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State Retail Sales Tax versus National Retail Sales Tax: A Critical Examination

Jennifer L. Langley

Introduction

This paper will show that adoption of the proposed national retail sales tax would have a detrimental effect on state economies while failing to achieve the desired outcome. The national retail sales tax has been proposed as a measure to simplify the tax system by eliminating the federal income, business, estate, and gift taxes with a sales tax collected by businesses and remitted to the federal government.

This issue will be analyzed in three parts. First, various elements of state retail sales taxes will be examined as a basis for comparison. This will include the sales tax rates from the states in the Sixth Circuit, which are Michigan, Ohio, Kentucky, and Tennessee, plus California, as well as the various exemptions provided by most state sales tax statutes. Second, the elements of the proposed national retail sales tax will be explained; and the arguments for and against the proposed national retail sales tax will be summarized. Finally, there will be a discussion of the potential effects of the national retail sales tax on state sales taxes and state economies. This section also includes a discussion of the tax policy concerns relating to the national retail sales tax.

Sales and Use Taxes in General

Currently, forty-five states and the District of Columbia impose a state retail sales tax, with base rates ranging from a low of 2.9 percent in Colorado to a high of 7.25 percent in California.¹ These taxes are levied based on either the gross receipts of the vendor or on the purchase price of the product. These taxes are generally collected by the vendor at the time of

purchase. Each state has its own statutory scheme which provides for the retail sales tax. The Michigan Sales Tax Act² provides for a six percent sales tax on the sale of tangible personal property in Michigan. The tax is imposed on “sales at retail,” which is defined in by the State of Michigan as “a sale, lease, or rental of tangible personal property for any purpose other than for resale, sublease, or subrent.”³ In Ohio, the sales tax rate was increased to six percent for the period from July 1, 2003 through June 30, 2005.⁴ In Tennessee, the state sales tax is six percent on food or food ingredients, seven percent on all other tangible personal property, and each county has the option to impose additional sales taxes.⁵ The state of Kentucky also imposes a six percent sales tax on gross receipts from the sale of personal property and on sales of certain services.⁶ Finally, in California, there is a state retail sales tax of 7.25 percent.⁷

As a complement to the sales tax, Michigan has also imposed a use tax⁸, (“Michigan Use Tax Act” or “UTA”) which is a tax on the privilege of using, storing, or consuming tangible personal property⁹ in Michigan. The use tax is imposed on items purchased for use, storage, or consumption in Michigan only if they have not been taxed elsewhere. In addition, the Michigan Use Tax Act includes a presumption that a Michigan resident who brings tangible personal property purchased outside of Michigan into Michigan within ninety days of purchase intends to use, store, or consume the property in Michigan.¹⁰ The statute specifically defines use as follows, “the exercise of a right or power over tangible personal property incident to the ownership of that property including transfer of the property in a transaction where possession is given.”¹¹ The UTA allows for a number of exemptions from the use tax.¹² Unlike the sales tax, the use tax does not include a blanket exception for resale purchases. The Use Tax Act¹³ instead provides that a Michigan resident may be exempt from the use tax for purchases of automobiles, aircraft, off road vehicles, manufactured housing, snowmobiles, or watercraft if the item is

purchased for resale by a licensed dealer or retailer from a seller who does not sell such items in his normal course of business. For example, if a licensed snowmobile retailer in Michigan purchases a snowmobile for resale from a private individual in Ohio, the Michigan retailer will not be liable for use tax. The Michigan Use Tax Act is typical of use tax provisions in other states. For example, California's use tax provision is found in the California Revenue and Taxation Code §6201, and provides for an excise tax "imposed on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer . . . for storage, use, or other consumption in this state."¹⁴ The use tax statutes in Ohio, Kentucky, and Tennessee have similar language in their use tax statutes.¹⁵

In comparison to the states discussed above, the state of New Hampshire does not have a general income tax or a state sales tax. The state does have an eight percent tax on room rentals and on meals in restaurants. In addition, separate taxes are imposed on electricity usage and the purchase of tobacco products. The state also collects an eight and one-half percent tax on income from conducting business within the state. This tax is imposed on all business organizations. Although this is not a sales tax in the traditional sense, it does affect the price of the product, so the effect may be similar to a sales tax which is directly imposed on the end consumer. The state of New Hampshire shows revenues of \$358 million from the Business Profits Tax and the Meals and Rentals tax for Fiscal Year 2004.¹⁶ By contrast, for its Fiscal Year 2004, the state of Michigan collected revenues of \$8.3 billion from the sales tax and the single business tax.¹⁷

Exemptions from Sales and Use Taxes

Regardless of the form of the retail sales tax, no state levies a sales tax on any purchase made for resale. This exception for property purchased for resale is one of the most important

exemptions from the sales tax. This exemption for resale purchases eliminates the possibility of the state “double-dipping” by taxing a single item more than once, and furthers the policy that only the ultimate consumer should bear the sales tax. The consequences of this exception are well-known. In Michigan, an end user pays sales tax to a retailer on the purchase of consumer goods, such as furniture. The retailer remits this sales tax payment to the state of Michigan. The retailer, however, did not pay sales tax on its earlier purchase of that furniture from the manufacturer or supplier.

