

SALES TAXATION IN CONNECTICUT

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EXECUTIVE SUMMARY

Findings: Basic Structure of the Tax

Connecticut relies less on the sales tax than the national norm, though Connecticut's sales tax dependence is broadly consistent with the region. Connecticut raises 25.0 percent of tax revenues with the sales tax versus 31.2 percent in the average state. Further, approximately 35 states have local sales taxes, which are not employed in Connecticut. The State's standard 6.35 percent sales tax rate is below the median state and local sales tax rate of about 6.9 percent that is imposed across the country. The revenue elasticity is likely no more than 0.6, which means sales tax revenues grow much more slowly than the economy. The key reason is that the sales tax base falls relative to the economy over time, a pattern that exists across the country. The sales tax base breadth (defined as taxable sales divided by state personal income) appears narrower than the average state, but this may arise in part as buyers make many purchases out of state or online, since the definitions for what is taxable do not appear unusually narrow. Tax revenue elasticities have also been very volatile over the past ten years, indicating a relatively unstable tax.

Connecticut's sales tax structure is complicated in the sense that policy changes have been relatively frequent and a large number of tax rates are imposed. For example, most states have one or two sales tax rates while Connecticut has seven. Multiple tax rates require decisions both on whether the transaction is taxable and at what rate. The state has also adjusted the rate and the base frequently over the past several decades.

Finding: Intent to Tax Consumption

The sales tax is evaluated here as a levy on consumption in Connecticut. A wide range of 86 exemptions are included in statute to move the tax from a levy on all transactions to a base that is much closer to consumption. A consumption tax is imposed on final household purchases and not on intermediate purchases by businesses. Many of Connecticut's exemptions are for intermediate purchases, including, sales for resale and machinery for manufacturing. Connecticut also exempts sales where the item is shipped out of state, following the logic that the intent is to tax consumption in Connecticut and not sales to out-of-state residents and businesses. Both of these exemptions complicate the tax since they require different tax treatment depending on the purchaser in a transaction, but they are consistent with a tax on consumption and should not be seen as tax expenditures. Connecticut also imposes the use tax in an effort to collect tax on out-of-state purchases for consumption in the state.

As a general rule, intermediate inputs should be exempt from the Connecticut sales tax. Nonetheless, one estimate is that 35 percent of the State's sales taxes are currently collected on business-to-business transactions, which perhaps surprisingly, is a lower share than in many states. Taxation of intermediate purchases raises the cost of doing business in Connecticut, pyramids and therefore changes relative prices that affect consumption decisions, and potentially alters firm behavior

through means such as by encouraging vertical integration. On the other hand, tax evasion and higher compliance and administration costs can result if exemption for business purchases is allowed because of the difficulty of determining which transactions are for business purposes. Also, the state would need a revenue neutral sales tax rate greater than 8 percent if all intermediate inputs were exempt, though the necessary rate could be kept lower by expanding the base to more consumer goods and services. A significant rate increase could be politically difficult to achieve. Connecticut should continue to evaluate areas where intermediate purchases are being taxed to determine whether additional exemptions can be granted. In particular, goods and services that are almost exclusively sold to other businesses, such as employment agencies, should be exempted and exemption should be granted when taxation of transactions significantly alters business operations, through means such as causing firms to bring activities in house to avoid the tax.

Economists generally support taxing consumption as broadly as possible, though some consumption is exempted by states for reasons such as (1) reducing regressiveness of the sales tax, (2) compliance problems with the tax, (3) economic development/growth, and (4) political pragmatism. Nonetheless, these goals are often better achieved using other tax instruments and means. For example, vertical tax equity is better achieved by focusing on the individual income tax where fairness can be targeted to individuals. Allowing exemptions to achieve these other goals harms horizontal equity, requires a higher sales tax rate to raise any given amount of revenue, and changes people's consumption choices. The best policy for generating a specific amount of revenue from the sales tax is normally to tax consumption broadly at a low rate and allow as few exemptions of consumer goods and services as possible. Limiting additional exemptions of consumer purchases is the first step in creating a broad tax on consumption. The next step is to examine current exemptions of consumer goods and services to find areas where the base should be broadened to additional consumption. The report identifies some goods and services that are currently exempted and raises the issue of whether any of these exemptions should be eliminated. Examples are food for human consumption, the sales tax holiday, residential utilities and residential repairs and renovations. Connecticut should also continue to identify means of better imposing sales and use tax on purchases from out of state for consumption in the state.

Finding: Taxing the Changing Economy

The economy is constantly evolving and Connecticut needs to regularly analyze the tax structure to ensure that taxes are being imposed in a consistent, neutral manner. A key principle is that taxes should be levied the same on goods and services that are highly substitutable, regardless of the means or form in which they are obtained. E-commerce is one example, where it is important that tax is collected similarly on remote purchases and in-state purchases. Among the reasons are that in-state firms are disadvantaged, the tax likely becomes even more regressive, and tax rates need to be even higher to raise any given amount of revenue. Constitutional rulings limit the ability to enforce a collection responsibility on remote firms, but Connecticut should continue to seek ways to collect the tax in a more even manner, including working with other states.

The sharing economy is a second example where the goal should be to maintain neutral taxation regardless of the way in which households access or use goods and services. The sharing economy will continue to develop for some years and it is difficult to know all the forms it will take. Connecticut could take some additional steps to ensure similar taxation with the traditional economy, but this area must be monitored and changes made over the years as appropriate. Provision of digitized goods and services is another area where the state must stay current to ensure similar taxation of highly substitutable items, such as books and e-books. The best ways for businesses to produce goods and services are also in transition and these must be followed and taxes kept consistent to limit impacts on good business practices. Taxes on services provided by a parent company for a partially owned subsidiary are one specific example, though a practical rule must be in place. Another is the provision of refunds for default on private label credit cards. Restricting the taxation of intermediate goods and services will help restrain effects of the sales tax on the ways that businesses operate.

Policy Recommendations

The policy options include several areas where the tax base can be broadened to cover more consumption and narrowed to reduce taxation of business inputs. These are not intended to be all inclusive, but instead to evidence the type of base reforms that should be considered.

Policy Option 1: Reduce the number of sales tax rates. One rate is preferred, though the state may want to levy separate taxes on items purchased heavily by tourists, such as a hotel or rental car tax. A small number of rates is easier to comply with and limits the role that the sales taxes play in determining consumption choices. Connecticut can only have one general tax rate if it joins the Streamlined Sales Tax Governing Board.

Policy Option 2: Impose the sales tax on all food purchases, regardless of whether regarded as part of a meal. Purchases made with food stamps would remain exempt under any policy change. The sales tax is intended as a broad tax on consumption and should exempt as little consumption as possible to allow a lower revenue neutral tax rate and to limit the tax's impact on consumption choices. Tax equity should be achieved using other tax instruments, such as the personal income tax.

Policy Option 3: Eliminate the sales tax holiday. Arguments for this option are similar to Option 2.

Policy Option 4: Broaden the sales tax to more services used by consumers, including residential utilities and repairs to residential real property. Again, the sales tax is intended as a broad tax on consumption and should be structured with a base very similar to total consumption. Broader taxation of services could increase the sales tax elasticity if fast growing services are included in the base.

Policy Option 5: Reduce taxation of intermediate services and particularly employment and computer services. Many intermediate services are currently taxable, which is inconsistent with the intent to tax consumption, except in cases where the final good or service is not taxed. Taxing intermediate purchases raises the cost of doing business in Connecticut, likely alters relative prices as final products have supply chains of different length, and encourages vertical integration or bringing certain production in house. On the other hand, exemption of intermediate services

requires a determination of whether the buyer is a business or a final consumer. Employment and most computer services are likely purchased only by other businesses.

Policy Option 6: Legislate a less stringent ownership rule for exemption when services are sold between a parent and a subsidiary. Tax should not be imposed on business-to-business transactions. Exemption is particularly important in cases where business behavior is altered by tax treatment and sales between related companies could be limited by taxing the sales. Current practice limits exemption to cases in which the parent owns 100 percent of the subsidiary, which is a high standard and may limit efficient business practices. The parent should have substantial control and ownership of the subsidiary for this exemption, which suggests at least 50 percent ownership.

Policy Option 7: Eliminate the exemption for sales to charitable organizations except when the purchases are used to produce goods and services that are sales taxed when provided to beneficiaries, or add a requirement that the charitable organizations meet certain criteria evidencing that their work is in the public interest. Purchases by not-for-profit organizations should be exempt if the inputs are producing sales taxable final products, as should also be true for the for-profit sector. Exemption for other purchases that are not available for the for-profit sector subsidizes the buyers without any explicit decision on whether the use is in the broad public interest, encourages businesses to become part of the not-for-profit sector and narrows the tax base which requires higher tax rates.

Policy Option 8: Impose the sales tax on sales to government entities. Exemption for government purchases or sales subsidizes the public sector relative to the private sector. The after tax cost of purchasing inputs should be the same for both sectors so that decisions are made while facing the same relative prices.

Policy Option 9: Levy the sales tax on sales by government in cases where the public activities compete with the private sector, such as parking. See Policy Options 7 and 8.

Policy Option 10: Join the Streamlined Sales Tax Governing Board. Connecticut should continue to seek ways to ensure that sales and use tax revenues are collected on sales from out of state vendors to Connecticut residents. This helps level the playing field between out-of-state and in-state vendors thereby improving the Connecticut economy, increasing the horizontal equity of the tax, and increasing the revenue elasticity. Other means of improving collection of tax on purchases from out-of-state should also continue to be sought out.

Policy Option 11: Connecticut should continue to investigate and where possible legislate a more expansive definition of nexus. Good sales tax policy collects tax on remote sales to Connecticut residents. Collection from vendors is much more effective than through use tax compliance by buyers. The State should aggressively seek to use sellers to collect the tax wherever possible because few options are available for enhancing collection through buyers.

Policy Option 12: Use companies organizing the sharing economy for enforcement and remittance of the sales tax. Sales tax compliance should be organized to limit compliance and administration costs. Organizing companies such as Airbnb and Uber are in a better position to remit the tax sales tax than are individual service providers such as Uber drivers and homeowners.

Policy Option 13: Tax digitized downloads for consumption, such as books, video and music at 6.35%. Highly substitutable forms of consumption should be taxed similarly, so the digitized versions and the physical items should be taxed the same. This enhances vertical and horizontal equity, helps maintain the sales tax base, and creates a level playing field between the digitized and physical providers. The tax may be difficult to enforce on some vendors since they may not have physical presence in Connecticut. Difficult decisions may also be required to make determinations of what are taxable sales.

Policy Option 14: Ask the Department of Revenue Services to carefully review the sharing economy to ensure that consistent taxation is occurring between the sharing and digitized economies and traditional economy. Enact legislation where necessary to ensure that neutral taxation is occurring. The sharing economy should be taxed similarly to the traditional economy, particularly to the extent that they are highly substitutable, so that the two sectors are placed on a level playing field. The sharing economy is still developing so that it is early to make comprehensive decisions on the details of how to tax the entire sector. A comprehensive analysis should be conducted by the Department of Revenue Services over the next year to articulate current practice and appropriate changes.

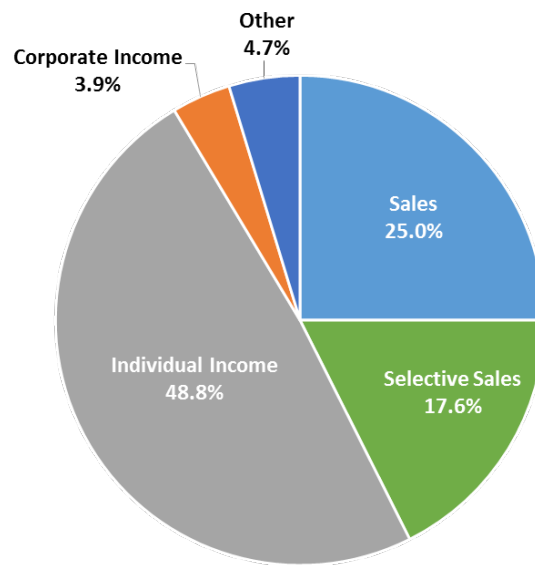
Policy Option 15: Allow a refund for the included sales tax when private label credit cards were used to finance a purchase that becomes a bad debt. The sales tax is intended to be imposed on paid consumption. The goods and services are obtained in cases where no payment takes place, such as home production or theft, but the sales tax is not collected. Default on private label credit card debt is another case where payment is not made and the State should not keep the sales tax. By statute, the tax is remitted by the vendor when the credit card is used for payment but the vendor and its associated financial institution are not provided with a refund. The firms lose the purchase price of the product but also effectively become the guarantor of the sales tax unless refund is made. This places the vendor at a disadvantage relative to other firms and potentially alters decisions on how credit cards are to be offered.

