Sales Tax Exemptions

Another Viewpoint

A new threat to the stability of Arizona's already complicated sales tax system is the ongoing discussion of expanding the sales tax base through the elimination of exemptions.

The focus on sales tax exemptions began with press reports that characterized the exemptions as "loopholes." Such media reports on the issue were based on a report by the Arizona Department of Revenue entitled *The Revenue Impact of Arizona's Tax Expenditures*. Under A.R.S. §42-1005, the Department of Revenue is required to submit an annual written report to the Governor and Legislature detailing the estimated loss in revenue attributable to state sales tax expenditures.

If the underlying assumption of the *Tax Expenditure Report* is that the state has lost revenue as a result of these "exemptions," then many of the items should not be included since they have *never been subject to the tax since the establishment of the tax.*

Much of the controversy surrounding sales tax exemptions was based on a misunderstanding about the data in the Department's *Tax Expenditure Report*. Taken literally, the 1999 report suggests that the state loses $4.140 billion annually as a result of exemptions from the state sales tax. However, a thorough review of the report reveals that many of the items characterized as exemptions have never been subject to tax in Arizona and many others are clarifications of tax liability, as opposed to exemptions for activities that were clearly taxable.

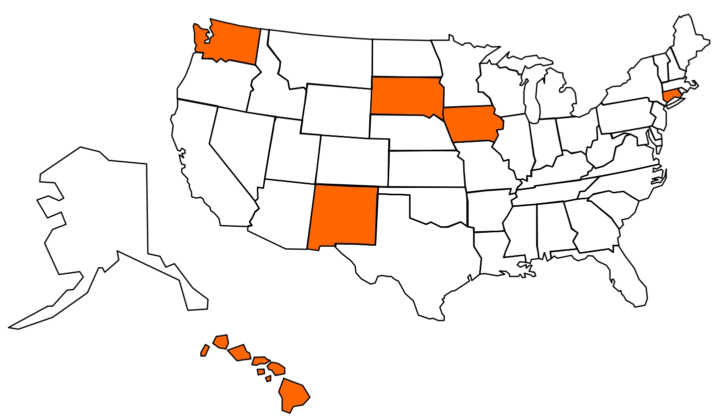
Note: This paper summarizes research by Arthur Andersen and ATRA, as presented by Chris Kelling, Arthur Andersen's Manager of State and Local Taxes, at ATRA's Outlook Conference in November, 2000.

What's a Tax Expenditure?

Under A.R.S. §42-1005, a tax expenditure is defined as "any tax provision in state law which exempts, in whole or in part, any persons, income, goods, services or property from the impact of established taxes including deductions, subtractions, exclusions, exemptions, allowances and credits." The report states that "Such provisions, when enacted into law, result in a loss of tax revenues, thereby reducing the amount of revenues available for state (as well as local) programs. If the underlying assumption of the report is that the state has lost revenue as a result of these "exemptions," then many of the items should not be included since they have ***never been subject to the tax since the establishment of the tax.***

Over half of the estimated $4.140 billion in exemptions are in the area of wholesale trade and services. The $2.643 billion from these two areas represent activities that have not been subject to tax since its inception. The report also estimates that $671 million is lost by

States Taxing Professional/Personal Services



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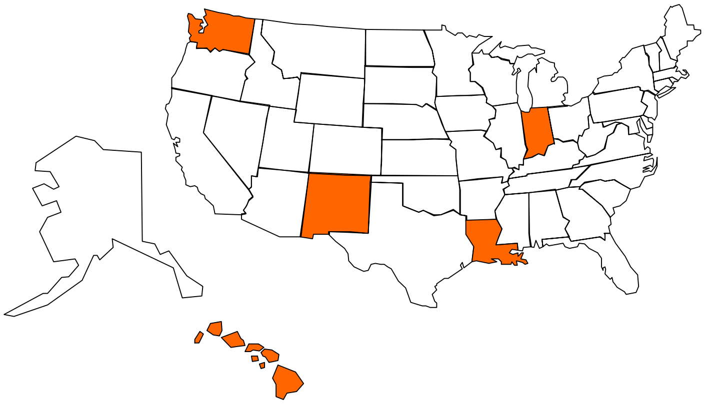
States Taxing Wholesale Transactions



exempting the tax on the sale of articles incorporated into a manufacturing process. The State of Arizona has never taxed raw materials involved in the manufacturing process, obviously due to concerns of double taxation.

In addition to the inclusion of items that have never been subject to the sales tax, the report also includes many items in disputed areas of taxation. Arizona's sales tax system is one of the most complicated in the country, disputes relating to whether an activity falls within one of the sales tax classifications are common. For example, construction contracting has been altered several times since the inception of the tax and continues to be a disputed area today. Legislative clarifications regarding the machinery and equipment exemptions are also the reason for some of the "exemptions" in statute. In most instances, disputes with the Department regarding the taxation of an activity can only be resolved through legislative clarification. While the affected taxpayers view the statutory change as a clarification of an activity that was never subject to tax, it is characterized as an exemption for purposes of the *Tax Expenditure Report.*

The report does include items that were clearly once subject to tax and are now exempt. Key examples include food (estimated at $243 million), commercial leases ($204 million) and advertising ($19 million).

National Comparisons

Looking at how the major sales tax "exemptions" identified in the *Tax Expenditure Report* compare to other states is instructive. Most of the major exemptions from the sales tax base are the same in Arizona as they are in other states. All but five states exempt wholesale trade, the largest dollar item in the report. Professional and personal services are also exempt in all but six states.

Another approach to compare Arizona's sales tax base with other states is through per capita sales tax collections. Arizona's current 5 percent sales tax rate is about average nationally: 13 states have the same rate while 16 are higher and 15 lower. However, even with an average state sales tax rate, Arizona ranks 8th nationally in per capita state and local sales tax collections. According to the Bureau of Census, sales tax revenue accounts for 50 percent of the "big three" revenues (sales, property, and income) in Arizona, ranking us 17th nationally. Contrary to the impression created in the press, the evidence suggests that ***Arizona has a broad sales tax base in comparison to other states***.

Final Points

Sales tax exemptions have to be viewed in a broad context. Many of the exemptions are critical to economic development and the state could potentially *lose* revenue if they were eliminated. As the *Tax Expenditure Report* prominently notes, "***There is no consideration of decreased demand as the result of higher taxes***" if the exemptions were removed. In addition, overall tax treatment for business should also be considered before eliminating perceived sales tax advantages. Arizona businesses pay some of the highest property taxes in the United States because of a classification system that shifts the burden from homeowners to business.

States Taxing Construction Labor