Another well known exemption in Michigan is that food and beverages which are to be consumed at a place other than the location of purchase are exempt from sales tax. Under this provision, a purchase of food at a grocery store is not subject to sales tax, but a meal at a restaurant is subject to the tax. Similarly, Michigan does not impose a sales tax on the sale of prescription drugs¹⁸. This exemption was recently examined by the Michigan Court of Appeals, in *Birchwood Manor*,¹⁹ in which the court overruled an earlier case²⁰ and held that any drugs dispensed by a licensed pharmacist pursuant to a licensed physician’s written prescription or order were “prescription drugs” for purposes of the exemption from sales tax.²¹ This was a unique situation because the drugs involved were not “prescription drugs” as that term is commonly understood, but were over-the-counter drugs. The court in *Birchwood* concluded that the statutory exemption did not define “prescription drugs” as only those *required to be* dispensed by a licensed pharmacist, only as those which were dispensed by a licensed pharmacist.²² Therefore, a purchase of over-the-counter drugs dispensed by a licensed pharmacist pursuant to a licensed physician’s written order for a designated person are not subject to Michigan sales tax.

The states in the Sixth Circuit are split on the taxation of service transactions. The definition of “sale at retail” in the Michigan Sales Tax Act does not include service transactions, making them exempt from sales tax. Unlike Michigan, Ohio does not provide a wide exception for the provision of services in its sales tax statute. In fact, Ohio imposes a sales tax on most service transactions, including personal care service.²³ Similarly, Tennessee imposes its sales tax on most service transactions.²⁴

Taxing Mixed Transactions

Another important difference among state sales tax statutes is the determination of the sales tax consequences of mixed transactions. A mixed transaction is one which has both a transfer of a tangible good and a service component. Each state has dealt with the mixed transaction differently. In some states, the state legislature has specifically stated that certain types of transactions will or will not be subject to sales tax. The most commonly used method is to apply the “real object” test to determine whether a given transaction constitutes a taxable sale transaction. The “real object” test requires a trier of fact to determine if the purchaser’s real object in the transaction was the purchase of a service or of the tangible property.

The “real object” test was used to determine sales tax liability in Michigan prior to 2004. In *Shelby Graphics*²⁵, the customer, Chatham Supermarkets, Inc., was contracting with Shelby Graphics for the creation of artwork and other advertising materials. The Tax Tribunal looked at the supermarket’s viewpoint to determine whether the “real object” of the transaction was the acquisition of the various advertising materials or the service of having the materials designed. The Tribunal determined that the “real object” in *Shelby Graphics* was the procurement of advertising materials, a tangible good, by the customer Chatham Supermarkets, Inc. As a result, the transaction was deemed to be a “sale at retail” subject to Michigan sales tax. This test was

recognized by the Michigan Department of Treasury as its official approach to mixed transactions in Revenue Administrative Bulletin 95-1. It appears that the Michigan Department of Treasury used this test successfully in the years from 1995 through 2004, as there were few challenges to sales tax assessments imposed on mixed transactions.

The “real object” test had also been applied in other states through *Federated Department Stores v Kosydar*²⁶ and *Hasbro Industries, Inc v Norberg*²⁷, from Ohio and Rhode Island respectively. These cases specifically involved advertising and promotional materials produced for a purchaser. In both of these cases, the state courts applied the “real object” test to determine taxability of the transactions. The real object test imposed sales tax on a transaction if the “real object” or “dominant purpose” of the purchaser was to acquire a tangible end product. A North Dakota case, *Clayburgh v American West*,²⁸ examined a situation where a promotional company sold coupon books for \$43.95 each. The tax commissioner in that state had enforced a statute which expressly stated that the sale of coupon books was a taxable event. The taxpayer, American West, challenged its tax bill levying the sales tax on its sales of the coupon books. The Supreme Court of North Dakota applied the “real object” or “essence” test to the sale of the coupon books. The court found that the sale of the coupon books was not a sale of tangible personal property subject to sales tax. In this case, the court found that the real object of the purchaser was to obtain the intangible item, which was the right to receive some specified discount, as opposed to the tangible coupon itself. Although this decision was based on the “real object” test and looked at the transaction solely from the buyer’s perspective, the court also considered the value of the tangible coupons absent the intangible right to receive a discount, and found that the coupons have no value in the absence of an intangible right. This fact is

exemplified by the fact that a coupon, used once, cannot be used a second time, and therefore, has no further value as a tangible item itself.

The “real object” or “true object” test is also used by other states in the Sixth Circuit of the federal Courts of Appeals. Ohio specifically includes this provision in its definition of vendors,

Physicians, dentists, hospitals, and veterinarians who are engaged in selling tangible personal property as received from others, such as eyeglasses, mouthwashes, dentifrices, or similar articles, are vendors. Veterinarians who are engaged in transferring to others for a consideration drugs, the dispensing of which does not require an order of a licensed veterinarian or physician under federal law, are vendors.²⁹

This means that, under certain circumstances, physicians and veterinarians are treated as vendors in the business of making taxable retail sales, but are otherwise treated as service providers. In Ohio, the Ohio Revised Code Annotated³⁰ provides that “[o]ther than as provided in this section, 'sale' and 'selling' do not include professional, insurance, or personal service transactions which involve the transfer of tangible personal property as an inconsequential element, for which no separate charges are made.” In *Emery*³¹, the plaintiff chemical manufacturing company had contracted with an outside design firm for design blueprints for its facilities and equipment. The documents prepared by the design firm were sent to contractors who bid on the construction project. The Supreme Court of Ohio held that the true object of the transaction from the purchaser’s perspective was to obtain professional design services, not to obtain the bid documents themselves.³² Therefore, the transaction was exempt from sales tax. In contrast, in *Amerestate, Inc. v Tracy*,³³ where a real estate company created a service to provide real estate reports to customers, the same court held that the “overriding purpose” of the customers was to obtain the reports and that the transaction was taxable.³⁴