SALES TAXATION IN CONNECTICUT

I. INTRODUCTION

Connecticut is one of 45 states that employs a sales tax as a source of state tax revenue, having initiated the tax in 1947. The sales tax generated \$3.98 billion in 2014, or 25.0 percent of the state's tax revenues (see Figure 1). Connecticut's reliance on the sales tax is low on national standards though approximately the norm relative to the region (Figure 2). Sales taxes provided 31.2 percent of tax revenues in the average state.¹ Connecticut's use of the sales tax is in the middle of the region. Maine, Rhode Island and New Jersey generate a larger share of state tax revenue from the sales tax, and Massachusetts, New York, and Vermont raise smaller shares. New Hampshire is one of the five states with no sales tax.²

Figure 1: Percent Distribution of Connecticut Taxes



Source: <http://taxadmin.org/fta/rate/14taxdis.html>

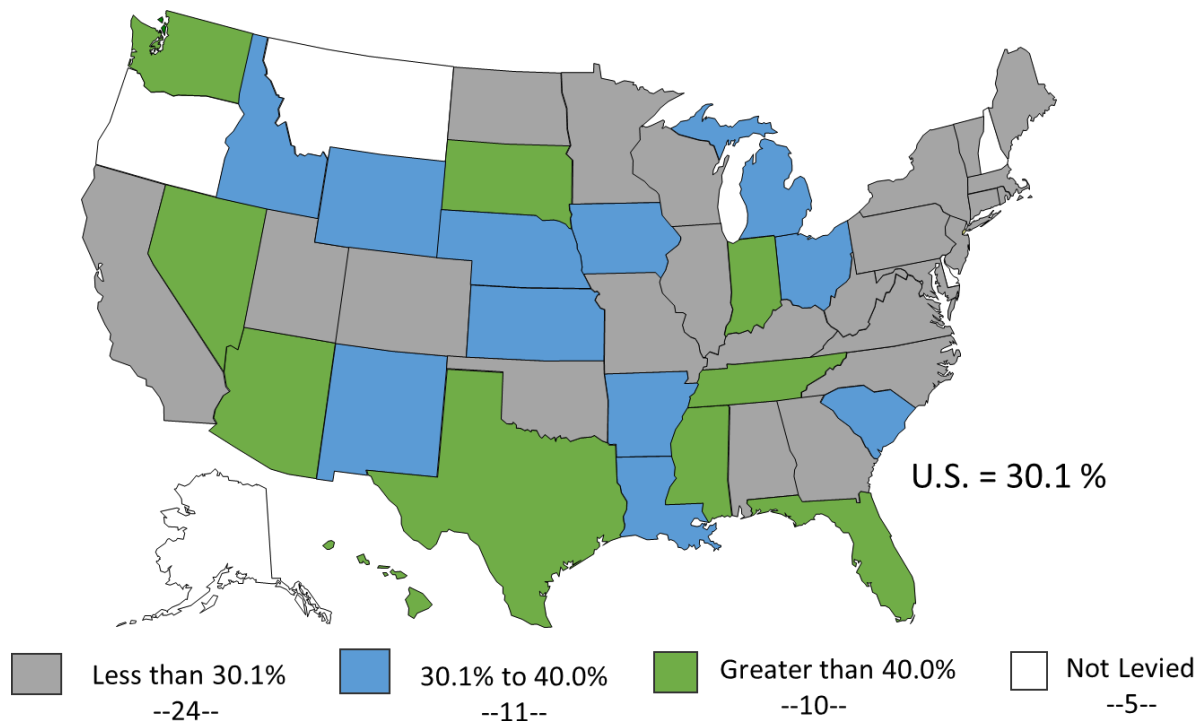
Economists use the concept of revenue elasticity to describe the relationship between revenue growth and economic growth. The elasticity is simply the growth rate in tax revenues divided by the growth rate in the economy (often measured by state personal income). Revenue elasticities differ over the long term and short run. Sales tax revenues have grown at a modest compound annual 2.4 percent

¹ See <http://www.taxadmin.org/fta/rate/14taxdis.html>

² Alaska, Delaware, Montana, New Hampshire, and Oregon do not have a state sales tax.

over the past decade. The growth rate is an even slower 1.8 percent when effects of the 2011 rate increase are adjusted out (even without accounting for base expansions that have occurred). By comparison, Connecticut's state personal income rose 3.3 percent over the past decade. Thus, a simple calculation of the rate adjusted revenue growth suggests a long run revenue elasticity of 0.57, which is very low. To make matters worse, the annual elasticities vary widely, ranging from negative calculations in three of the past 10 years to elasticities over 1 in others, suggesting considerable volatility in sales tax performance. The elasticities were particularly low in many years until 2010, and have been better during the past four years though this may be affected by the various base expansions. Bruce, Fox and Tuttle (2006) found higher revenue elasticities for Connecticut using a more sophisticated approach, but their work used data proceeding the decade applied for the above calculations.

Figure 2: State General Sales Taxes as a Percent of Total Taxes, 2013



This report to the Connecticut Tax Study Panel investigates six key aspects of the State's sales tax following this introduction. After this introduction, the report discusses the sales tax structure, including the sales tax rate and breadth of the sales tax base. Each is considered in the context of good sales tax policy and the sales taxes levied in other states. Third, some options for improving the tax base are addressed. Fourth, issues associated with taxation of remote sales, and particularly e-commerce, are discussed. Approaches used by states to address problems with collecting tax due on remote transactions are described and evaluated. Fifth, several topics related to the changing economy including taxation of the sharing economy and treatment of bad debt associated with private label credit cards are considered. Finally, how the sales tax affects economic activity is discussed.

II. TAX STRUCTURE

This section discusses Connecticut's sales tax rates, sales tax base and use tax. Each is placed in the context of sales taxes in the nation and the region.

Tax Rates

Connecticut imposes seven sales tax rates, not including the 0 percent rate. Thirty-one states have more than one sales tax rate, including Maine, New York and Rhode Island, but the extent to which Connecticut has multiple tax rates is unusual and few if any states have as many as seven tax rates. Connecticut's standard rate has been 6.35 percent since July 1, 2011. In addition, a 15.0 percent rate is levied on hotel rooms;³ 9.35 percent rate on the rental of motor vehicles for 30 or less calendar days; 10.0 percent for admissions (6.0 percent for movie theaters);⁴ 7.75 percent for vehicles costing more than \$50,000, other luxury items such as jewelry costing more than \$5000 and clothing and footwear costing more than \$1000; 4.5 percent for the sale of a motor vehicle to a non-resident member (or family member) of the armed forces stationed in the state; and 1 percent on computer and data processing services.⁵ Connecticut's standard sales tax rate rose several times in the 1980's. The rate was 7 percent in 1980, 7.417 percent in 1981, and 7.5 percent from 1982 until 1990 when it reached 8.0 percent. It was reduced to 6.0 percent when the personal income tax was adopted in 1992 and stayed at that level until 2011.

Connecticut's choice of rates appears to have several different motivations. One is intent to reduce regressiveness of the tax (such as the higher rates on certain luxuries and admissions). The rates also appear to be influenced by the intent to tax tourists more heavily (rental car and hotel rates) and by efforts to limit taxation of certain business purchases (computer tax rate).

The presence of multiple tax rates potentially raises compliance costs for vendors and creates confusion for buyers. Imagine a car dealer that needs to remit sales tax at one rate for low priced cars, a different rate for high priced cars, a third rate for cars purchased by non-resident military families, and then have the rate associated with parts and repairs. Other vendors, such as hotels, may also be subject to multiple tax rates. Indeed, individuals remitting the use tax (see below) may need to make payments at more than one tax rate.

Also, the high rate on expensive jewelry and clothing may not achieve the intended objective of taxing high income residents more heavily. It may expand out of state purchases of these items, and have less impact on sales tax revenues than would otherwise be anticipated. Further, multiple tax rates reduce the transparency for taxpayers who are unlikely to understand the large number of different tax rates with which they may be confronted. Finally, Connecticut would need to reduce the number of sales tax rates if it is to join the Streamlined Sales Tax Governing Board (see below). One rate is

³ Many other state or local governments add a separate hotel tax rather than impose a higher sales tax rate.

⁴ Admissions and dues are actually subject to the admissions and dues tax.

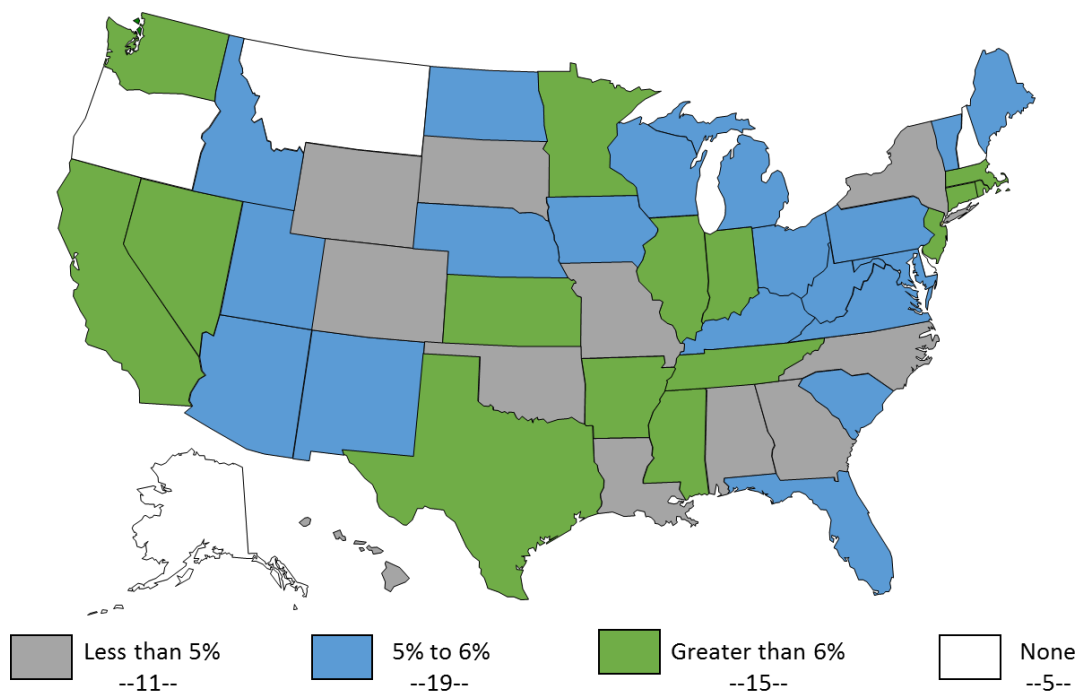
⁵ Legislation to increase the rate on computer services from 1 to 3 percent was recently repealed. Other recent changes include expanding the taxation of computer and data processing services to include creation, development, hosting, and maintenance of an Internet website and retaining the use tax exemption for computer services. See Teresa Callahan, *State and Local Taxes Weekly*, 07/06/2015.

preferred, though the state may want to levy a separate tax on items purchased heavily by tourists such as a hotel or rental car tax.

Policy Option 1: Reduce the number of sales tax rates. One rate is preferred, though the state may want to levy a separate tax on items purchased heavily by tourists such as a hotel or rental car tax.

Connecticut's 6.35 standard sales tax rate is slightly above the median state rate of 6.0 percent, and is essentially the median rate for the region (see Figure 3). Local sales tax rates are also levied in at least 35 states, though on average they generate only about 11.7 percent of local revenues. New York is the only state in the region where significant local sales taxes are collected. The national median combined state and local sales tax rate is about 6.9 percent, above the rate levied in Connecticut. Several neighboring states tend to have similar tax rates, with Rhode Island at 7.0 percent and Massachusetts at 6.25 percent. The average combined state and local rate in New York is 8.45 percent.⁶

Figure 3: State Sales Tax Rates as of January 1, 2015



⁶ See <https://thestc.com/states.stm>

Connecticut's Sales Tax Base

Approximately one-third of states levy their sales tax on buyers (though normally collected by sellers), one-third levy their tax on sellers, and the others use a mix of the two approaches.⁷ Connecticut imposes the sales tax as a privilege tax on retailers, lessors, and service providers, using gross receipts as the measure of the base. Sellers are entitled to add the tax to the purchase price and collect it from buyers.

Quantifying Connecticut's Sales Tax Base

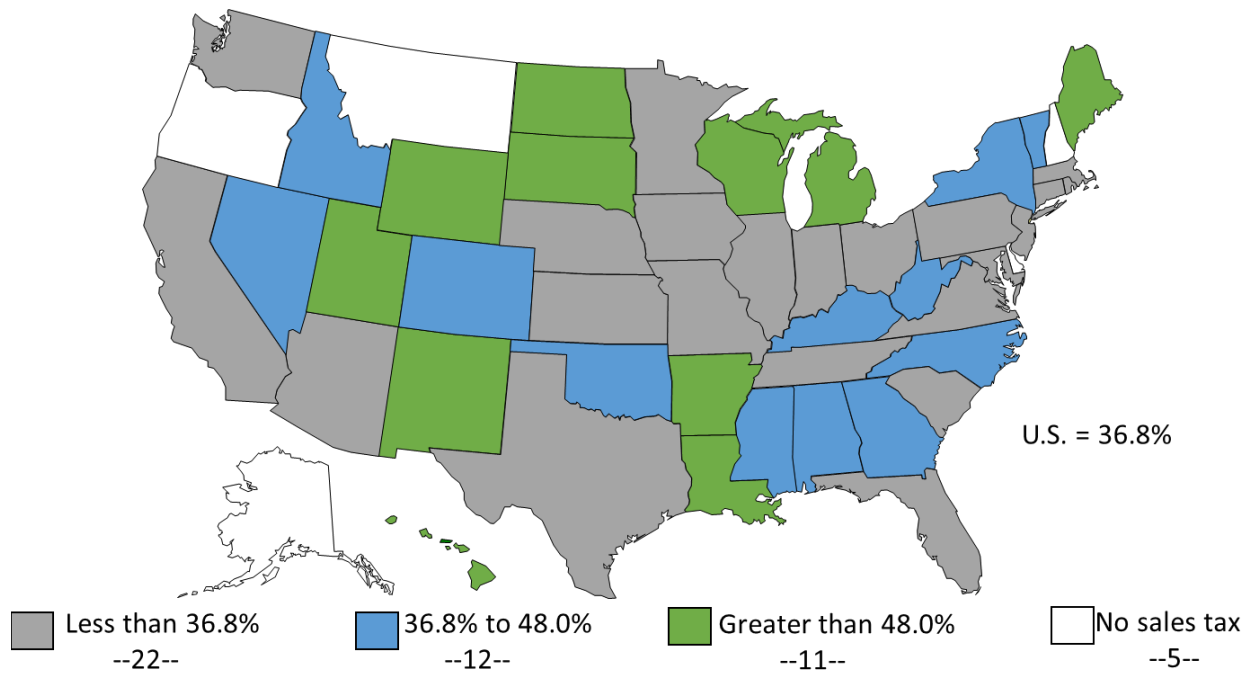
The character of every tax is determined by defining the set of taxable transactions. Comparing sales tax base breadth across governments is difficult because of differing consumption patterns, a very wide range of goods and services on which the tax can be levied, divergent definitions of specific goods and services in statutes, and so forth. The sales tax base as a percent of personal income is one comprehensive measure of the sales tax breadth that accounts for both the size of the economy and sales tax characteristics. Connecticut's base was 27.9 percent of personal income in 2012.⁸ The sales tax base as a percent of personal income has been falling in recent years. For example, Connecticut's base was 35.1 percent of personal income in 1990 and rose somewhat to 40.5 percent in 1999, but has fallen nearly every year since. Sales tax bases in other states have also generally shrunk over the past 35 years so this is not unique to Connecticut. Some explanations for the narrowing sales tax bases include legislative actions that have narrowed the set of taxable transactions, movement of consumption away from goods and towards services (many of which are not taxable, such as health care), and the shift of transactions towards remote commerce. For example, services represented 47.4 percent of national consumption in 1979 but had risen to 66.2 percent by 2012.

