states.

The 2006 Department of Revenue Annual Report contains one of the best overall descriptions of the sales and use tax:

> Nebraska sales tax is imposed upon the gross receipts from all sales, leases, or rentals of tangible personal property made at retail in this state and upon the gross receipts of selected services; gross receipts of every person engaged as a public utility or as a community antenna television service operator; the gross receipts from the sale of admissions in the state; the gross receipts of persons selling, leasing, or otherwise providing intellectual or entertainment property; and the gross receipts from the sale of warranties, guarantees, service agreements, or maintenance agreements when the items covered are subject to tax. Property is defined as all tangible and intangible property that is subject to tax in the above paragraph.

[1] The majority of this report was first published in the Report to the Legislature: LR155 – Nebraska's Tax Modernization Committee, December 2013.

All gross receipts from the sale of the items listed above are subject to the tax unless an exemption is specified by law. Conversely, services are excluded from the base and not subject to the tax unless they are specifically listed in statute.

Comparison of Taxable Services[2]

Historically, most states have not implemented a broad-based tax on services, with a few notable exemptions. South Dakota and Hawaii both have very broad service taxes. South Dakota taxes approximately 146 services, Hawaii 160, Connecticut 143, and Wisconsin 105. New Mexico, which uses a gross receipts tax on the retailer rather than a true retail sales tax on the purchaser, taxes 158 services. Washington State, which uses a Business and Occupation Tax, taxes 158 services.

Nebraska does tax a number of consumer and personal services, including labor charges for installation and repair when the item of property being installed, repaired, or replaced is taxable and is not annexed to real property. Nebraska has added a number of consumer and personal services to the tax base since 1967. Most have been done in an ad hoc manner with the exception of LB 1085 (2002) and LB 759 (2003) which added:

LB 1085

- Building cleaning and maintenance;
- Pest control;
- Security services;
- Motor vehicle washing, waxing, towing, and painting;
- Computer software training;
- Installation and application labor on tangible personal property if the sale of the property is subject to tax.

[2] All data used in this section is from the Federation of Tax Administrators, Survey of Services Taxation, Update, July 2008.

LB 759

- Recreational vehicle park services;
- Detective services;
- Repair and maintenance labor on tangible personal property, excluding motor vehicles;
- Animal specialty services; and
- Contractor labor.

The tax on contractor labor was modified in 2004 (LB 1017). Labor on residential or new construction was repealed in 2006 (LB 968) and commercial labor was repealed in 2007 (LB 367).

From a national perspective, Nebraska has done an adequate job in expanding its base to include consumer services. The Federation of Tax Administrators (FTA) published its first survey of sales tax on services in 1990. The report has been updated several times (1991, 1994, 1996, 2004, and 2007). Nebraska taxed only 49 services in 1996. By 2004 and 2007 the number had risen to 76 and 77, respectively. This puts Nebraska relatively on par with Kansas, Minnesota, Wisconsin and Wyoming, far ahead of Colorado, Missouri, North Dakota and Oklahoma, somewhat behind Iowa and far behind South Dakota, of course.

1996

	Utilities	Personal Services	Business Services	Computer Services	Admissions/ Amusements	Professional Services	Fabrication, Repair & Installation	Other Services	Total
Nebraska	14	6	6	3	11	0	5	4	49
So. Dakota	12	19	28	6	12	4	18	42	141

2004

							Fabrication		
		Personal	Business	Computer	Admissions/	Professional	Repair &	Other	
	Utilities	Services	Services	Services	Amusements	Services	Installation	Services	Total
Colorado	4	0	2	1	2	0	3	2	14
Iowa	13	15	18	1	13	0	14	20	94
Kansas	7	10	9	1	13	0	16	15	71
Minnesota	15	7	12	2	14	0	6	11	67
Missouri	8	1	2	2	11	0	0	4	28
Nebraska	14	8	15	3	12	0	13	11	76
North Dakota	6	1	4	2	11	0	1	2	27
Oklahoma	8	3	4	2	10	0	0	5	32
South Dakota	14	19	28	8	13	5	18	41	146
Wisconsin	11	11	7	3	14	0	14	14	74
Wyoming	10	6	7	3	7	0	16	13	62

2007

State	Utilities	Personal Services	Business Services	Computer Services	Admission/ Amuse	Professional Services	Fabrication, Repair & Installation	Other Services	Total
Colorado	4	0	2	1	2	0	3	2	14
Iowa	13	15	18	1	14	0	13	20	94
Kansas	10	11	9	1	13	0	15	15	74
Minnesota	15	7	12	2	13	0	6	11	66
Missouri	8	1	2	2	10	0	0	3	26
Nebraska	14	9	14	3	12	0	13	12	77
North Dakota	6	1	4	2	11	0	0	2	26
Oklahoma	9	3	4	1	10	0	0	5	32
South Dakota	14	19	28	8	13	5	18	41	146
Wisconsin	11	11	8	3	14	0	14	15	76
Wyoming	10	6	6	2	6	0	16	12	58

Survey of Studies and Reports

The article, *Characteristics of a Balanced and Moderate State-Local Revenue System* by Robert J. Kleine and John Shannon, focuses on several characteristics which are almost uniformly cited in most tax studies and academic research as the appropriate standards by which to analyze a state revenue system.