Kentucky uses the “real object” test as well, although the courts in Kentucky generally refer to it as the “essence of the transaction” test. In Kentucky, this test is codified in the Kentucky Administrative Regulations.³⁵ As applied in Kentucky, the test states that “[t]he providing of a service is any transaction which includes both services and tangible personal property for a consideration where the performance of the service is the essence of the transaction.”³⁶ In an appeal, the Kentucky courts look at whether the performance of the service is the “essence of the transaction.” If so, the transaction will be considered a non-taxable service transaction. The Kentucky statute goes on to state that certain leases or rentals of real property in connection with the performance of a service do not constitute the lease or rental of tangible personal property.³⁷

In Tennessee, sales tax is also imposed on the retail sale of tangible personal property.³⁸ The Tennessee statute specifically includes the performance of certain taxable services in its definition of tangible personal property. In this regard, Tennessee is more similar to states which specifically define, usually by business or profession, the transactions which will be subject to sales tax in that state. In general, these states have additional regulations that specifically articulate the various types of service transactions which will be exempt from state sales tax. For example, the Maryland statute provides “[t]he sales and use tax does not apply to a personal, professional, or insurance service that . . . involves a sale as an inconsequential element for which no separate charge is made”³⁹ but then specifies in its regulations that services provided by “physicians, dentists, lawyers, accountants, insurance agents, pest exterminators, barbers, beauticians, funeral directors and storage warehousemen”⁴⁰ are not subject to sales and use taxes.

In Michigan, the courts have previously applied the “real object” test to some transactions, but the “incidental to service” test to others. The “incidental to service” test was

introduced in 1996, in *University of Michigan Board of Regents v Department of Treasury*,⁴¹ in which the Department of Treasury had contended that the university was liable for sales tax on the five cents per page charge for making photocopies on university photocopy machines and on the five dollar charge for a replacement diploma. The Court of Appeals disagreed, stating:

Fundamentally, the sales tax is a tax upon sellers for the privilege of engaging in the business of making retail sales of tangible personal property. “Business” is defined in the sales tax act as “an activity engaged in by a person or caused to be engaged in by that person with the object of gain, benefit, or advantage, either direct or indirect.” MCL §205.51(1)(j). The university was not in the business of selling photocopies as a retail enterprise with a profit-making objective; the five cent charge closely approximated the actual cost of one photocopy. Rather, the university provided an academic library, and the convenience of and charge for photocopies were an incidental part of library operations.⁴²

The Court of Appeals stated that the use of the photocopy machines was incidental to the missions of the library and the university as a whole, which were to provide academic and educational services to students.⁴³ As a result, the Court held that the university was not liable for sales tax on either the photocopies made by students or for the provision of replacement diplomas to alumni.

In 2004, the Michigan Supreme Court stated that the “incidental to service” test was the governing test for determining the sales tax consequences of a mixed transaction.⁴⁴ This test provides that no sales tax should be imposed on a transaction where the exchange of a tangible good is merely incidental to the transaction as a whole. The *Catalina*⁴⁵ decision provides a specific method to determine whether a transaction is a “sale at retail” as defined by MCLA 205.51(1)(c). The adoption of the “incidental to service” test by the Michigan Supreme Court signals that the sales tax consequences of a transaction should not be determined solely by viewing the transaction from the buyer’s point of view, but by looking at all the facts of the

entire transaction in order to determine if the transfer of tangible personal property was truly incidental to the service provided. In the appeal of Catalina Marketing Corporation⁴⁶, the Michigan Supreme Court significantly changed Michigan sales tax law. There, the court rejected the “real object” test and adopted the “incidental to service” test to determine state sales tax applicability in the situation of a combined service and tangible goods transaction.

Catalina Marketing Corporation is involved in providing marketing services to corporate manufacturing clients. Catalina Marketing installs and maintains thermal paper printers at grocery store registers around the nation. These printers are linked to Catalina’s computer network, which instructs the printer to print a coupon or not, depending on the item scanned. Product manufacturers contact Catalina and block out a four week period during which the manufacturer controls the response of the system. The manufacturer can choose to print a coupon for a repeat purchase of its own product, print a coupon for its product upon purchase of a coordinating product, or print nothing. For example, if Campbell’s Soup contracts for the four week period beginning March 1, Campbell’s Soup will direct Catalina’s system to print a coupon for Campbell’s soup if Campbell’s Soup is scanned, print a coupon for Campbell’s soup if another brand of soup is scanned, print an advertising message only, or print nothing.