Connecticut's sales tax base calculation of 27.9 percent is smaller than the average states' 33.9 percent, suggesting a somewhat narrower base than national norms (see Figure 4). At the same time, Connecticut's taxation of services is more expansive than the average state's (see discussion below). This may be suggestive that Connecticut consumers make relatively more of their purchases in other states or online where the sales tax is not collected, because the calculation measures the collected sales tax base and not the legislated sales tax base. Some states, such as Hawaii (with a base over 100 percent of personal income), South Dakota and New Mexico have sales tax bases that are much broader than national norms. The northeast generally has narrow tax bases since all states except Maine, with a 38.7 percent ratio, have a narrower tax base than Connecticut's. Vermont has the narrowest base at 19.9 percent. The specifics of what is included in the bases can vary significantly across governments regardless of the apparent expansiveness of the base and this is discussed in more detail below.

⁷ See Due and Mikesell (1994).

⁸ The sales tax base is proxied by dividing sales tax revenues by the standard sales tax rate. Multiple tax rates and late payments are among the reasons why this calculation differs to some degree from the actual base.

Figure 4: State Sales Tax Base as a Percent of Personal Income, 2012



Connecticut's Sales Tax Base Calculations

The actual sales tax base for a business in Connecticut is measured by adding its gross receipts plus its expenditures for items on which its suppliers will not remit the sales tax. Thus, companies doing business in Connecticut begin their sales tax calculation by totaling their gross receipts from the sales of goods, leases and rentals and labor and services (see Form OS-114). Use tax related expenditures are added to this total. A wide range of 86 deductions are permitted from these totals. Some deductions are for intermediate purchases by businesses including:

- sales for resale⁹
- large trucks
- machinery used for manufacturing, commercial printing or publishing
- vessels and machinery used for commercial fishing
- some labor and services
- services between wholly owned business entities
- repair services.

⁹ Services must be for resale of a taxable service and must be an integral part of the resold service.

Businesses are also able to deduct sales to certain buyers including:

- out of state sales
- sales to charitable or religious organizations
- sales to federal, Connecticut or municipal agencies.

Further, receipts associated with certain types of sales are deducted including:

- food for human consumption
- prescription drugs
- trade-ins
- college textbooks
- renovation and repair to residential real property
- sales of electricity, gas, and heating fuel to residences
- aviation fuel.

In addition, cases where a sale may be deemed as never to have occurred, such as returns within 90 days of purchase, are exempt.

The Connecticut Department of Revenue Services *2013-14 Annual Report* lists the value of exemptions that businesses take based on Connecticut Gen. Stat 12-412. These exemptions totaled \$239.2 billion from the base defined at 6.35 percent tax rate and \$4.4 billion from the base defined at the 7.0 percent rate. The Department concluded that this reduced revenues by \$15.6 billion, nearly four times greater than the actual collections.

It is important to recognize that most of these exemptions are appropriate to establish the sales tax as a levy on consumption and are not forgone revenue relative to the proper sales tax base. Over 70 percent of the exemptions fit in two broad categories where tax should not be imposed. Approximately \$106 billion of the exemptions are for business-to-business sales and should be exempt. Sales for resale are a large part of the exemptions, but there are many others, such as machinery and sales of tangible property to farmers. Also, about \$66 billion of the exemptions are for sales of goods and services and labor and rentals out of state. Combined, these two sets represent about 72 percent of the total reported by the Department of Revenue Services. Both sets of exemptions are consistent with the intent to impose a tax on Connecticut consumers.

Use Tax

This report generally treats the sales and use tax as one tax, but this section is an exception by providing some detail about the use tax. The sales tax is generally evaluated as a tax on consumption and to achieve this objective states must tax transactions at their destination and not at their origin. This

has several implications. First, sales of items shipped out of Connecticut should be exempt from the State's tax, and this is achieved with the exemption mentioned in the previous section. Second, out-of-state purchases should be subject to Connecticut's tax, and this is the purpose of the use tax.

Connecticut and all sales taxing states levy a corresponding use tax, which imposes tax when sales tax has not been collected by Connecticut or another state or is collected at a lower rate in another state. Specifically, the tax is on "the storage, acceptance, consumption, or any other use in Connecticut of tangible personal property purchased from any retailer; the acceptance or receipt of tangible services; and the storage, acceptance, consumption or any other use in Connecticut of tangible personal property that has been manufactured, fabricated assembled or processed from materials by a person, either within or outside the state."¹⁰ Purchases are exempt from the use tax if they are exempt from the sales tax. The use tax liability is the difference between the tax paid to another state and the Connecticut liability if tax was paid to a state with a lower use tax. The Sales and Use Tax Return allows firms to include goods, leases and rentals and purchased services on which the use tax is due. Individuals can include their use tax liability with their income tax return or may submit the liability with a separate form. This is discussed further below. Connecticut collected about \$242 million from business use taxes in 2014.

The use tax is generally levied at the same rate as the sales tax. Use tax may be imposed at 1%, 6.35% or 7.0% depending on the transaction.

The best evidence is that use tax compliance is very poor relative to other state and local taxes. The State of Washington undertook random audits of a wide range of businesses every two years from 1996 to 2010 and found that noncompliance with the use tax is the greatest of any state tax paid by business, at between 23 and 25 percent.¹¹ Consumers are believed to have much lower compliance with the use tax except for items that must be licensed such as vehicles. Low use tax compliance explains much of the revenue loss from e-commerce that is discussed below.

Guidelines for Defining the Sales Tax Base

As noted above, the taxable base determines the character of every tax. Economists evaluate sales taxes as levies on consumption, but actual sales taxes often deviate from the standard in a number of ways as will be discussed here.¹² Characteristics of a broad consumption tax are:

- All household purchases should be taxed. All purchases of goods and services by households are consumption and belong in a consumption tax base.¹³
- The tax should be imposed regardless of the vendor. Sales tax should be collected on the sales of both for profit and not-for-profit entities if the goal is to tax all consumption since the tax is intended to be on the consumer rather than on the seller. The argument then is that subsidies

¹⁰ See Commerce Clearinghouse State Tax Guide, 41,101.

¹¹ See for example http://dor.wa.gov/Docs/Reports/Compliance_Study/compliance_study_2010.pdf

¹² Robert Cline, Andrew Phillips and Thomas Neubig, (2013) estimate that only 24 percent of consumption is taxed. Sales tax bases are generally larger shares of personal income because many business inputs are also taxed.

¹³ Durable goods consumption is spread over multiple years so an adjustment could be made for the timing of when consumption occurs relative to when the item is purchased, but this adds significant compliance difficulties.

for not-for-profit vendors, should they be desired, could be legislated directly through the appropriations process and not through tax subsidies.

- The tax should be imposed regardless of how the purchase is consummated. The tax should be levied on all purchases to be consumed in Connecticut regardless of whether purchased in Connecticut, bought via cross border shopping, or purchased via the Internet or mail order. The mode of purchase does not alter whether the purchase is for consumption.
- Tax should be imposed on consumption in Connecticut, meaning taxes should be levied on items brought into the state for consumption and out-of-state sales should be exempt.
- The tax should *not* be levied on any business-to-business transactions. Businesses purchase to produce and do not consume (even if the input is used up in the production process). Households purchase to consume and do not produce.¹⁴

This ideal consumption tax system offers many advantages. The broad base permits a low rate for any given amount of revenue to be raised.¹⁵ Further, it spreads the tax burden evenly across all consumption so that taxes are levied in proportion to consumption. The consumption tax structure has no effect on the relative prices of different goods or services so it does not encourage the purchase of one set of items relative to another. Further, the taxes would not alter business behavior.

Other Goals for Setting the Tax Base

No state fully follows the consumption tax prescription for a series of political, administrative, fairness, and economic reasons. For example, all states tax many business purchases and exempt a number of consumer purchases (with the possible exception of Hawaii). Many allow exemption for certain purchases by or sales by not-for-profits. The ability to impose tax on remote sales and cross border sales is limited by Constitutional restrictions and administrative feasibility, and so forth. Still, the criteria listed above are a standard against which Connecticut's tax structure can be compared.

A series of goals may cause states to narrow their sales tax base relative to a tax on all consumption. Several of these are briefly discussed below.

Fairness. Fairness is an important goal in setting tax structures. Connecticut's sales tax, as in all states, is regressive, particularly when measured against current income. For example, the Institute for Taxation and Economic Policy found that in 2015 households in the lowest 20 percent of the income distribution pay 4.6 percent of income in general sales taxes and households in the upper 1 percent pay 0.6 (see Figure 5).¹⁶ The Department of Revenue Services also analyzes incidence of the sales and use tax relative to current income (measured by Adjusted Gross Income).¹⁷ The tax is found to be regressive,

¹⁴ Of course, self-production occurs in households when they perform services that they otherwise would purchase. Sales tax is seldom imposed on these activities, though it may be levied on inputs used in the production (such as paint for the walls, etc.).

¹⁵ Of course, taxation of intermediate inputs also allows a lower tax rate, but creates other problems.

¹⁶ See <http://www.itep.org/pdf/whopaysreport.pdf> The analysis assumes full forward shifting of the sales tax to consumers and attempts to account for both tax on intermediate inputs and on final sales to consumers.

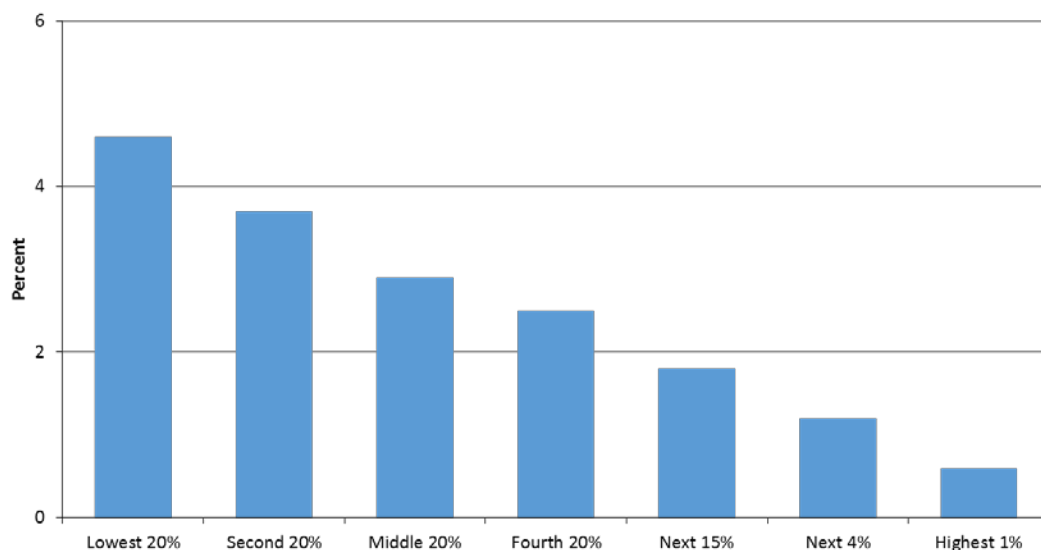
¹⁷ See "Connecticut Tax Incidence," Connecticut Department of Revenue Services, December 2014.

with households in the lowest decile paying 5.81 percent of income in sales taxes, households in the 5th decile paying 1.56 percent of income in sales taxes, and those in the top decile paying 0.17 percent. The study concludes that the average household pays 1.7 percent of income in sales taxes.

The regressiveness of sales taxes arises from several factors including: (1) failure to tax some purchases, such as professional services, that may not be as regressive in consumption, (2) very high consumption relative to income for households at the bottom of the income distribution, and (3) higher savings relative to income by higher income households.

Also, the tax structure is less regressive when the tax is compared with lifetime income rather than current income (as is done in the ITEP report).¹⁸ The idea is that some of the sales tax's regressivity arises because households are being evaluated at different times in their life cycle. Younger families may have high spending relative to their income (regardless of their income) as they equip a house and make purchases for their children. And, their incomes may be relatively low as they are early in their careers. These very same households may have relatively lower sales tax payments later in life as less additional expenditures are required to furnish the home and the children have grown up. At the same point the household's income may have risen. The regressivity in this case is associated partly with life cycle and not with household wellbeing. Lifetime income is a measure of what households can expect to earn in some average sense over their life and helps distinguish between differences based on stage of life and on overall income.

