S.C. Sales Tax Reform FAQs

May 2019

What does this bill do?

As it did with its income tax reform effort, the House Tax Policy Review Committee seeks to create a **broader, fairer and flatter tax policy** that creates a modern, more stable and viable sales tax system. The bill expands sale taxes on certain services, adjusts the current exemption laws and seeks to achieve as a policy goal a sale tax rate of approximately 3%. The Committee recognizes that the myriad of variables may determine a 4% rate but nevertheless one lower than the current 6%.

What is the background to all this?

The House Tax Policy Review Committee was established by Speaker Lucas. The Speaker charged the committee to delve deeply into this state's various taxes, including sales and use tax, income tax, property tax, and related taxes and make recommendations that would modernize and rationalize those systems to make them **"broader, flatter, and fairer."** It is important to keep in mind of what the Committee's name is: tax *policy* review. The Committee's ability to step back and take a wide view of overall policy and specially to take a bold stance has enabled the Committee to open up the conversation on what might be possible. The committee took a wide view at the ten-thousand-foot level in looking at tax reform. ***These bills get the conversation started.*** What is good for the state? Is a 1950s tax policy working in a 21-century economy?

What do you mean by "broader, flatter, and fairer"?

Broader - The bill **broadens** the sale tax base by substantially expanding taxes on services, capturing more of the expanding service economy versus solely relying on a declining tangible goods economy. This bill seeks to modernize sales taxes. Our sales tax system a vestige of the 1950s, relying on a dwindling base of taxable tangible goods. Broadly taxing services develops long run revenue adequacy and helps in reducing year to year volatility.

We heard testimony from a number of experts who has presented to the committee **that our taxable base on tangible goods is declining and the service economy is expanding**. The percentage of sales that are taxable has dropped from about 50% in 2002 to 35% today. This is in part that the percentage shift of total personal consumption expenditures of goods vs services has changed: in 1930 it was about 57% and today it is about 33%. Generally, our sales tax base is considered to be "narrow." Of the states in the Southeast crescent only Virginia has a narrower sales tax base.

By broadening the base, it could be fairer - brick and mortar stores are at a disadvantage to sellers of services. **Taxing services broadly develops long run revenue adequacy and helps in reducing year to year volatility**. If we don't broaden the base, there will one day be pressure to raise the rate to maintain the current revenue level. In staff's conversations with people in North Carolina who were involved in their changes, they also noted the need to expand their base.

The primary issue for policy makers is that sales tax revenues are declining because of the state's dependence on decline of taxes from tangible goods -- a consequence of a changing economy.

Flatter - this effort flattens the rate from 6% to a range of 3% to 4% (likely more realistic is 3.5 to 4%). While more activities (services) are taxed, that tax would be less (3% approximately) on those new activities than what the rate is now (6%) and this then enables a rate reduction to 3 or 4% on the myriad of tangible items taxed now at 6%.

Fairer - granted, while a tax is imposed on services, it reduces the regressivity of the sales tax on lower income persons by lowering the rate from 6% to 3 - 4% and it could be argued shifts the taxation more to consumers for whom regressivity may be less of an issue.

Does the bill raise <u>or</u> lower taxes?

It does both. It raises taxes on certain services and changes some of the current exemptions. The overall goal of modernizing the system also has the policy goal to reduce the overall tax rate to about three to four percent (3% to 4%). It broadens the revenue base, reduces the structural price disparity between taxes and non-taxed goods, and adds stability and balance.

Do you change some of what are referred to as "exemptions" (Section 14)

Yes, the bill does. The Committee began by closely examining the exemptions. The common-sense problem was that until recently the exemption totals almost surpassed the amount of sales tax revenue. We examined many of these and also availed ourselves to the work of the previous Tax Realignment Commission (aka "TRAC") practices. TRAC: reduced the current rate from 6% to about 5.0%. **Could this Committee?** TRAC was able to suggest changes on the taxation on several major items that the GA has recently set policy on: gas, the cap on vehicles, and changed policy on certain major consumer items (electricity, food and medicines).

The bill as drafted (tracking what TRAC did) partially taxes electricity, food and medicines, but for the most part maintains to varying degrees the exemption on them. For example, the change in electricity exempts 75% of the amount (it would then apply 3% to the 25% the tax payer would be liable for. If your power bill was $150, you are taxed 3% on $37.50 (which comes to $1.12).

Upon close examination, the Committee recognized the importance of maintaining many of the exemptions since they were essential business inputs protecting agriculture and manufacturing production. The Committee sought to avoid tax stacking or pyramiding.