In its appeal, Catalina argued that it was not subject to sales tax because it was not in the business of selling a tangible product, but that it was being paid for its specialized services of targeting and identifying supermarket customers for its manufacturer-clients. Catalina pointed out that the same result would be obtained if, instead of printing a coupon, employees were stationed at each register to examine each customer’s cart and instruct the cashiers to gather some identifying information about the customer which would allow them to redeem any offer on a future visit to the store.⁴⁷ Catalina maintained that, in the latter instance, it is clearly and

merely selling a service to the manufacturers, which would be exempt from sales tax. Catalina further contended that it could not be “selling” the coupons to the manufacturers, because Catalina never owned the coupons.⁴⁸ Catalina pointed out that the manufacturers retained ownership of all coupon content at all times.⁴⁹ Additionally, Catalina refuted the argument that it was selling a tangible product by contending that its clients paid a base fee regardless of how many, if any, coupons were distributed, and an additional per coupon fee was charged on top of the base fee.⁵⁰ Catalina asserted that it is similar to an express mail service, which charges by weight and destination, but is providing a service rather than making a sale at retail, and is not subject to the sales tax.⁵¹

The Department of Treasury argued that Catalina was making sales at retail as defined by the state of Michigan, and was therefore liable for the sales tax on the monies received from its manufacturer-clients.

The question to the Supreme Court was whether the Michigan Tax Tribunal had erred by analyzing the transaction under the “real object” test. The Court held that the Tax Tribunal had erred, and that the “incidental to service” test was the applicable test for mixed transactions. The Michigan Supreme Court adopted the “incidental to service” test in *Catalina Marketing*⁵², specifically rejecting the “real object” test as applied by the Michigan Department of Treasury. The “incidental to service” test, as adopted by the Michigan Supreme Court, requires the court to examine

what the buyer sought as the object of the transaction, what the seller or service provider is in the business of doing, whether the goods were provided as a retail enterprise with a profit-making motive, whether the tangible goods were for sale without the service, the extent to which intangible services have contributed to the value of the physical item that is transferred, and any other factors relevant to the particular transaction.⁵³

On remand, the Michigan Tax Tribunal analyzed the factors identified by the Michigan Supreme Court for the “incidental to service” test. Under the “incidental to service” test, the court should analyze the transaction as a whole, rather than only from the purchaser’s perspective as in the “real object” test. In looking at the transaction as a whole, the Tax Tribunal found that Catalina Marketing was providing a service to its manufacturer-clients in identifying targeted groups of shoppers. The Tribunal agreed with Catalina Marketing that the printed coupon was merely incidental to the transaction, so the transaction did not constitute a “sale at retail” under Michigan statutory provisions.⁵⁴

This test was also applied by the Michigan Court of Appeals in *Herman v Best Buy Stores, LP*,⁵⁵ where the petitioner claimed that a Best Buy store had erred in charging him sales tax on the delivery and haul away charges imposed on his purchase of a new stove. The Michigan Court of Appeals stated “that the purchase of the new stove was the substance of the transaction, to which the provision of the delivery services was merely incidental.” This is the opposite of the result in *Catalina*,⁵⁶ because this transaction was determined to be a sale at retail with an incidental service. Since the transaction was a sale at retail, the Court of Appeals held that the sales tax was properly imposed on the total amount of the transaction, including the delivery and haul away charges.

The use of this test should significantly alter the manner in which the Michigan Department of Treasury will attempt to impose sales tax on business transactions where there is both a tangible good and a service provided to the customer. The Department had previously issued Revenue Administrative Bulletin 95-1, which indicated that the Department would apply the “real object” test to mixed sales and service transactions. The main focus of the real object test, as stated above, is to analyze the transaction from the purchaser’s point of view. If the

purchaser's dominant purpose is to obtain a tangible end product, such as advertising materials, regardless of the degree of service provided to create the end product, the transaction would be considered a "sale at retail" subject to sales tax in Michigan. Since the adoption of the "incidental to service" test, the sales tax consequences of mixed transactions must now be determined under the "incidental to service" test, which analyzes the entire transaction. Overall, the "incidental to service" test represents a departure from the sales tax consequences of mixed transactions in most other states, which still rely on the "real object" test.

It is not difficult to see that the "real object" test has many deficiencies. In Ohio, a number of assessments have been upheld against companies for the transfer of cards or printouts of bank transactions.⁵⁷ The problem is that, in these cases, the tangible property is valueless without the underlying service. Despite the potential weaknesses of this test, it has been incorporated into the sales tax statute of Pennsylvania⁵⁸ and the regulations of California⁵⁹. This is one of the more widely used tests. Although the outcome in *Shelby Graphics*⁶⁰ has been prevented by an amendment⁶¹ to the Michigan statute which specifically provides that the purchase of advertising materials from a graphic design firm is not a taxable transaction, other instances exist where the "real object" test may result in the imposition of tax on a transaction that truly is a service transaction.

An example of this is the situation in which a homeowner hires an architect to design blueprints for a home addition. Under the "real object" test, this transaction could be considered to constitute a "sale at retail" because the "real object" of the transaction, from the purchaser's point of view, is the blueprints, which are tangible personal property. The adoption of the "incidental to service" test, which focuses on analyzing the transaction in its entirety, will alter the result of the above example. Under the factors described in *Catalina Marketing*, this

transaction would more likely constitute a transaction which is not a “sale at retail” as defined in MCL 205.51(c).