Figure 5: Sales Tax as Percent of Family Income, 2015



Source: ITEP.

¹⁸ See Fox (2006) for discussion of differences in incidence between current and lifetime incidence.

Connecticut appears to be using two approaches to reduce regressivity – exempting items purchased more heavily by low income households and imposing higher rates on items purchased more frequently by upper income households. ITEP’s estimates indicate that fairness is not achieved if the intent is to avoid a regressive tax. It is difficult to target fairness objectives with the sales tax because the tax is collected by vendors when transactions take place and not from means-tested buyers. Exempting food for consumption at home, for example, offers some tax reduction for low income households, but their purchases with food stamps would already be exempt. In all likelihood, most of the actual tax reduction accrues to higher income households and tourists. Neither of these groups is likely the target of the exemption. Higher tax rates on luxury goods may reduce regressivity, but it may lead to more online purchases or cross border shopping where the tax often cannot be collected, meaning the intended objective is not achieved.

Presumably fairness goals are focused on overall tax payments relative to income rather than on the liabilities associated with specific taxes, such as the sales tax. This perspective allows the income tax to be used to achieve the desired overall tax fairness without distorting the sales tax structure with intent to improve equity. Income tax liabilities can be structured directly on the household and its overall demographics rather than using a poorly targeted sales tax change to achieve the goals. Difficulties of using the sales tax exemptions to improve equity are discussed more below in the section on exemption of food.

Limit effects of taxes on the location of production and sales. Some types of consumption can be difficult to tax because of evasion/avoidance through cross border shopping in Massachusetts, New York or another nearby state or by shopping on the Internet. Such concerns always exist, but the relatively small size of Connecticut and the nearness of several other states enhance the problem. The use tax is due on many of these purchases but Connecticut’s capacity to enforce the tax is limited, particularly on individuals. Many large ticket items are easily purchased outside Connecticut and shipped in for use without the tax being collected. Services produced from outside Connecticut and items purchased online are examples where tax avoidance may be particularly easy and where attempts to tax the class of goods or services could significantly harm economic activity located in the state because the tax can only be collected on sales of some items when purchased from in-state sellers. In the extreme the tax could only be collected from domestic firms, making it hard for Connecticut firms to compete inside the state. Thus, the capacity to evade tax by purchasing elsewhere, and the resulting negative effects on production in Connecticut, must be taken into account when selecting the tax base. At the same time, this argument can be used as an excuse to tax favor certain businesses or industries, so considerable care must be taken in allowing exemptions for this purpose.

States are often inclined to exempt certain goods and services to encourage their production and purchase in the state. Sales tax holidays are such an example but the case is often made for exempting other goods and services. States are generally better off to avoid efforts to engineer economic performance by tax favoring one industry and set of products relative to another. Sales tax holidays are unlikely to achieve an improvement in the state’s economy and are discussed more below. The tax can become a levy on consumption purchased from Connecticut producers because the tax is not collected on sales out-of-state or on purchases from out-of-state. The general approach should be on keeping the base broad by enforcing the tax on purchases from out of state. Exemptions should be considered in only the most extreme cases where production in Connecticut becomes a large problem.

Related exemptions are given to encourage particular behaviors. Exemptions are given for purposes that the legislature wants to encourage, of which the exemption for weatherization purposes is an example. The other side is when higher tax rates are legislated to discourage consumption, such as is done with tobacco products and has been talked about in other states for sugary drinks. Even in cases where broad agreement might exist that the encouraged expenditure is laudable, such exemptions narrow the tax base and require a higher revenue neutral tax rate. Such policies also shift the tax system from its main purpose of raising revenues to regulatory functions.

Keep compliance and administrative costs low. Compliance and administration costs could be very high in collecting the tax on some goods and services. For example, some services are produced by very small providers or the costs of separating business buyers from consumers could be high. On the other hand, exemptions often require decisions on taxability based on the buyer (not-for-profits and governments), the use of the product (food versus meals), or location (in-state and out-of-state). As a result, exemptions raise the compliance and administration costs and expand the opportunities for evasion or misreporting of the taxability of transactions.

Relatively little is known about sales tax compliance costs but some data are available from PriceWaterhouseCoopers (2007), which estimated that sales tax compliance costs were 13.5 percent of tax revenues for small retailers, 5.2 percent for medium retailers, and 2.2 percent for large retailers. Bruce and Fox (2013) find the vast majority of e-commerce firms are small, suggesting significant compliance costs for these firms. These may not be sufficient reasons to exempt transactions, but are arguments for care in designing the structure.

III. ALTERNATIVES FOR IMPROVING THE TAX BASE

This section discusses some changes to the tax base that would make it more consistent with the consumption standard provided above. These include eliminating exemptions for certain consumer goods and services and some possible changes in the base to reduce taxation of business purchases. Expanding the base to currently exempt buyers is also addressed. The section does not raise all possible reforms, but discusses reforms by example. The tax base must be routinely re-evaluated because the economy is evolving and types and forms of consumption are changing.

Reducing Exemption of Goods

Connecticut's base is narrow on consumers compared with the standard described above and could be expanded, but narrowed further on business purchases. Further, Connecticut's tax base has been shrinking over time as consumers purchase more non-taxable services and more remote purchases and when more exemptions are legislated. Several strategies can be used to reverse the pattern of narrowing tax bases. The first strategy to ensuring a good tax base is to avoid the seemingly continuous process, at least in some states, of expanding the set of exemptions. Thus, an important way to keep the base broad before worrying about potential expansions is to avoid new exemptions of consumer goods and services. Exemption of the tax on food was enacted in many states during the past decades and

several states have expanded their exemptions for clothing in more recent years. This does not mean that no further exemptions should be granted, but further exemptions should be based on the criteria listed above (and the additional criteria below).

Second, Connecticut can broaden its base by either eliminating exemptions for consumer goods or identifying additional services to tax. This is not an argument for bigger government. A broader tax base with lower tax rates is very good policy, even if revenues are held constant. Economists generally lean towards taxing the broadest set of consumption purchases (as in the criteria above) at the lowest rate, but other factors, such as administrative and compliance capacity, should be considered in the detailed decisions on what to tax. Thus, decisions on whether to expand the base often must be made on a case-by-case basis rather than applying across the board determinations regarding whether each category of goods and particularly services should be taxable. Ultimately, the best structure requires judgments that may vary across governments and these judgments often lead to structures that differ from a true consumption tax. Connecticut defines its base with limited exemptions for goods purchased by individuals. Two examples of such exemptions are given to illustrate how the base could be expanded. Of course, such expansions can often be politically difficult to enact. Other exempt goods include prescription and non-prescription drugs, children's car seats, motor fuel, and residential weatherization products.

Food for Consumption at Home

Connecticut, like 31 states, exempts food for consumption at home from the sales tax.¹⁹ In Connecticut the general approach is to exempt food but then impose the tax on certain meals.²⁰ The exemption results in a narrower tax base, higher rates for any given amount of revenue that is raised, and additional volatility in revenues collected (since consumption of food is more stable than overall consumption). The exemption also requires decisions on what food constitutes a meal and is taxable or is exempt. The Department's Annual Report indicated that \$402.4 million was forgone by exemption of food. Of course, the actual potential revenue gain from expanding the base may be smaller since some people may choose to shop in neighboring states or to make some purchases online if Connecticut chose to tax food for consumption at home.

Exemption of food is normally justified on vertical equity grounds – to keep low income people from bearing tax on necessities – and because of the political benefits of granting exemptions. However, the benefits of exempting food are very poorly targeted to low income households since all households, including tourists, benefit from the lack of tax. Exemption of food only makes the sales tax less regressive to the extent that low income households spend a larger share of their income on taxable food than high income households. Many low income households receive food stamps, which are exempt throughout the country based on federal policy meaning the state exemption does not provide additional benefits for low income households buying food in this fashion. Further, much of the other tax savings accrues to higher income households or non-residents when they purchase food in Connecticut. Food could be taxed and low income households compensated with credits against the personal income tax (which in practice is a reduced income tax for lower income households not a sales

¹⁹ See <http://www.taxadmin.org/fta/rate/sales.pdf>

²⁰ Alcoholic beverages are specifically excluded from this exemption in Connecticut.

tax exemption) or a smart card could be provided to low income households to use as payment of sales tax on food purchases. Exempting food for consumption at home raises compliance and administration costs since it requires additional decisions to be made. No neighboring state taxes food, so Connecticut retailers would be placed at a disadvantage relative to its neighbors if food was taxable.

Exempting food creates a number of undesired distortions and costs. For example, horizontal equity is likely worsened since households with the same level of consumption pay more tax if they purchase meals as opposed to food. Decisions must be made on what are taxable meals and what is exempt food. Purchasing meals is discouraged, which harms restaurants and others while food purchases are encouraged. A higher tax rate is required to generate any given amount of tax revenue, which creates many distortions such as encouraging more efforts to buy out-of-state without sales tax included for items that remain taxable and to purchase non-taxable items in-state.

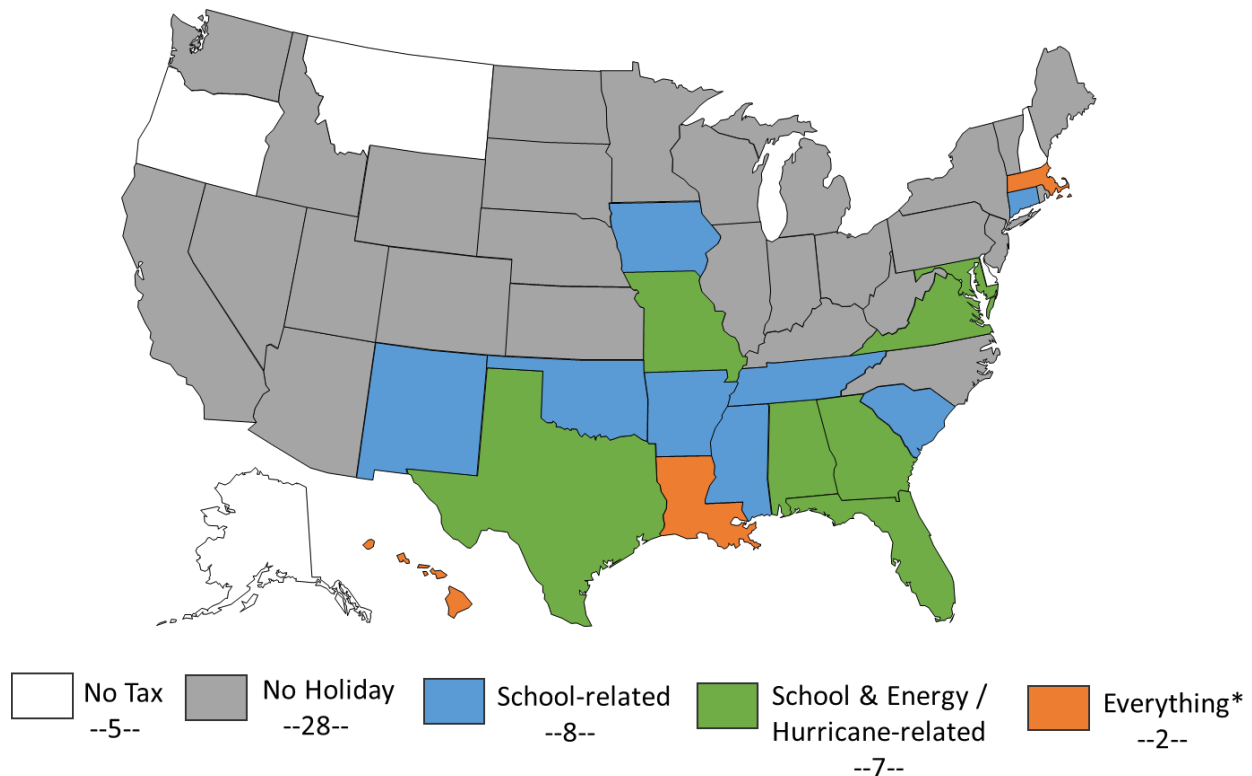
Policy Option 2: Impose the sales tax on all food purchases, regardless of whether regarded as part of a meal. Purchases made with food stamps would remain exempt under any policy change.

Clothing and Footwear Sales Tax Holiday

Connecticut is one of 18 states that allows a sales tax holiday and along with Massachusetts is the only state north of Maryland with a holiday (see Figure 6). Connecticut allows a one week sales tax holiday in August for clothing and footwear costing less than \$100. The exemption amount was reduced from \$300 to \$100 this year and the complete exemption of clothing and footwear costing less than \$50 was eliminated. The 2013-14 Annual Report estimated the sales tax holiday reduced tax revenues by \$5.2 million. Reduction in the overall exemption of clothing and footwear, as was enacted earlier this year, is good policy and a better policy would be to eliminate the holiday entirely. Tax holidays are generally justified as a way to enhance vertical equity and stimulate the economy. In fact, tax holidays are unlikely to achieve these objectives and are generally weak policy because they:

- Are poorly targeted to low income households since they are widely available to all buyers. High income buyers, with greater capacity to time their purchases during the holiday, may make many of the purchases so the perceived regressiveness of the tax may not be improved or even be made worse.
- Are more likely to change the timing of purchases than the total amount of purchases. People purchase during the holiday in lieu of before or after the holiday, but the total amount of purchases may be unchanged. So, the Connecticut economy is not stimulated.
- Are more likely to result in higher profits for vendors than lower prices for buyers. For example, vendors may advertise the sales tax holiday rather than offer a back-to-school sale.
- Raise administration and compliance costs since they change practices for the brief period of time during the year.