What are business in-puts and why are they important?

Business in-puts - the principle of not taxing goods at each stage of the manufacturing or agriculture process to avoid pyramiding - if they are taxed, this just raises the taxes on the consumer at a higher amount and affects business competitiveness.

Do you tax services and why?

Yes. Since there are a limited number of exemptions that can be repealed, only with taxation of services can the tax base be broadened and only with such a broadening can the overall rate be reduced.

How much money does taxing services raise?

It will depend on what the final determinations are made at Ways and Means, but it is possible that we are seeing a range of one to two billion dollars.

These suggested services represent approximately a $67 billion base in service related activities (note: the current sales tax base is approximately $82 billion and the exemptions base is $56 billion).

Where does this list of services come from?

They come from a Census Dataset which are listed under the North American Industry Classification System Codes (aka "NAICS") published by the Office of Management and Budget.

Did you change this services list?

Yes, we accounted for some business inputs and preferable tax treatments for the elderly and disabled, but mostly as a guiding effort.

How do you make all this work?
When would all this happen?
The bill accomplishes this by phase-ins/phase-outs of taxes on services and exemptions along with time-tables so that revenues are balanced out, a circuit breaker to halt this if certain estimated are not met and a trust fund to cover short-falls.

Section 21 - Phase-outs on exemptions (provides period for DOR to administer). Collections begin FY 21-22 at the rate of 5%, 4% in FY 22-23 and is fully implemented by FY 23-24 at 3%.

Phase-ins on services: Sales taxes on services (identified per the NAICS codes) begins in FY 20-21 with a year for DOR administration (identification and contact) and then a two-year phase-in of the rate: FY 21-22 "Test Year" first year of implementation (rate of 1%). Full implementation to 3% FY 22-23. (The revenues from the first year at 1% fund the Tax Reform Reserve Fund).

Overall goal: Lowering of overall rate to 3% by FY 23-24 (3% for ALL goods, services and former exemptions). The rate is reduced by a percent to 5% in FY 21-22 and then one percent each year over the last two years (FY 22-23, 23-24). Halving the rate to three percent would be a substantial and profound change. Taxes on tangible goods would be cut in half. Even if the final equilibrium point is 4% then two percent would be a substantial reduction and would also give policy makers the flexibility to perhaps (if revenue neutrality is less of an issue) use funds to rebalance other taxation issues.

This may help see it as a whole:

7/1/20-21: DOR goes to work on administration of the bill
7/1/21-22: Services are 1%, Sales Rate is 5%, and 66% of eliminated exemptions are left in place
7/1/22-23: Services are 3%, Sales Rate is 4%, and 33% of eliminated exemptions are left in place
7/1/23-24: Services are 3%, Sales Rate is 3%, and 0% of eliminated exemptions are left in place

Note: The ideal is that the exemptions are phased-down, by FY 22-23 the rate on sales tax on services rises to 3% and by FY 23-24 the overall sales tax rate falls to 3% (the policy target). This staggering provides for a built-in lag so that there is sufficient revenue to fund the overall rate reduction of 3% or a final equilibrium point based on revenue evidence and projections.

Section 18 (B)(1) Circuit-breaker: If the projected fiscal year's sales tax collection estimate is less than the last completed fiscal year, the rate reduction is halted.

> (B)(1) In addition to making its forecast of economic conditions, revenues, and recurring general fund revenue in this State pursuant to Section 11-9-1130, the Board of Economic Advisors shall make the same forecast except that the board shall assume that the reduction in the state sales tax and the elimination of sales tax exemptions that began on July 1, 2021, had not taken effect. This additional forecast must be made with each forecast required by Section 11-9-1130. If the April tenth

final forecast for the upcoming fiscal year is less than the same additional forecast, then the General Assembly shall appropriate from the fund an amount up to the amount of shortage and the scheduled reduction in the state sales tax rate must be delayed by one year. The scheduled rate reduction must be implemented the next fiscal year if the provisions of this section are met.

Section 18 (A)(1) and (2) Tax Reform Reserve Fund - a reserve fund of at least one half cent or not less than $500 million (this amount is approximately half a cent of revenue as of FY 19-20) and only may be appropriated to cover any loss of sales tax revenue resulting from a decreased sales tax collections. If unused, this provides a refundable individual income tax credit for tax year 2024. That is, if un-needed during or after the phase-ins, excess funds of more than $500 M are returned to the tax payer in the form of a rebate with the full amount rebated in FY 23-24. [**Section 18 (B)(2)]**.