The first factor looks at what the buyer sought in the transaction. In the example of the architect, the homeowner is seeking the blueprints for a home addition. The second factor asks what the seller or service provider is in the business of doing. In our example, the architect is in the business of drafting blueprints and overseeing various construction projects. The third factor questions whether the goods were provided as part of a retail enterprise with a profit-making motive. An architect is not involved in a retail enterprise with a profit-making motive. An architect is involved in a professional service occupation, providing his services to his customers. The fourth factor looks at whether the goods in question were available for sale without the service. In the case of the architect, it is more likely that the tangible property transferred (the blueprints) would not be available from the architect without contracting for his professional services. For homeowners who are simply interested in purchasing blueprints, alternative sources exist, such as blueprint books and magazines that sell blueprints as a retail enterprise. The fifth factor considers the extent to which the service contributes to the value of the tangible good which is transferred. In our example, the services are critical to the value of the blueprints obtained. As stated above, the professional service of the architect allows the homeowner to communicate his customized preferences to the architect. In contrast, a blueprint purchased from a book or magazine is simply a standard plan, not customized at all. Therefore, the customization of the blueprints drafted by the architect in connection with the homeowner makes these blueprints more valuable to the homeowner. The final factor requires a finder of fact to consider any other relevant factors in the individual transaction. This final factor thus varies on a case by case basis.

Overall, it is clear that under the “incidental to service” test, where the architect drafts blueprints for a home addition, those blueprints should be considered incidental to the service provided, the professional expertise and supervision of the eventual construction. As a result, this transaction should not be viewed as a “sale at retail” and should not be subject to sales tax in Michigan.

The recent nature of the Michigan Supreme Court’s decision in *Catalina Marketing* means that, as of yet, it has not been tested by courts in other jurisdictions. However, the “incidental to service” test does not appear to have the weaknesses of the “real object” test. As a result, other jurisdictions should consider adopting this test when analyzing mixed sales and service transactions under their individual state sales tax statutes.

Other tests are also used for determining sales tax consequences of mixed transactions. The District of Columbia applies a test which looks at the relative cost or value of the materials which constitute the tangible property in comparison with the value of the services provided. In the leading case, the United States Court of Appeals for the District of Columbia interpreted a District of Columbia statute⁶² and regulation⁶³ to find that the transfer of tangible property with a value of less than ten percent of the value of the services transferred was “inconsequential” and not subject to sales tax.⁶⁴ The weakness of this approach is that it fails to tax certain transactions. For example, if a customer wanted a custom designer gown, the value of the material to make the gown might be considered inconsequential, and the transaction as a whole considered a nontaxable service transaction. This would be an erroneous result from a sales tax standpoint, because the main purpose of the transaction is to transfer the tangible property in the form of a designer gown.

Another alternative test is the custom goods test. The custom goods test is a test which looks at the sale of a custom product as a sale of service since the tangible product is unusable to anyone other than the purchaser.⁶⁵ Under this test, a transaction involving the sale of a customized product would not be subject to sales tax. This test was applied in some early Illinois cases.⁶⁶ However, this test was later rejected in *Voss v Gray*⁶⁷, a North Dakota decision. There, the North Dakota court said:

There is no article fabricated by a machine or fashioned by human hand that is not the fruit of the exercise and application of individual ability and skill. And few, indeed, are the instances where the greater part of the cost thereof is not chargeable to personal service directly or remotely applied. The fact that an article is made to order and is of particular value to one individual and of little or no value to anyone else, does not bring about the legal result that the property in it is at all times in him who contracts to have it made and never at any time in the maker.⁶⁸

According to the North Dakota court, all tangible personal property is created by the exercise of human skill, and the result under the custom goods test would be that all transactions would be considered service transactions not subject to sales tax.

Some commentators have advocated a “common understanding” test for determining whether a particular transaction is a sale of tangible personal property or is a service transaction.⁶⁹ As described by Professors Hellerstein and Hellerstein, this test looks at the common understanding of “whether a trade, business, or occupation involves selling products or rendering services.”⁷⁰ By way of example, the vast majority of people consider attorneys to be service providers, not sellers of tangible products. This “common understanding” test overcomes the major difficulty of the “real object” test, because the idea of “common understanding” recognizes that, in most mixed transactions, the purchaser needs both the service

and the tangible property in order to receive value. This test has not been adopted by any jurisdiction, but is most similar to the “incidental to service” test adopted by the Michigan Supreme Court in 2004. Under the “common understanding” test, a judge would not consider only one party’s point of view, but would make a determination based on the characterization of the particular transaction in the general public.

Sales Tax Implications of a National Retail Sales Tax

Any discussion of state sales taxes may someday be rendered irrelevant if the United States adopts a national retail sales tax. In recent years, some legislators have proposed a national retail sales tax as a replacement for the federal income tax. House Bill HR 25⁷¹, or the Fair Tax Act of 2003, contained a number of Congressional findings of fact, alleging that the income tax was hampering business and was too complicated for citizens. This bill proposed that a federal retail sales tax replace all income, estate, and gift taxes.⁷² The sales tax would still be administered and collected by the states, but would be governed by federal law. Under this bill, the states would receive some compensation for administering the tax system on behalf of the federal government. The substance of the bill was that there would be a sales tax imposed on every purchase of goods or services, with exceptions for purchases made for a “valid business purpose.” In addition to the listed exceptions, the proposed plan provided for some rebates for sales taxes paid. One such rebate was a general rebate of up to \$2,500 per family. In addition, there would be a rebate of up to \$400 for casual or isolated sales, which are the occasional sales by someone who is not a retail seller. One example of the casual sale is the sale of goods at an annual garage sale. In addition, the proposed plan provides for an exemption for spending up to the federal poverty standard, in response to criticisms that a national retail sales tax would have a disproportionate impact on the poor. This bill is still under consideration in the House Ways and

Means Committee. The major stated impetus for this bill is to eliminate the complicated federal income tax rules and regulations. A comparison of the national retail sales tax versus the federal income tax is beyond the scope of this paper. This paper simply introduces some of the considerations of the national retail sales tax from a sales tax perspective.