Figure 6: States with Sales Tax Holidays, 2014



*Louisiana has 3 holidays: 1) hurricane prep; 2) hunting supplies; and 3) all tangible personal property.

Policy Option 3: Eliminate the sales tax holiday.

Imposing Tax on Additional Services

A consumption tax is levied on consumer services as well as goods, though services are less frequently taxed around the country. Connecticut is relatively expansive in taxation of services. A survey conducted by the Federation of Tax Administrators in 2007 lists Connecticut taxing 79 of 165 services, which is well above the national average of about 50 services.²¹ The state has added more taxable services since 2007.²² Connecticut taxes more services than any state in the region. New Jersey is second highest at 74 services, followed by New York (57), Vermont (32), Rhode Island (29), Maine (25), and Massachusetts (18). Connecticut's broad taxation of services is generally good policy.

States often consider adding additional services to the sales tax base, particularly when revenues are tight or during a recession. Some extensions have been made across the country over the past several decades, but the issue often attracts more discussion than action. Florida's brief experiment with a major expansion of the base in 1986 has been widely discussed. Other states, such as South Dakota and Texas, have made relatively significant expansions and many other small expansions have

²¹ See <http://www.taxadmin.org/fta/pub/services/services.html>

²² Also see the list of taxable services at <http://www.ct.gov/drs/cwp/view.asp?a=1477&Q=269930&drsPNavCtr=>

been enacted. Connecticut, Florida and Rhode Island are among the only states that have extended the sales tax to additional services since 2010, though frequently to limited services. Florida imposed the tax on telecommunications services linked to convention centers and civic centers and Rhode Island is now taxing non-veterinary pet care services. Connecticut's changes are more expansive including manicures, pedicures, spa services, intrastate livery services, coin operated and other car washes and others. But, services remain broadly exempt in most states. Professional services, health care services, business services, and certain personal services are commonly not taxed in many states.

As with goods, the focus should be on taxing services used by consumers rather than businesses. Some services, such as legal and accounting services, are frequently purchased by both businesses and individuals so broadening the base to these services may expand the extent of taxes levied on intermediate transactions or carefully crafted exemptions must be used to limit taxation of business purchases of the services. Care must be taken in expanding taxation of services without appropriate exemptions for business purchases. Exempt services frequently purchased by consumers in Connecticut include:

- Renovation and repair services to residential real property
- Marina service and towing
- Travel agents
- Residential utilities, including electricity, water and natural gas
- Barber shops and beauty parlors
- Doctors, nursing, dental and other health care services
- Bowling and billiards
- Automotive road and towing services

Broad taxation of sales to final consumers improves horizontal equity of the tax, reduces tax induced changes in behavior, allows a lower tax rate for any given amount of revenue to be raised, and often is easier to comply with because fewer decisions need to be made on whether the transaction is taxable. Further, the revenue elasticity could be increased if fast growing services are added to the base. Of course, this is in part an argument for taxing some health services. For example, residential utilities would generate \$238.9 million and renovation of residential property would generate \$28.0 million based on the Department of Revenue Services' estimates.

Policy Option 4: Broaden the sales tax to more services used by consumers, including residential utilities and repairs to residential real property.

Exempting Intermediate Purchases

Business inputs (which are everything a business buys for its operations) should be free from taxation or at least taxation should be limited wherever possible. Taxing business inputs encourages vertical integration, raises the costs for businesses operating in Connecticut, and distorts prices to the extent that differential input taxes (because of differences in the length of supply chains) cascade into

final product prices. Differing taxes included in product prices can alter decisions on what to buy and therefore make people worse off. The economic effects of taxing intermediate goods and services are discussed in some detail below.

Some intermediate transactions will remain taxable in practice despite the general intent for exemption. First, a strong case can be made for taxing intermediate purchases when the final sale is not taxed, such as with many health care services (such as dental services).²³ Taxing the intermediate inputs effectively results in partial taxation of the final sales. This is also a reason why many states have not allowed the same sale for resale exemption for producing services that generally exists for goods. Second, a common problem is that identifying business purchasers is difficult since sellers are being asked to determine taxability based on characteristics of the buyer, which opens up opportunities for evasion and raises compliance and administration costs. Taxation of some intermediate transactions *may* be necessary because of the difficulty of determining whether the buyer is a consumer or a business. Certain professional services, such as legal services, may be examples where determining whether the transaction is for business or personal purposes is simply too difficult to allow exemption for the sales (should it be included in the taxable base). On the other hand, the case for exemption of some services may rest in part on the difficulty of determining whether sales are for intermediate purposes. Finally, intermediate goods may have been exempted because of the political difficulty of explaining why household purchases are taxable and business purchases are not. Or, the related political issue that taxes on intermediate inputs are less transparent and the revenue neutral statutory tax rate on household purchases alone would be politically very difficult to achieve. Connecticut's sales tax rate would need to be at least 8 percent if all intermediate inputs were exempt and the same revenue was to be collected. Broadening the base to additional consumer goods and services while reducing taxation of intermediate transactions could allow for a revenue neutral tax rate that is lower than 8 percent.

Many intermediate purchases, such as sales for resale, are specifically exempted as discussed above. Connecticut exempts many business services as well, some of which may also be used by households. Exempt services that would often be used by business include most fabrication, installation and repair services, professional services (legal, architecture, accounting, and engineering services), and business services such as advertising.

Other intermediate purchases that should be considered for more limited taxation include:

- Employment services and agencies
- Computer services
- Lobbying and consulting services
- Business analysis and management services provided by a general partner to a limited partner

Policy Option 5: Reduce taxation of intermediate services and particularly, employment, consulting and computer services.

²³ Economic research on optimal tax structures also allows for taxation of intermediate inputs as an exception to the general case of their exemption when the final product is not taxable.

Connecticut's exemption for services between a parent and wholly owned subsidiary makes sense, but consideration could be given to reducing the ownership requirement below 100 percent since good business practices could result in subsidiaries being owned by several partners. The parent should have substantial control and ownership of the subsidiary for this exemption based on ownership, which suggests at least 50 percent ownership.

Policy Option 6: Legislate a less stringent ownership rule for exemption when services are sold between a parent and a subsidiary.

Taxing Sales and Purchases by Not-For-Profit Organizations

Businesses are one example where exemption arises based on the buyer, but others exist as well. States vary in their tax treatment towards the purchase and sale of goods and services by not-for-profits. These firms are of two types, philanthropic (such as food banks) and service providing (such as hospitals). Exemption of non-profit organizations is usually based on the expectation that they provide goods and services that benefit society, such as helping low-income individuals or delivering services that the public sector would otherwise provide. Service providing firms often sell a service, similar to for-profits firms. The tax exemption is effectively a subsidy to not-for-profit organizations, which can be questioned despite the benefits that many not-for-profits offer. Several points are made here for the Tax Panel to consider with the possibility of recommending tight restrictions on when not-for-profit purchases are exempt and allowing very few cases. First, a stronger case exists for exempting purchases by not-for profits (as is done by Connecticut) than sales by not-for-profits. Purchases by non-profits should be exempt if they are producing and selling goods and services, just as they should be for for-profit firms. Also, a case can be made for exempting purchases where substantial benefits to the public are expected from the non-profits activities. The case is weaker for exempting sales by not-for-profits because the tax is intended to be levied on the buyer not the seller. Exemption of sales to not-for-profits and taxation of sales by not-for-profits parallel good practice and the general treatment of profit making businesses.

Second, exemption of sales to not-for-profits is a subsidy if the firm is not selling goods and services. Direct cash subsidies could be provided by the public sector rather than the indirect subsidies through the tax system, which would allow the State to more carefully evaluate the benefits of each subsidy. Third, exemptions of the sales by not-for-profits advantage not-for-profits in their direct competition with for-profit firms. Hospitals are a case where the state generally does not collect tax on the sales of goods and services. Very few states tax health care services, but this exemption could extend to gift shops, cafeterias, parking lots and other activities that are more peripheral to the main purpose of the hospitals. A report found that four for-profit higher education institutions recently shifted to not-for-profit status to avoid the regulatory structure of the for-profits.²⁴ Tax treatment may also have been a factor, though this is not the focus for the research. Founders of the schools potentially benefit in other ways, though users of goods and services provided by not-for profits may receive many of the benefits through lower prices since the evidence is that sales taxes are reflected in higher consumer prices. Exemptions for the sales by not-for-profits explain part of the rapid expansion of the not-for-profit

²⁴ See "Research Raises Questions about Colleges that Shift from For-Profit to Nonprofits," *Chronicle of Higher Education*, Mary Ellen McIntire, October 6, 2015.

sector relative to the for profit sector in the U.S. Fourth, not-for profit firms determine the size of the subsidy by their level of activity rather than the State determining the size of any subsidies through its budget process. Specifically, not-for-profits have a 6.35 percent subsidy on their purchases and the more they purchase the bigger the subsidy. Fifth, not-for-profit firms receive the subsidies even if the State's population does not value the services since no direct evaluation is taking place of the benefits of the not-for-profits. Next, compliance costs rise because sellers must discern determine which sales are exempt, and these decisions raise the potential for fraud and abuse. Finally, imposing taxes on not-for-profits can ensure they face similar after tax prices when making decisions as do for-profit firms.

Connecticut recently eliminated exemptions for non-metered parking spaces of 30 or more at not-for-profit hospitals. This is an example of the type of exemptions that Connecticut should continue to identify and eliminate unless a strong public policy case can be made for their retention.

Policy Option 7: Eliminate the exemption for sales to charitable organizations except when the purchases are used to produce goods and services that are sales taxed when provided to beneficiaries, or add a requirement that the charitable organizations meet certain criteria evidencing that their work is in the public interest.

Taxation of Federal, State and Local Government Purchases

The case for exempting purchases or sales by government is similar to not-for profits. Most states do not tax sales to state and local governments.²⁵ Exemption provides an additional opportunity for fraud as sellers report sales for taxable purposes as sales to governments. Ensuring the governments and their consumers face the same after-tax prices as purchases from for-profit businesses is an important reason to consider sales taxing the public sector similarly to the private sector. Connecticut cannot tax federal government purchases, but likely can tax the revenues received by firms that sell to the federal government (as some other states such as New Mexico do). Imposing the tax on government sales and purchases levels the playing field to the extent that they compete with the private sector. The tax also causes governments to face the same after tax input prices as the private sector, which can help ensure that efficient decisions are being made throughout the economy. Exemption further subsidizes government delivered services. The Department's Annual Report lists exemptions for government sales as \$13.7 billion. Of course, taxing government purchases collects tax revenues that must then be used to pay taxes on government purchases so there is little or no revenue generation to the overall public sector.

Policy Option 8: Impose the sales tax on sales to government entities.

Policy Option 9: Levy the sales tax on sales by government in cases where the public activities compete with the private sector, such as parking.

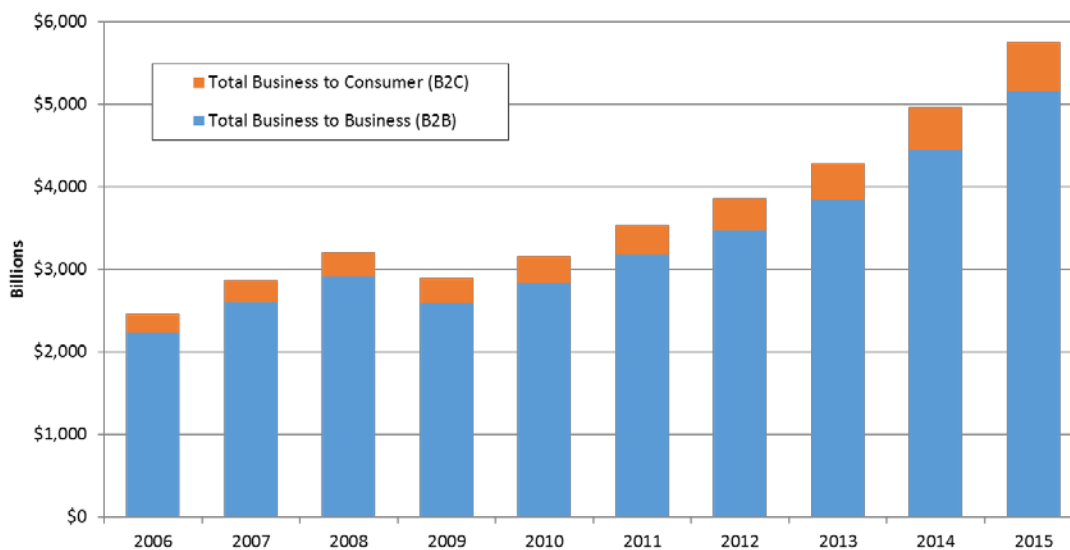
IV. THE SALES TAX AND E-COMMERCE

²⁵ Due and Mikesell (1994) report that eight states impose tax on sales to state and local governments.

The sales tax and the corresponding use tax are generally intended to tax sales at their destination, where consumption occurs, rather than at the origin of the transaction. The advent of e-commerce together with other remote sales including via catalogs and cross border shopping creates significant challenges for Connecticut and other states in enforcing the tax on a destination basis. This section focuses on e-commerce, but cross border shopping (driving to Massachusetts, New York, Rhode Island and other states and bringing purchases back or having them shipped back to Connecticut) is an unusually large concern given the relatively small space and the other states' close proximity.