Characteristics was written in 1985 as one chapter in the book *Reforming State Tax Systems*, Edited by Steven Gold for the National Conference of State Legislatures (NCSL). In 1991, the Foundation for State Legislatures joined NCSL in publishing the first edition of *Principles of a High-Quality State Revenue System*. The report has been updated four times, most recently in 2001. Across all these reports, the basic characteristics of a "balanced," "moderate" or even "high-quality" revenue system have remained materially unchanged.[3]

Authors Kleine and Shannon emphasize three values:

- Balance or Revenue Diversification;
- Tax Fairness (shielding low income households from the tax collector's reach); and
- Moderation

Applying these values in terms of taxation of services, the authors note that taxing consumer services may make the tax less regressive, but that the most "progressive services," such as foreign travel and most personal household services are difficult to tax. The services likely to be taxed, dry cleaning, barber and hair salons, may not lessen the overall regressivity. The authors also note that as the service sector continues to grow faster than other sectors of the economy, taxing more services will improve the growth potential of the tax. Finally, they state that compliance and administration will be easier as those businesses that currently must separate taxable goods and exempt services will simply collect tax on the total amount.

[3] "Characteristics" had seven general guidelines, while "Principles" outlined nine guidelines.

There have been recent discussions about expanding Nebraska's sales tax base to include more services. The policy reasons for doing so have varied from using the additional revenue to lower property taxes to reducing or eliminating state income taxes. Another policy option would be to expand the sales tax base to more services and then lower the state sales tax rate to offset the inherent regressivity in the tax.

In terms of principles and characteristics, there are several considerations to be taken into account. First, adequacy of the sales tax. Consumer expenditure and demographic data indicate that consumers continue to purchase an increasing number of services than in the past. If a general sales tax is intended to be reflective of the economy, then the observation may be made that expanding the base to more services would increase stability and adequacy of the sales tax in Nebraska.

However, many of those services being purchased are not likely to be added to the base. In addition to foreign travel, which is not a service provided or consumed in the state and therefore incapable of being taxed at the state level, consumers continue to expend more income on health related services. If health care is viewed as a necessity, akin to food and housing, it is unlikely to be added to the general sales tax. Accordingly, the list of potential consumer services that could be added begins to dwindle, along with the potential for significant increases in revenue, stability or adequacy.

The most recent proposal to tax consumer services was LB560 (Cornett, 2011). The services to be taxed included:

- Repair or maintenance labor on motor vehicles;
- Personal care services, including hair care, personal grooming, skin care and nail care;
- Funeral services, including burial and cremation services;
- Dating services;
- Cleaning of clothing and other personal items;
- Storage of tangible personal property;
- Waste hauling, waste disposal, and recycling services;

- Motor vehicle parking;
- Landscaping services, yard maintenance, seed planting snow removal.

The fiscal note estimated the potential sales tax revenue from taxing these services as follows:

FY2011-12	$62,377,000	FY2012-13	$84,200,000
FY2013-14	$85,284,000	FY2014-15	$86,521,000

The second consideration is tax fairness. If, as Klein and Shannon observe, the services most likely to be taxed are those that are typically consumed by low-income households, adding these services does little, if anything, to offset the regressive impact of taxing those services. However, taxing goods purchased by low-income households, like clothing and utilities, while not taxing purchases of common consumer services, leads to inequities and a lack of balance in the sales tax base. Again, the mantra of "broad base and low rates" would imply that exempting consumer services continues to narrow the base and prohibits a state from lowering its rate.

Consumer expenditure data again shows that even during economic downturns, consumers do not restrain spending on services as much as they do on durable goods. As a result, the stability of the sales tax to generate adequate revenue is lessened. If adequacy, equity, fairness and stability are indicative of a "modern" system, then the observation may be made that the sales tax base be broadened to include more common consumer services.

Based on the generally accepted concept of avoiding pyramiding of the tax, principles and characteristics would argue against adding services that are exclusively or primarily purchased by businesses. Unlike tangible personal property, it is much more difficult to determine whether a service is being purchased solely as a business input or whether it is simply being consumed by the business as part of its costs. Further, there are certain services, such as motor vehicle repair, that would be very difficult to precisely delineate between a business purchase and a consumer service. The classic example is the pickup truck used for both business and personal purposes.

The observation to be made then is that it is desirable to avoid adding services to the sales tax base that are exclusively business to business purchases.[4]

For a comparison of services that are either subject to tax or exempt in Nebraska and its neighboring states, please see the attached spreadsheet.

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[4] See, *What's Wrong with Taxing Business Services*?, Council on State Taxation, R. Cline, A. Phillips and T. Neubig, Ernest & Young LLP, April 2013.