One major weakness of the bill as proposed, from a sales tax perspective, is that it is more complicated than most current state sales tax statutes. For all of the differences among state approaches, and types of exemptions, the state sales tax statutes are generally fairly simple. Most states have developed remittance systems which work very well; and the citizens of the states, both consumers and retailers, are accustomed to those systems.

The proponents of the national sales tax maintain that it would eliminate the income, estate, and gift taxes, which would virtually eliminate the complicated Internal Revenue Code. Nevertheless, the national sales tax rate would have to be high to replace the revenue from the income, estate, and gift taxes. For example, under the proposed sales tax in Congressman Linder's bill, the rate would be 23%. Some critics maintain that the rate would have to be much higher than that, perhaps 30 to 40%, in order to maintain realistic government revenues.⁷³ Mr. Gale, a scholar and economic commentator at the Brookings Institute, suggests that

even under the strong assumptions made in H.R. 25 - no avoidance, no evasion, no legislative erosion of the private consumption or the state and local government consumption and investment purchases tax base – the NRST would still require a 31 percent tax-inclusive rate (44 percent tax-exclusive) to be revenue-neutral and hold government programs constant relative to current law over the next 10 years.⁷⁴

According to Gale, the lost revenue to the federal government would be approximately \$7 trillion over the next 10 years if the proposed national sales tax rate of 23 percent were adopted.⁷⁵

Another issue which must be resolved in the proposal for a national retail sales tax is exactly which taxes are going to be replaced. The plan before Congress right now, H.R. 25, proposes to replace all income taxes, corporate taxes, estate and gift taxes.⁷⁶ This is a more extreme idea, as it eliminates the majority of the Internal Revenue Code.

In an April 2005 press release, the National Retail Federation (“NRF”) indicated its opposition to the national retail sales tax.⁷⁷ NRF argues that implementation of a national retail sales tax would make every day, not just one day per year, tax day. In addition, the group points out that the national retail sales tax would be imposed on top of the state and local sales taxes already imposed.⁷⁸ According to NRF, the consequences of the national retail sales tax would include “a three year decline in the economy, a four year decline in employment, and an eight year decline in consumer spending.”⁷⁹ If NRF is correct that the national retail sales tax would be imposed on top of any state and local sales taxes, there would clearly be a significant economic impact. A national retail sales tax would bring the total sales tax in Tennessee to 29 or 30 percent if the national retail sales tax rate was set at the 23 percent proposed in H.R. 25.

Yet another significant problem that many see with the national retail sales tax is the cost and complexity of administering such a tax. The proposed national retail sales tax⁸⁰ covers all purchases of all goods and services, with exceptions for purchases “for business purposes.” In response to the criticisms that such a sales tax would cause the nation’s poor to be unable to afford food and other necessities, the national retail sales tax proposal includes “prebates” which would be issued to all families every year for taxes paid on all purchases up to the federal poverty level. The proponents of the national retail sales tax argue that this, along with other proposed exceptions and rebates, would allow all Americans to afford to purchase necessities such as food and clothing. Critics contend that the proposed “prebates” will still be insufficient

to allow the nation's poor to be able to afford everything that they need to survive, especially since the national retail sales tax would apply to the purchase of housing and transportation as well as of tangible personal property.

In addition to arguing that the proposed "prebates" are insufficient in amount, critics of the national retail sales tax contend the "prebates" and exceptions proposed will make the national retail sales tax just as complex as the Internal Revenue Code, which the national retail sales tax is intended to replace. According to the proposal, each family would be required to register in order to receive the "prebate" for taxes paid on the purchase of necessities. This means that the need for each taxpayer to provide paperwork would not be eliminated.

Overall, the use of a sales tax at the state level is more effective than adoption of a retail sales tax at the federal level. The citizens in those states which impose a retail sales tax are accustomed to paying a sales tax at the time of purchase. The sales taxes in these states have come to be accepted as part of life. Those states which do not impose a retail sales tax use other methods to raise revenues. In addition, those taxpayers who are in a lower federal tax bracket will be paying more under the national retail sales tax, because, as stated above, the national retail sales tax rate would be at least 23%, and would be even closer to 30% if the state sales taxes remain in effect. As a result, if the federal government were to adopt a national retail sales tax, the states would be essentially coerced into eliminating the state sales taxes. Currently, the states which have imposed a sales tax receive a significant amount of money from those sales taxes. The potential consequences of the reduction of this revenue are difficult to measure. There would clearly be a significant impact on the states' budgets, which rely on the sales tax revenue for schools and for many other critical functions. If the states did not eliminate the state or local sales taxes, consumers would diminish the amounts of money spent on unnecessary

items and only purchase the absolute necessities. This would have a negative impact on the economy, even more than in recent years. For example, in Michigan, the sales tax revenue is used for the schools. This was a compromise reached in 1994, when the state passed a bill which capped the property tax increases on real property, but increased the sales tax from four percent to six percent. Even with the increased sales tax rate, Michigan schools are currently facing significant budget cuts, and to lose even more state funding would be disastrous.