E-commerce has expanded rapidly over the past 15 years and has become a significant and growing share of the remote sales problem. The U.S. Census Bureau reports that e-commerce sales totaled \$1.06 trillion in 2000 and grew at a compound annual rate of about 14 percent through 2013 when they reached \$5.14 trillion.²⁶ Figure 7 illustrates the rapid growth in e-commerce. About 87 percent of e-commerce sales are made by manufacturers and wholesalers, with retailers and service firms accounting for the rest. Most, but not all sales by manufacturers and wholesalers are intermediate transactions and some sales by retailers are to other businesses, so intermediate sales probably dominate e-commerce.

Figure 7: Estimated Total E-Commerce Sales



*Sales-taxing states only.

State efforts to collect tax on remote sales are limited by *Quill v. North Dakota* (504 US 298 (1992)), which only permits states to require vendors with physical presence in a state to collect and remit its sales tax. The result has been lost sales and use tax collections, distortions in the ways that businesses operate, and changes in consumer behavior. For example, Bruce, Fox and Luna (2009) in a widely quoted report estimate that state and local governments lost a combined \$11.4 billion in sales tax collections in

²⁶ Author's calculations based on data taken from <http://www.census.gov/econ/estats/2013/all2013tables.html>

2012 because of the inability to collect tax that is due on e-commerce transactions. These losses do not include catalog sales and cross border shopping in other states. States were unable to collect about \$23 billion when catalog sales are added to e-commerce, but this still omits cross border shopping. In some more recent analysis they find that the loss for state and local governments likely will exceed \$17 billion in 2015. Connecticut is expected to lose over \$100 million in uncollected sales and use taxes in 2015. Nonetheless, it is important to remember that most tax on e-commerce sales is collected, perhaps over \$300 million in total for Connecticut during 2015. The tax is collected on many remote sales because the selling vendor has taxable presence in the State, but much remains uncollected as well. B2B and B2C catalog, TV and other remote sales are also expected to result in significant revenue losses.

The inability to enforce sales/use tax collection on many online purchases is expected to alter how some sales are consummated and to change some business practices. A key conclusion is that the higher the sales tax rate the greater the incentive to make online purchases where tax is not collected. This provides a strong incentive for a broad sales tax base and a low rate. Several academic papers have determined that remote purchases are very responsive to the inability to collect the sales tax. The inability to collect the tax effectively means the tax rate is 0 percent on certain purchases versus the 6.35 percent (or one of the other rates) that is imposed on purchases in Connecticut.²⁷ The papers generally find a “home state effect,” which means buyers have a tendency to purchase more from firms (even e-commerce firms) with in-state presence than otherwise would be anticipated, all else equal. Still, the sales tax creates a tendency to buy more remotely than would be expected, particularly in states with higher sales tax rates. Ellison and Ellison (2009) only analyze online purchases of memory sticks, but find that a one percent sales tax rate increase raises online purchases to evade the tax by 6 percent. Einav et al. (2013) study a wide range of purchases through EBay and find that every one percent increase in the sales tax rate raises online purchases by almost 2 percent and reduces online purchases from in-state sellers by over 3 percent.

Anecdotal evidence shows business behavior is altered by current sales tax enforcement limitations. Amazon and at least some other firms appeared to be selecting locations only after careful consideration of the implications for nexus, and to plan corporate structures in an effort to avoid nexus for online retail firms. One example is decisions by Amazon to locate distribution centers in South Carolina, Tennessee, and Texas but only after agreements were reached to limit sales tax collections, at least for a period of time. More recently Amazon appears to be accepting nexus in an increasing number of states as it alters its business model. Amazon, after collecting for only five states for several years, is collecting for at least 16 states. In one research paper on the subject, Bruce, Fox, and Luna (2015) examined the determinants of the states where firms establish nexus and concluded that firms are more likely to create nexus in larger states (consistent with the home state effect observed by Ellison and Ellison and Einav et al.) and to some extent less likely in states with higher sales tax rates.

Russo (2005) examined effects of extending the sales tax to Internet sales. He finds that state economies would be slightly larger and the level of wellbeing higher if all Internet sales could be taxed. Presumably this is because the incentives to avoid the tax by purchasing out of state via the Internet are

²⁷ The online purchasing option often allows buyers a zero tax alternative. Shopping in neighboring states offers the other state’s rate on many purchases unless the item is shipped to Connecticut. So, the online channel is often more intense tax competition than the neighboring states.

eliminated. The result is also consistent with the conclusion that low sales tax rates are better for Connecticut's economy because it reduces the incentive to buy outside.

Efforts to Enhance Collection of Sales Tax on Remote Sales

Efforts have been made both in Congress and in a number of states to expand sales tax collections on remote sales. The court ruled in *Quill v. North Dakota* that requiring remote vendors to collect and remit the sales tax would hamper interstate commerce because these firms would be subject to an undue compliance burden. Specifically, the decision, made prior to e-commerce and current technologies, was heavily based on the argument that the costs for remote vendors to comply with the sales tax in multiple jurisdictions were greater than the compliance costs for local firms in a single state. The PriceWaterHouse Coopers report also finds that costs of complying with the sales tax in multiple states exceeds the cost in a single state, though with some economies of scale. This section discusses federal and state efforts to expand the capacity to collect taxes on remote sales. Federal legislation or reconsideration of the *Quill* case by the Supreme Court are the only ways to make large headway in allowing states to enforce the sales tax effectively on remote commerce, though other options are also discussed here.

Federal Activity

Congress can regulate interstate commerce, so it can enact legislation that allows states to require remote firms to collect the tax. Three bills to extend state nexus to at least some remote sales were introduced in Congress during 2011,²⁸ the Marketplace Fairness Act of 2013 was introduced in 2013 with 23 sponsors in the Senate and 48 in the House of Representatives and several more bills were introduced in 2014 and 2015. An advisory vote taken in the Senate in 2013 passed 75 to 24 to allow states to collect tax on remote sales. Subsequently, several procedural measures passed in the Senate by strong margins and the Senate passed the Marketplace Fairness Act 69 to 27. The bill was never introduced in the House and died.

The Marketplace Fairness Act would have allowed states that adopt the simplification criteria built into the Streamlined Sales Tax Agreement or that enact a set of specified simplification steps to require remote vendors to collect their sales tax. The simplifications included:

- providing firms with advance notification of sales tax rate changes
- using a single tax collection agency for both state and local sales taxes
- creating a uniform sales tax base for the entire state
- using destination sourcing
- providing free sales tax compliance software
- relieving remote sellers of any liability associated with incorrect compliance because of errors made by a certified software provider.

The legislation included a small seller exception that only permitted states to impose the compliance responsibility on firms with at least \$1.0 million in *online U.S.* sales. Bills that have been introduced more

²⁸ The Main Street Fairness Act (S. 1452, 112th Cong., 1st Sess. (2011); H.R. 2701, 112th Cong., 1st Sess. (2011)), the Marketplace Fairness Act (S. 1832, 112th Cong., 1st Sess. (2011)), and the Marketplace Equity Act (H.R. 3179, 112th Cong., 1st Sess. (2011)) were all introduced.

recently raise the small seller exception (for example, to \$10 million), at least in the initial years. Even a \$1.0 million small seller exception leaves out significant remote sales, though the various proposed pieces of legislation require aggregation of businesses based on ownership relationships. Bruce and Fox (2013) concluded that there are millions of e-commerce firms and fewer than 2000 would have been covered by the Marketplace Fairness Act Of 2013. For example many bricks and mortar retailers that have significant sales may not have a collection responsibility for their e-commerce activity because their online sales are below the threshold.

Passage of federal legislation would generate significant new revenues for Connecticut, but likely much less than the \$100 million estimated loss mentioned above (see Bruce and Fox, 2013). It is important to remember that the loss estimates were not intended as a revenue estimate associated with a particular bill in Congress. First, the small seller exception limits the collection responsibility for many firms and provides an incentive for firms to plan their structures to avoid the collection responsibility. More than one-third of the revenue loss will likely continue because of the small seller exception alone (even at \$1.0 million). Second, non-compliance can remain an issue. The approaches to enforcing any piece of legislation have not been articulated but they could hamper the states to some extent. For example, who would audit online firms operating in multiple states? How would people alter their behavior towards either non-compliant firms, or firms below the threshold? Thus, state budgeters should estimate new revenue gains cautiously, particularly until the details of any federal legislation are more clearly available.

State Activity

States have followed four avenues to expand collections on remote sales in the current national environment: work cooperatively, define the meaning of physical presence (nexus) more inclusively, collect more information and enforce use tax compliance more effectively, and potentially re-litigate the Quill decision.

Working Together

The Streamlined Sales Tax Governing Board (SSTGB) is a cooperative effort by states to simplify the sales tax so that Congress is more likely to enact legislation allowing states to require collection by remote vendors. The streamlined sales tax project has been underway for more than a decade and 24 states are currently in full compliance with the Streamlined Sales and Use Tax Agreement (SSUTA). Connecticut is not a member and the Connecticut Streamlined Sales Tax Commission recommended in 2008 that the state postpone its decision on joining until after federal legislation is passed.

Connecticut could join the SSTGB, but would need to undertake a number of simplifications, such as reducing the number of sales tax rates. Two benefits can be expected from becoming a member of SSTGB: additional revenue and simplification of the sales tax. In addition, Connecticut could join with other states in creating an environment where the capacity to collect tax on remote sales becomes more likely. Connecticut could expect some additional revenues from the voluntary compliance program, which appears to be concentrated in firms that already have nexus in a number of SSTGB states and not to the wide range of firms with more limited connection to these states. More than 1900 firms have voluntarily complied with the SSUTA, and combined they have provided an additional \$1.2

billion in collections since 2005.²⁹ Significant revenues can only be expected from the SSUTA if Congress enables members of SSTGB to require remote vendors to collect the sales tax.

Policy Option 10: Join the Streamlined Sales Tax Governing Board.

Defining Nexus

The Quill case indicates that physical presence is necessary to require a collection responsibility, but does not define physical presence.³⁰ Nexus clearly is established through any form of owning or leasing real or personal property but a number of states have legislated more expansive definitions of physical presence. States have asserted nexus based on having company owned vehicles in a state or relying on third party distributors to ship or deliver goods in the state. Some states have also asserted that having a local phone number, being listed in the phone book or having a bank account or a P.O. Box in the state is sufficient presence. Some states also argue that nexus is established by having employees in a state, including to make sales calls or provide repair services.

States have also been more aggressive in asserting nexus using concepts of attributional and affiliate nexus. Affiliate nexus generally ignores corporate structures and focuses on the relationships between in-state retailers and remote vendors, such as shared ownership or trademarks. Affiliate nexus has been argued in cases where the in-state seller provides any services for the remote firm. For example, a statute considered in Florida would establish nexus if a person, other than a common carrier:

- Sells a similar line under a different name
- Maintains an office, warehouse, etc. to facilitate delivery or services sold by the dealer
- Uses trademarks that are the same or substantially the same as the dealer
- Delivers, installs, assembles, or maintains for the dealer
- Facilitates the dealer's delivery of property
- Conducts any other activities that are significantly associated with the dealer's ability to maintain a market in Florida.³¹

Click-through-nexus, enacted through what have been termed Amazon laws, has been enacted by at least 12 states including Connecticut, New York, and Rhode Island.³² Another 12 states may seek to assert nexus based on administrative pronouncements. These laws attribute nexus to remote firms in circumstances where affiliates with physical presence in the state direct more than a de minimus amount of sales to the remote firm in exchange for a percent of the sales price. In these cases the affiliates do not have shared ownership or products. New York law presumes the seller is doing business in the state if the seller "contracts with New York residents and pays them a commission for referring

²⁹ Daniel C. Vock, "States Rack Up Victories in Bids to Collect Online Sales Taxes," *Stateline*, April 2013.

³⁰ See Bruce, Fox, and Luna (2015) for a broader discussion of sales tax nexus concepts.

³¹ "Florida Bill would Amend Definition of "Mail-Order Sale" to Include Internet Sales," *CCH State Tax Review*, March 27, 2013, Volume 74, No. 13.

³² See <http://www.taxrates.com/blog/2014/05/07/24-states-with-click-through-nexus-policies/>

customers to its website.”³³ Amazon challenged the New York law arguing that the law violated the commerce clause because it requires firms without physical presence to collect and remit sales taxes. The New York court denied the claim and said that physical presence did not need to be substantial and can be met by economic activities performed on behalf of the seller. Effectively, the court ruled that the relationship between Amazon and the affiliates was sufficient to establish substantial nexus. Click-through-nexus was not upheld in Illinois, but over procedural grounds.

Click-through-nexus only affects a small number of relatively large firms that have these affiliate relationships. Amazon and Overstock have threatened to eliminate the affiliate relationships in states that adopt the legislation and in some cases have done so – though not in the large states such as New York where the litigation has taken place and California where an alternative agreement was reached. Connecticut has enacted click-through-nexus. Any other nexus changes must be considered in light of how affected firms may choose to respond, in addition to potential new revenues and ensuring even taxation of remote and bricks and mortar vendors.

It is important to remember that the dormant Commerce Clause is also a constraint on states’ abilities to define nexus. Only remote vendors with sufficient contacts, as defined by federal law and the courts, can be required to collect a state’s sales tax. Thus, the various expansive definitions of nexus potentially test the boundaries of nexus and are subject to potential review through the courts; the Supreme Court in the *Quill* case recognized this but noted the controversy and confusion associated with making such determinations. Remote vendors can challenge the nexus definitions but this is an expensive and risky endeavor because the court may affirm the definition.

The next step could be for states to require firms such as Amazon (referred to as marketplace providers) to collect sales tax for all firms operating on the platform. New York considered such legislation this past year but decided not to proceed.³⁴ A larger state such as New York may need to be the first mover for this new direction in asserting nexus.