TAXABLE SERVICE	NEBRASKA	COLORADO	IOWA	KANSAS[1]	MISSOURI	SOUTH DAKOTA[2]	WYOMING
	State = 5.5%	*State = 2.9%*	*State = 6%*	*State = 6%*	*State = 4.225%*	*State = 4%*	*State = 6%*
	Local = 0 – 2%	*Local = 0 – 7%*	*Local = 0 – 2%*	*Local = 0 – 2%*	*Local = 0.5% - 6.625%*	*Local = 0 – 2%*	*Local = 0 – 4%*
Aircraft lease/rental			T	T		T	
Armored car services			T			T	
Assembly labor	T					T	
Bank and financial institution service charges			T			T	
Barber and beauty services			T			T	
Boat repair	T		T	T		T	
Cable/pay television fees	T		T	T		T	
Campgrounds			T			T	
Carpentry			T	T		T	
Carpet and upholstery cleaning/repair	T		T	T		T	
Clothing alterations			T	T		T	
Commercial recreation fees (golf and country clubs)	T, not membership		T	T		T	
Communications services	T		T, not Internet	T		T	
Computer software services	T, except training		T, except maintenance/support	T, if prewritten software		T	T
Contractor services						T, at 2%	
Dance school/studio fees			T			T	
Dating services			T			T	
Demolition			T	T		T	
Digital audio/books/audio visual	T					T	T
Dry cleaning			T	T		T	
Electrical and electronic installation	T		T	T		T	
Employment and executive search agencies			T			T	
Engraving			T			T	
Excavating and grading			T			T	
Extermination	T		T			T	
Flying service/instruction			T			T	
Freight/delivery charges	T			T, if direct mail		T	T
Garbage collection			T, nonresidential			T	
House/building moving			T			T	
Installation labor	T			T		T	T
Investment counseling			T			T	
Janitorial and building maintenance	T		T, nonresidential			T	
Landscaping, lawn care, tree removal			T	T, not lawn mowing		T	
Limousine service			T			T	
Lodging	T	T	T	T	T	T	T, except outfitters
Machine operator fees			T			T	
Massage			T, unless licensed therapist			T	
Office and business machine repair			T	T		T	
Oil and gas well site services							T
Oilers and lubricators on vehicles/machines			T			T	
Painting and interior decorating			T	T		T	
Parking facilities			T			T	
Pet grooming, boarding, breeding, training	T, unless by vet		T, only grooming	T		T	
Pipe fitting			T			T	
Plumbing			T	T		T	
Production labor	T				T	T	
Recreational vehicle park services	T						

TAXABLE SERVICE	NEBRASKA	COLORADO	IOWA	KANSAS[1]	MISSOURI	SOUTH DAKOTA[2]	WYOMING
	State = 5.5%	*State = 2.9%*	*State = 6%*	*State = 6%*	*State = 4.225%*	*State = 4%*	*State = 6%*
	Local = 0 – 2%	*Local = 0 – 7%*	*Local = 0 – 2%*	*Local = 0 – 2%*	*Local = 0.5% - 6.625%*	*Local = 0 – 2%*	*Local = 0 – 4%*
Reflexology			T			T	
Rental of equipment/personal property			T	T		T	
Rental of motor vehicle, recreational vehicle, boat			T	T		T	T
Repair of tangible personal property	T		T, certain types	T		T, not ag	T
Restaurants	T	T	T	T	T	T	T
Roof, shingle, and glass repair			T	T		T	
Security and detective services	T		T			T	
Services necessary to complete a sale							T
Sewage services			T, nonresidential			T	
Sewing and stitching			T	T		T	
Sign construction/installation			T			T	
Storage of household goods			T			T	
Storage warehouse of raw agricultural products			T				
Swimming pool cleaning/maintenance			T			T	
Tanning beds/salons			T			T	
Taxidermy	T		T			T	
Telephone services	T, only intrastate	T, only intrastate	T, only intrastate	T	T	T	T, only intrastate
Test laboratories			T, not human or animal				
Turkish baths			T			T	
Vehicle painting	T			T		T	
Vehicle repair (inc. motorcycle, bicycle)			T	T		T	
Vehicle wash/wax	T		T	T		T	
Warranties and guarantees	T			T			
Water conditioning/softening			T			T	
Weighing			T			T	
Welding			T			T	
Wood preparation			T			T	
Wrapping/packaging merchandise (not meat, vegetables)			T			T	
Wrecker/towing	T		T			T	

1. Kansas has an exemption for any taxable services that are performed in conjunction with original construction of a building, construction of a bridge or highway, reconstruction of building or utility structure damaged by natural disaster, or renovation of a residence.

2. South Dakota taxes all services, except the following: agricultural services, storage of ag products, ag machinery repairs, forestry services, advertising services, commissions, credit and credit counseling services, membership fees, radio and television broadcasting, rodeo services, services to a rural water system, water supply services except for irrigation, research and development services, financial services, sanitary services, security or commodity brokers, warranties, trucking and courier services, rail service, local transportation service, health services, educational services, and social services.

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