In addition to the obvious industries that would suffer, such as travel and entertainment, a national retail sales tax would have a huge negative impact on the housing industry across the country, because House Bill H.R. 25 would impose the national retail sales tax on the purchase of homes as well. This would result in increased disparity of already disparate housing costs in different areas of the country. In Bakersfield, California, a 3 bedroom, 2 bath home with 1,391 square feet of living space is listed for \$264,900. A similar house in Lansing, Michigan is listed for \$169,900.⁸¹ If a sales tax of 30 percent were imposed on each of those purchases, the home in California would cost \$344,370 and the home in Michigan would cost \$216,970.

Another significant consideration in the decision of whether to move to a national retail sales tax is efficiency. The national retail sales tax would be administered at the state level, with the state government receiving a payment from the federal government for its services.⁸² Although proponents of the national retail sales tax argue that it would be much more efficient than the current federal system of income taxes, corporate taxes, estate taxes and gift taxes, the national sales tax would be less efficient than currently existing federal tax system. If a national retail sales tax were implemented on top of state and local sales taxes, retailers and service providers would have to have some way to determine whether every transaction is subject to state sales tax, national sales tax, or both. This would also require the seller to track the monies

received for each sales tax separately. This imposes a significantly greater burden on either the retailer or the state to track the sales tax payments received and allocate them appropriately.

Conclusion

In conclusion, the current federal tax system should not be replaced with a national retail sales tax at this time. The national retail sales tax, as proposed, would have a negative impact on state economies and would not be any less complicated than the current system.

In the United States, many states have chosen to implement a state sales tax. Other states have chosen not to have a state level sales tax, but instead rely on other business-level taxes or income taxes for revenue. Within the states that have implemented a state sales tax, each state's statute is different in its scope. As a result, each state imposes the sales tax on different transactions. In most states, the state sales tax is only imposed on the sale of tangible personal property, not on service transactions. Each state must then decide, either through legislation or in the courts, how mixed sales and service transactions should be treated under the sales tax statute. Many states have previously adopted the "real object" test, which considers the purchaser's intent in determining the sales tax consequences of a transaction. Through *Catalina Marketing*,⁸³ Michigan has adopted the "incidental to service" test, which examines at a number of factors to determine whether the transfer of personal property was merely incidental to the provision of service to the purchaser. This test has a number of advantages over the "real object" test. The major advantage is that the "incidental to service" looks at the transaction as a whole, rather than only at the purchaser's intent in the transaction, therefore, leading to a more rational result in most cases.

If a national retail sales tax was to be imposed and state sales taxes eliminated, there would be no differences in sales taxes across the country. Significant interest exists in

eliminating the federal income tax, and the national retail sales tax is one proposal with a significant amount of support among federal legislators. House Bill H. R. 25 had fifty-four co-sponsors in its initial introduction in 2003, and has retained thirty-eight co-sponsors in its latest incarnation, introduced on January 4, 2005. However, the national retail sales tax also has many opponents. The National Retail Federation has spoken out against the national retail sales tax,⁸⁴ as has the Brookings Institution.⁸⁵ Many critics argue that the proposed sales tax rate is too low to maintain government programs at current levels. Others contend that the imposition of a national retail sales tax will cause a drastic drop in consumer spending, leading to even more economic difficulties for the country. The current proposal for a national retail sales tax does not adequately address all of the potential problems that could result from its adoption. At this time, a national retail sales tax should not be enacted, due to the many problems which still need to be addressed.

¹ Base rates are the general retail sales tax rates in each state. Each state provides differing exemptions or lower tax rates on certain items. Rates are as of January 1, 2005, from www.taxadmin.org.

² Mich. Comp. Laws Ann. §205.51 *et seq.*

³ Mich. Comp. Laws Ann. § 205.51(1)(c).

⁴ Ohio Rev. Code §5739.02.

⁵ Tenn. Code §67-6-101 *et seq.*

⁶ Ky. Rev. Stat. Ann. §139.00 *et seq.*

⁷ Cal. Rev. and Tax. Code §6001 *et seq.*

⁸ Mich. Comp. Laws Ann. § 205.91 *et seq.*

⁹ Mich. Comp. Laws Ann. § 205.93(1).

¹⁰ Mich. Comp. Laws Ann. § 205.93(1)(a).

¹¹ Mich. Comp. Laws Ann. § 205.92(b).

¹² Mich. Comp. Laws Ann. § 205.94 *et seq.*

¹³ Mich. Comp. Laws Ann. §205.91.

¹⁴ Cal. Rev. and Tax. Code §6201.

¹⁵ O.R.C. §5741 *et seq.*; KRS §139.310; T.C.A.T. 67-6-203 *et seq.*

¹⁶ See 2004 Annual Report at <http://www.admin.state.nh.us/accounting>.

¹⁷ See Michigan's 2004 Annual Report at www.michigan.gov/budget.

¹⁸ Mich. Constitution Article 9, §8; Mich. Comp. Laws Ann. §2-5.54g(1)(a).

¹⁹ *Birchwood Manor, Inc. v Comm'r of Revenue*, 261 Mich. App. 248; 680 N.W.2d 504 (2004).

²⁰ *CompuPharm-LTC v. Dep't of Treasury*, 225 Mich. App. 274; 570 N.W.2d 476 (1997).

²¹ *Birchwood* at 251; 680 N.W.2d 506.

²² *Id.*

²³ O. R. C. §5739.01(B)(3)(r).

²⁴ Tenn. Code §67-6-205.