Policy Option 11: Connecticut should continue to investigate and where possible legislate a more expansive definition of nexus.

Encouraging Sales and Use Tax Compliance

Buyers are required to remit the use tax in circumstances where the sales tax has not been collected. As noted above, use tax compliance is generally regarded as the weakest of any state tax and this has been confirmed by audits conducted by Washington State. At least 27 states, including Connecticut and almost all states in the eastern half of the US, seek to enhance compliance by including a line on the individual income tax return requiring tax filers to report use tax due (see Figure 8).³⁵ Connecticut is successful relative to most states in collecting use tax revenue through the income tax return, but the amounts are still small. Manzi reports that New York received the greatest amount of revenue from this provision at \$33.5 million in 2012. California (\$18.6 million), Connecticut (\$13.5

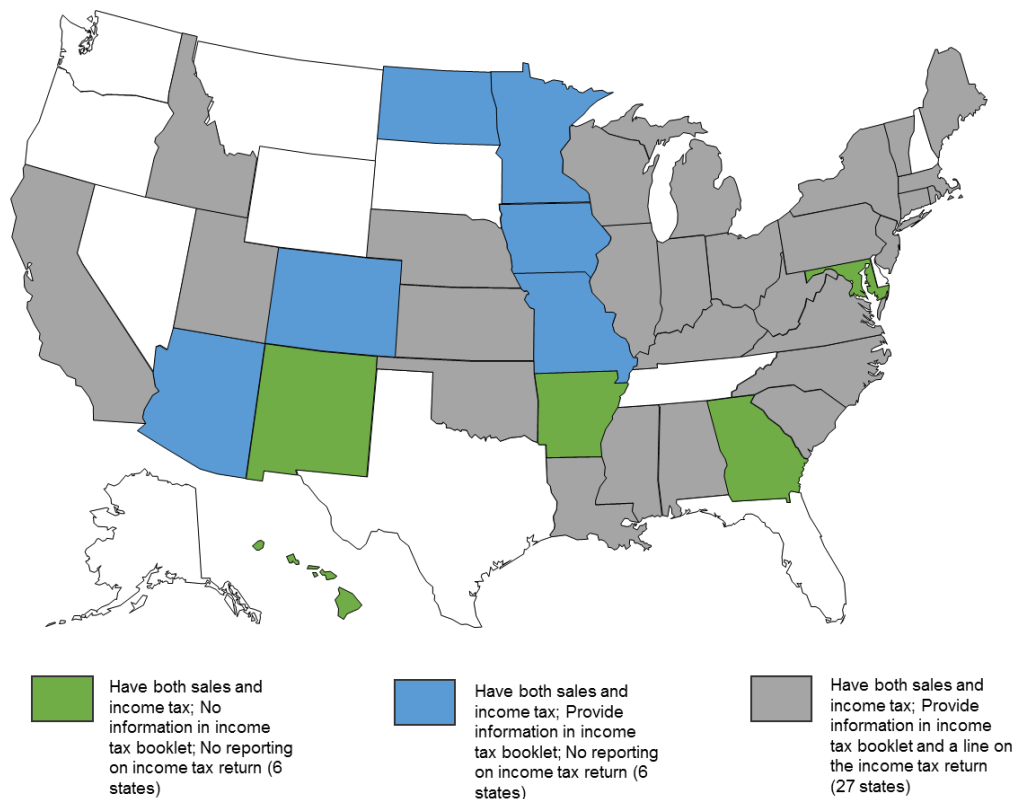
³³ Shonda Humphrey, “New York’s Highest Court Rejects Challenge to Amazon Law,” *State Tax Notes*, April 1, 2013, pp 12-13.

³⁴ See Jennifer DePaul, “Hecht Says Sales Tax Nexus for Small Vendors is Next Big State Tax Issue,” *State Tax Notes*, 78(1) October 5, 2015, p. 21.

³⁵ See Nina Manzi “Use Tax Collection on Income Tax Returns in Other States,” Policy Brief, Research Department, Minnesota House of Representatives, April 2015.

million) and Illinois (\$11.9 million) are the only other states to collect more than \$10 million in use tax payments on the income tax return. Twelve of the states obtain less than \$2.0 million. Connecticut only received use tax payments from 0.9 percent of income tax returns, which is a lower share than 16 states. But, Connecticut receives much higher revenue per return (\$876 per return) than any other state (California is second at \$154 per return). Manzi observes that Connecticut receives a very high share of use tax payments from income tax returns with more than \$1.0 million in adjusted gross income.

Figure 8: States with Use Tax Reporting on Individual Income Tax Returns



Source: Manzi, Nina. Policy Brief: Use Tax Collection on Income Tax Returns in Other States. Research Department, Minnesota House of Representatives, April 2015. Retrieved from <http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf>.

The effectiveness of the line on income tax returns has not been subject to careful research but states like Louisiana, Massachusetts and Michigan saw significant growth in use tax revenues after the line was added to returns. State provisions differ to some extent and Connecticut's use of several may help explain the high payments per positive liability, though use tax responses in Connecticut are mostly inconsistent with Manzi's general observations. Connecticut was one of 14 states that require income taxpayers to specifically indicate that they have no liability. Also, Connecticut is one of 13 states that provide a lookup table for the use tax liability given various purchase levels. Manzi finds that slightly

more returns include sales tax liability and the amount is slightly higher in states requiring taxpayers to clearly indicate no liability if they have none.

Also, several states have enacted legislation requiring remote retailers to provide buyers with notice that use taxes might be due on the transactions. Oklahoma, South Dakota, Vermont and most recently Kentucky have enacted such legislation. Some questions have been raised about the constitutionality of such provisions and a court ruled that Colorado's reporting requirements were unconstitutional. The Colorado case is being reconsidered through the appeals process. South Dakota and Vermont's legislation appears to have no penalties for vendors who fail to comply.

Amazon agreed to provide an email to all Tennessee customers reporting their amount of purchases made during the previous year and noting that there may be a use tax liability. A significant increase occurred in the number of returns filed during the month of the email and the effect persisted for several months afterwards. But, the number was still very small relative to the overall population and the amount of revenues collected was also small.

Returning to Court

States may ultimately seek to have the Supreme Court reconsider the Quill case arguing that the simplifications implicit in the SSUTA plus other changes in technology and retailing have resulted in a sales tax that is no longer an impediment to interstate commerce. Supreme Court Justice Kennedy recently argued in a case linked to the Colorado information requirement that the Quill decision should be reconsidered (*Direct Marketing Association v. Brohl*, 134 S. Ct. 2901 (U.S. 2014)). Perhaps hoping the *Quill* decision would be overturned, the Alabama Department of Revenue has proposed a regulation requiring remote retailers to collect tax on sales to Alabama customers if they have substantial economic presence in the state, regardless of whether they meet the physical presence required by the *Quill* decision. The *Quill* case has not been reconsidered as yet, but it is a future possibility. If so, states or businesses will use the Alabama regulation or some other specific case to raise the issue to the courts.

V. SALES TAXATION AND THE CHANGING ECONOMY

Sales taxes, like all taxes, are affected by the changing economy and the structure must evolve with new practices and technologies. Rapid evolution has raised a series of issues that Connecticut should consider and several are briefly addressed here, including digitization of tangible personal property (such as electronic delivery of books, video and music), the sharing economy and bad debt deductions and the changing form of credit cards. These are not the only topics that could be raised, but they are indicative of the kind of changes that are underway.

The Sharing Economy

This report summarizes a few of the issues raised in the excellent discussions on the sharing economy provided by LeAnn Luna (2016) and Janet Nellen (2015). The sharing of capital and other resources (and particularly labor) through peer-to-peer arrangements is the key attribute of the sharing

economy. Examples include the ride sharing services offered through Uber and the room sharing services offered through Airbnb. Others are concierge type services such as shopping and meal delivery services. Luna mentions a PwC report that estimates the sharing economy at \$15 billion today and with the potential to reach \$355 billion in a decade, suggesting that the tax implications could become large. It may not be possible to determine what will ultimately be the best approaches to taxing these services as they are still developing and the companies are adding new services (such as delivery services by Uber). The best (and possible) approaches to taxing the sharing economy may need to move with the industry and the challenges of taxing this industry have been noted by others.³⁶ But, some thoughts can be given on how to think about the issue and a good starting point for taxation.

Two basic rules should be considered when deciding appropriate taxation of the sharing economy. First, the sales tax is intended as a levy on consumption, so the sharing economy should be taxable to the extent that it represents consumption. Second, goods or services that are highly substitutable with one another should be taxed the same regardless of the form or the way they are ordered or obtained. The arguments for taxing goods and services offered through the sharing economy parallel the arguments for taxing goods and services delivered through e-commerce in the same manner as those delivered through traditional means. The intent is to place alternative means of acquiring access to assets and services (transportation, for example) on a level playing field and to ensure horizontal and vertical equity in the sales tax. This would make the tax neutral in its treatment of the sharing and traditional economies. Appropriate taxation of the sharing economy will also help maintain the sales tax base. Thus, the sharing economy should be taxable when similar services are taxable. Much of the sharing economy involves renting assets, and rentals are generally taxable in Connecticut. Hotel rooms and lodging are generally taxable suggesting that rental of rooms should be taxable. Current statute applies a 15 percent tax on rooms rented for 30 days or less, which should include most Airbnb rooms. The tax should be collected from the homeowners which likely means that enforcement is going to be difficult in many cases.

Connecticut imposes tax on intra-state livery services and rental cars are taxable. The Department of Revenue Services is currently examining any tax treatment that is appropriate for Uber. This means that Uber could be exempt while Zip Car is taxable; raising the question of what is good policy in this case. Or, certain Uber services may become taxable but not others. For example, transportation charges via Uber could be taxable while delivery services are not, so the taxability could depend on how various services are bundled. Tennessee recently passed legislation that is specific to issues that arise for companies that digitally connect riders and drivers. Connecticut is currently considering the appropriate way to proceed.

There are, of course, subtle issues in applying these broad principles. For example, many of the shared assets may have been subject to sales taxation when acquired, though they may have been exempt from sales tax if acquired solely for rental purposes. This would be true if a taxi or car obtained through a rental company is purchased without sales tax while a personal car used for Uber is sales taxed when purchased. Thus, it is possible that the sharing economy could be subject to more levels of tax than comparable services acquired through other means. But, exemption from sales tax for any car

³⁶ See Jennifer DePaul, "Unified Taxation of Sharing Economy is Problematic for State Tax Officials," *State Tax Notes*, 78(1), October 5, 2015, p.24.

used for ride sharing purposes could lead to significant avoidance opportunities as drivers provide very limited services so that no sales tax is due.

Also, some of the shared economy may be viewed as bundled transactions, such as when Shipt provides shopping services and the delivery of tangible goods. Could the bundling result in tax on some but not other parts of the shared economy? Decisions must be made on how to tax the items when taxable and non-taxable activities are occurring at the same time. High compliance and administration costs could arise with the sharing economy, depending on the way in which the tax is enforced. The sharing economy may be characterized by a large number of small vendors – many Uber drivers who each provide a modest number of rides, people who rent out rooms for a limited number of nights, and so forth. Relatively high compliance costs could result relative to the revenues collected if the tax is remitted by individual vendors rather than by the larger company. The compliance and administration costs could be kept lower and enforcement enhanced if Lyft, for example, remits the tax rather than the drivers. Collection of the room tax in Connecticut would almost certainly be improved if Airbnb could be required to collect the tax. Precedent is already in place since Airbnb recently agreed to being collecting both state and local lodging taxes for the State of Washington effective October 15, 2015, and is already collecting tax for North Carolina, Oregon and Rhode Island.³⁷ The problem can become much more intense if individual workers in the sharing economy choose to provide services through more than one company. Imagine a person who offers rides via Lyft, shops and delivers groceries via Shipt, and provides ice cream via Uber. Some of these services might be performed at the same time. Can such a person be expected to know which services are taxable and at what rate(s)?

Further, decisions must be made on how to think about the shared activity. In this regard, it may be helpful to consider staying in a room as a series of attributes including size of the room, various amenities, how the room is obtained, where the room is located and so forth. This type of analysis may be necessary to make decisions such as are services like Zipcar and Uber better thought of as car rentals or limousine services? The answers to these questions could help decide on the taxability of the transaction. But even this is complicated by the possibility that a single Uber service might include both a taxable and non-taxable component (a taxi service and package delivery). Further, should the bundling of various services affect their taxability?

Policy Option 12: Use companies organizing the sharing economy for collection of the sales tax.

³⁷ See Jennifer DePaul “Airbnb to Collect and Remit Lodging Taxes Statewide,” *State Tax Notes*, 78(1), October 5, 2015, p. 51.

Digitized Transactions

Digitized transactions can be considered using the same logic as the sharing economy. The intent should be to tax all consumption and to tax highly substitutable items similarly. This suggests that downloaded music should be taxed the same as a CD, digitized movies the same as DVDs and so forth. Digital downloads are currently taxed in Connecticut as computer services at 1%.³⁸ New York City recently estimated that it would collect \$21 million with a tax on digital purchases.³⁹ The tax on digital downloads of books, movies and so forth should be taxed at similar rates as the 6.35% on physical versions that are highly substitutable.

Policy Option 13: Tax digitized downloads for consumption, such as books, video and music at 6.35%.

Policy Option 14: Ask the Department of Revenue Services to carefully review the sharing economy to ensure that consistent taxation is occurring between the sharing and digitized economies and a traditional economy. Enact legislation where necessary to ensure that even taxation is occurring.

Credit Card Default⁴⁰

Changes in business practices can also influence the sales tax taxability of different types of transactions, though good sales tax policy is to levy the sales tax so that it does not alter how businesses behave. This section provides an example where the issue arises. Another example, mentioned above, may be when services are provided by a parent company to a subsidiary when there is a less than 100 percent ownership relationship.

A very strong trend away from company credit cards and towards private label credit cards has occurred over the past 15 years. Retailers often work with financial institutions that issue private label credit cards, which are branded with the name of the retailer and can be used at the retailer and its affiliates. Private label and company credit cards differ in who processes the credit and who holds the portfolio, but otherwise are quite similar. A key sales tax issue is the treatment of sales taxes when default on the credit occurs. Connecticut provides for refunds to the retailer in the event that buyers default on payments associated with the use of company credit cards. Connecticut, like other states, provides for refund because the intent is to impose sales tax on paid consumption.⁴¹ However, the refunds do not extend to other forms of payment such as private label credit cards, even though the credit cards are generally used both to finance purchase of items and the associated sales tax.

Fox (2015) argues that refunds should also be allowed in cases of default on private label credit cards. This ensures that the sales tax is a tax on paid consumption. Also, this would ensure neutral tax treatment between private label and company credit cards, allowing retailers to choose the best business model without the potential distortion from the sales tax. Further, under current practice, Connecticut has made retailers and the associated financial institutions the guarantors of sales tax

³⁸ Email communication from Susan Sherman, October 9, 2015.

³⁹ See Eric “Yauch, “City Loses by Not Taxing Digital Goods, Brief Says,” *State Tax Notes*, 78(1), October 5, 2015, p. 27.

⁴⁰ See William Fox (2015) for broader discussion of private label credit card debt and sales tax refunds.

⁴¹ Other forms of non-paid consumption include services produced at home and stolen goods.

payments even when payment does not take place for either the tax or the purchase. Finally, the refund would help level the playing field between retailers using private label credit cards and other retailers.

At least seven states allow refunds in the event that default occurs on private label credit cards. For example, Texas passed legislation that allows the retailer or an assignee a credit for the sales tax on the portion of debt that is determined to be bad. Texas requires the seller to determine that the debt is bad, enter the unpaid portion as bad debt on its books and claim the bad debt as deduction for federal tax purposes.

Policy Option 15: Allow a refund for the included sales tax when private label credit cards were used to finance a purchase that becomes a bad debt.

VI. INFLUENCE OF SALES TAXES ON THE ECONOMY

This section discusses the relationship between sales taxation and the economy in order to provide context for the Tax Panel's analysis and conclusions. Sales taxes induce several potential effects on economic activity:

- they raise the cost of producing or selling in Connecticut
- they encourage the purchase of goods relative to services, since the former is taxed more heavily, or at least to untaxed versus taxed purchases
- they encourage purchases online, via catalog or through cross border shopping because the tax is more effectively collected when sales are made in bricks and mortar stores.

Tax Pyramiding and Effects on Business

A considerable portion of sales tax revenue in Connecticut comes from taxing business-to-business transactions. This tax on business inputs has the potential to impact how firms behave, such as where they locate or whether they vertically integrate. The Council on State Taxation estimates that \$1.4 billion of Connecticut's 2013 sales taxes were levied on intermediate goods purchases by businesses, representing about 35 percent of sales tax collections.⁴² The share paid by business is small relative to the share that has been estimated for many other states.⁴³ This section describes the types of distortions in business behavior that can arise and the limited research on the likely magnitude of the influences.

Economists almost uniformly oppose taxes on business-to-business transactions. One reason is that the sales tax is intended as a tax on consumption, but businesses do not consume, they produce.⁴⁴ It is

⁴² See Council on State Taxation and Ernst & Young and Cline, Phillips and Neubig (2014).

⁴³ Also, see Birkland and Ring (2014) who estimated that in-state consumers pay 53 percent of the sales tax in the average state and that the in-state consumer share has fallen over the past 15 years.

⁴⁴ This statement ignores any propensity to use a company to make purchases of goods that are intended for personal consumption. This can be a form of tax evasion that is intended to lower sales and income tax liabilities, and is not associated with business production.

reasonable to presume that everything businesses purchase is necessary to produce and sell their product (regardless of whether the firm is a manufacturer, wholesaler, or retailer) and does not fit within the conceptual framework of a consumption tax. An exception is that an argument can be made to impose the tax on business inputs in cases where the final output is not taxed through the sales tax (such as with medical services). Indeed, a tax on all inputs is comparable to a tax on the output. But, even in this case taxing the inputs may discourage production of some goods and services in Connecticut, depending on how similar activity is taxed in other states.

Second, taxes on business inputs can potentially alter business behavior and harm the State's economy as firms seek to limit the amount of tax they pay. Firms can substitute non-taxable inputs for taxable ones, to the extent that taxability differs and input substitution is possible. Alternatively, firms can vertically integrate and bring more production within a single company, that is, they can self-provide intermediate inputs. For example, a firm can hire its own accountants and lawyers to avoid a tax on purchased services. Firms' costs net of taxes will rise to the extent that taxes alter the way that business operates, since firms would bring the lawyers and accountants into the firm without the tax if this were generally the lowest cost way to operate.⁴⁵ No evidence exists on the extent to which firms vertically integrate to lessen their tax burdens, but the largest responses are expected from big firms, which are best able to vertically integrate. Not only are smaller businesses less able to vertically integrate but they may also be hurt as larger companies outsource less in response to tax on transactions between firms.

Third, input taxes raise the cost of producing in the state, which can cause some firms to locate their production in states that impose lower tax burdens on business transactions. No empirical research directly examines the extent to which taxes on business inputs harm a state's economy, though some research considers whether higher sales taxes (measured by the tax rate) generally harm a state's economy. For example, Bruce, Deskins, and Fox (2007) find that Gross State Product falls as states increase their sales tax rates. They argue that the effects of taxes on location are growing because technology makes it increasingly easy for firms to geographically separate their production from their markets. Carroll and Wasylenko (1994) examine how a number of fiscal variables, including the sales tax, affect total employment and manufacturing employment in a state. They observe no relationship between sales taxes and total employment. They found that states with higher sales tax rates had lower manufacturing employment in the years between 1967 and 1983, though the effects were no longer present when they studied 1984 to 1988. This suggested that the effects of taxes on business location are diminishing, the opposite conclusion of Bruce, Deskins, and Fox. But, the Carroll and Wasylenko study entirely predates recent technology and the Internet and may be less applicable to today's more mobile economy.

The research described here does not directly examine the key issue of whether firms move their production activity in response to states' decisions to tax business inputs and to tax them at higher rates. Still, it is reasonable to presume that bigger taxes on business purchases reduce the propensity for firms to locate or produce in Connecticut, whether the firms are in manufacturing, retailing, or service production. Further, these effects are likely largest for those firms purchasing the greatest amount of taxable inputs and those firms that can most easily separate their point of production and their markets

⁴⁵ Of course, vertical integration is the best business model for some activities in some firms even without the encouragement from taxes.

(such as many firms producing for national or international markets). Thus, the effects are likely to vary across industries and sizes of firms.

Fourth, the sales tax on business purchases pyramids as tax is collected at several levels of the production process and on final sales. This means that effective rates on some purchases exceed 6.35 percent. The extent of pyramiding depends on the complexity of the production process (how many levels of production a good or service goes through), the tax treatment of the various business transactions, and the propensity to vertically integrate in the industry. Though a gross receipts tax differs somewhat from a sales tax, the State of Washington found that gross receipts taxes pyramided an average of 2.5 times. But importantly, the extent of pyramiding differed significantly by type of good.

Connecticut limits pyramiding through some of its exemptions for intermediate purchases. Examples include exemptions for sales for resale, large trucks, and various types of machinery. Still, pyramiding exists and varies significantly across economic sectors. Assuming that business purchases of capital equipment, communications equipment, utilities, and office supplies are taxable, Hawkins (2002) finds that the sales tax is imposed on inputs equal to 14.7 percent of the revenues of electric producers, 11.2 percent for firms taking fees and admissions, and 11.5 percent for firms providing non-shelter lodging. The cascading can have important economic effects as it raises the relative price of some goods and causes people to purchase less of these goods. Hawkins finds that the loss in wellbeing in a state as a result of differential effective tax rates because of pyramiding is small in states with broad based taxes, and the losses are much larger if states adopt narrow tax bases.⁴⁶ This conclusion follows because the sales tax distortions other than from pyramiding are smaller for states with broad based sales taxes. The Hawkins' pyramiding estimates are for an average state and do not necessarily fit Connecticut. The very open economy in which Connecticut operates will increase the economic effects of high effective tax rates resulting from pyramiding because the relative prices of some goods will be high for the region.

Firms may limit pyramiding by purchasing inputs from lower tax jurisdictions, buying online and not paying the use tax, or changing their behavior to purchase fewer taxed inputs. From a policy perspective, reducing taxation of business input purchases is the best means available to limit pyramiding. But reducing taxation of business purchases is often difficult because of the problem of distinguishing between businesses and consumers when purchases are made.

The Sales Tax and Consumption

The sales tax can affect consumer behavior in two key ways given that consumers bear the tax on local purchases and may not pay on remote purchases. First, they can alter *where or how* they buy, as was discussed in the section on e-commerce above.

Second, sales taxes can change *what* consumers buy since the relative price of exempt items (or items where the tax cannot be collected) is lower than for taxable items. Also, the relative prices of goods and services are changed to the extent that taxes pyramid more into one set of goods than another. The effects on behavior and tax revenues depend on how responsive consumers are to the price of the exempt versus the taxable goods. Merriman and Skidmore (2000) indirectly investigated this question by studying how the sales tax rate affected the allocation of expenditures between retail

⁴⁶ Effects on a state's wellbeing are measured by changes in the excess burden of the tax.

activity and service activity between 1982 and 1992. This is a reasonable test of the effect that sales taxes have on exempt versus non-exempt purchases since many services are exempt in most states and many goods are taxable in most states. Merriman and Skidmore find evidence that the share of the economy in the retail sector fell, and the share in the service sector rose in high sales tax rate states. This suggests, as would be expected, that sales taxes alter consumption behavior by increasing the quantity demanded for exempt items compared with taxable items. Thus, adding services to Connecticut's base can be expected to reduce the amount of service purchases and to increase goods purchases, at least to some extent, or to shift some service purchases outside the State. But, these effects result from leveling the playing field across types of consumption.

VII. CONCLUSION

Connecticut should continue to fashion its sales tax more like a levy on consumption. A broad consumption tax allows the burden to be shared across households according to their amount of consumption, does not tax favor one set of products relative to another, and has little effects on how businesses choose to operate. A broad base allows the tax rate to be kept low, which reduces the incentives to purchase out-of-Connecticut to evade the sales tax or to purchase non-taxed items. A broad sales tax base will be horizontally equitable in the sense that all consumption is taxed the same. Even a broad sales tax base will be regressive.

A consumption tax entails several key elements including a) taxing goods and services consumed by Connecticut households and visitors in the state, b) limiting taxation of intermediate goods and services used by businesses in producing/delivering their goods and services, c) exempting sales that are delivered out-of-state, and d) imposing tax on goods shipped into Connecticut for consumption. Efforts to achieve other goals, such as enhancing the economy or improving equity are usually better addressed in other ways and if appropriate using other tax instruments. For example, achieving strong economic growth for Connecticut is generally better attained by allowing the private sector to allocate capital in order to maximize returns with very limited efforts by government to engineer planned outcomes, particularly through means such as sales tax exemptions.

The sales tax is imposed on broad sets of goods and services sold by businesses and cannot easily be targeted to the situation of individual purchasers and households. Connecticut can view vertical equity as a goal for the tax system rather than a goal for each tax, and then use taxes linked directly to households, such as the personal income tax, to achieve the vertical equity goals. Exemptions from the sales tax create horizontal inequities, since they almost always mean the tax burden depends on what households purchase as well as how much they purchase. Efforts to achieve other goals through exemptions from the sales tax require a higher tax rate for any amount of revenue. Higher tax rates create a series of perverse effects such as a) encouraging more online purchases to evade the Connecticut sales tax (which probably helps higher income households most and makes the tax more regressive), b) encouraging additional purchases of non-taxed items, and c) providing greater incentives for sellers to evade or avoid the sales tax.

The economy and business practices are continuously evolving so Connecticut must consistently examine its sales tax structure to ensure that it is not harming traditional goods and services providers relative to emerging industries and is providing a level playing field. Many examples can be given for where such problems can arise. Remote sales including e-commerce must be taxed in a neutral way relative to traditional commerce, digitized goods and services the same as their physical counterparts and the sharing economy the same as highly substitutable goods and services. Failure to create the level playing field is most likely to disadvantage traditional Connecticut businesses and retailers and harm the State's economy. Further, sales tax statutes must be kept current so they do not prevent firms from adopting modern practices that help Connecticut firms be more productive and successful. Carefully thought out decisions are necessary to ensure that neither evolving nor more traditional activities are tax advantaged relative to one another.

Connecticut is limited in its ability to create a perfect sales tax on consumption because of the broader environment in which it operates. The Quill case prevents the state from requiring many remote firms to collect the sales tax, which hampers enforcement. The State operates in a highly competitive, limited geographic space where consumers and businesses can easily locate or purchase out-of-state. The economy is evolving rapidly making it difficult to keep tax practices current. But, the Tax Panel can advocate for improved practices including movement towards more taxation of consumption and less taxation of intermediate purchases plus careful monitoring of the sales tax as changes in the overall environment are occurring. Through these means Connecticut can enhance the sales tax structure in the second best way in which tax policy must be designed and implemented.

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