²⁵ *Shelby Graphics, Inc. v Michigan Department of Treasury*, 1986 Mich. Tax Lexis 59 (MTT Docket No. 83611)

²⁶ *Federated Department Stores v Kosydar*, 45 Ohio St 2d 1; 340 NE2d 840 (1976).
²⁷ *Hasbro Industries, Inc. v Norberg*, 487 A2d 124 (RI, 1985).
²⁸ *State ex rel. Clayburgh v American West Community Promotions, Inc.*, 645 N.W.2d 196 (N.D. 2002).
²⁹ ORCA §5739.01(C).
³⁰ ORCA §§5379.01(B), 5739.02
³¹ *Emery Industries, Inc. v Limbach*, 43 Ohio St.3d 134; 539 NE2d 608 (1989).
³² *Id.* at 139; 539 NE2d 614.
³³ *Amerestate, Inc. v Tracy*, 72 Ohio St.3d 222; 648 NE2d 1336 (1995).
³⁴ *Id.* at 223; NE2d 1337
³⁵ 103 Ky. Admin. Regs. 28:051 Section 1(1).
³⁶ *Id.*
³⁷ 103 Ky. Admin. Regs. 28:051 Section 3.
³⁸ Tenn. Code Ann. §67-6-01 *et seq.*
³⁹ Md. Code Ann., Tax-General §11-219(a)(2) (1997).
⁴⁰ Md. Regs. Code tit. 03, § 06.01.01 (RIA through June 1999).
⁴¹ 217 Mich.App. 665; 553 NW2d 349 (1996).
⁴² *Id.* at 669; 553 NW2d 349.
⁴³ *Id.* at 670; 552 NW2d 349
⁴⁴ *Catalina Marketing Corporation v Department of Treasury*, 470 Mich 13; 678 NW2d 619 (2004).
⁴⁵ *Id.*
⁴⁶ *Catalina Marketing Corporation v Department of Treasury*, 470 Mich 13; 678 NW2d 619 (2004).
⁴⁷ *Catalina Marketing Corporation*, Brief on Appeal 43 (2004)
⁴⁸ *Id.* at 31.
⁴⁹ *Id.*
⁵⁰ *Id.* at 29
⁵¹ *Id.*
⁵² *Id.*
⁵³ *Id.*
⁵⁴ *Catalina Marketing Corporation v Department of Treasury*, MTT Docket No. 231937 & 231938 (2004) (on remand from Michigan Supreme Court).
⁵⁵ *Herman v Best Buy Stores, L.P.*, 2005 W.L. 602547 (Mich. App.).
⁵⁶ *Catalina Marketing Corporation v Department of Treasury*, 470 Mich 13; 678 NW2d 619 (2004).
⁵⁷ *Miami Citizens National Bank & Trust Co. v Lindley*, 50 Ohio St. 2d 249; 364 NE2d 25 (1977); *Lindner Bros., Inc. v Kosydar*, 46 Ohio St. 2d 162; 346 Ned 690 (1976); *Citizens Fin. Corp. v Kosydar*, 43 Ohio St. 2d 148; 331 NE2d 435 (1975).
⁵⁸ P.A. Stat. Ann. Tit. 72, §7201(o)(5) (West Supp. 1999)
⁵⁹ Cal. Code Regs. tit. 18, §1501
⁶⁰ *Shelby Graphics, Inc. v Michigan Department of Treasury*, 1986 Mich. Tax Lexis 59 (MTT Docket No. 83611)
⁶¹ Mich. Comp. Laws Ann. §205.51 *et seq.*
⁶² Section 47-2701, subd. 1(b)(3), D.C. Code 1951.
⁶³ Regulations Pertaining to Sales and Use Tax, Section 202(b).
⁶⁴ *Washington Times-Herald v District of Columbia*, 213 F.2d 23; 94 U.S. App. D.C. 154 (11954).
⁶⁵ Hellerstein Jerome, and Walter Hellerstein, *State Taxation*, Third Edition 1999 WL 1398969 Chapter 12.
⁶⁶ *See, e.g., HG Adair Printing Co. v Ames*, 364 Ill. 342, 4 NE2d 481, 481 (1936).
⁶⁷ *Voss v Gray*, 70 ND 227; 298 NW 1 (1941).
⁶⁸ *Id.* at 4.
⁶⁹ Hellerstein Jerome, and Walter Hellerstein, *State Taxation*, Third Edition 1999 WL 1398969 Chapter 12.
⁷⁰ *Id.*
⁷¹ Sponsored by Rep. John Linder (R-GA) and co-sponsored by 54 others.
⁷² Website of Representative John Linder, <http://linder.house.gov>.
⁷³ Gale, William, *The National Retail Sales Tax: What Would The Rate Have To Be?* April 2005
⁷⁴ *Id.*
⁷⁵ *Id.*
⁷⁶ H.R. 25, introduced April 2004 and January 2005

⁷⁷ Shearman, J. Craig, Retailers Say National Sales Tax Would Make Every Day Tax Day (April 2005) from www.nrf.com.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ House Bill H.R. 25.

⁸¹ Real Estate Listings from Realtor.com.

⁸² House Bill H.R. 25.

⁸³ *Catalina Marketing Corporation v Department of Treasury*, 470 Mich 13; 678 NW2d 619 (2004).

⁸⁴ Shearman, J. Craig, Retailers Say National Sales Tax Would Make Every Day Tax Day (April 2005) from www.nrf.com.

⁸⁵ Gale, William, The National Retail Sales Tax: What Would The Rate Have To Be? April 2005