

# California's Tax System – Report #2c

## Sales and Use Tax Weakness & Possible Remedies: The Pyramiding Nature of the Tax

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*This is one in a series of reports on weaknesses in California's tax system. Report #1 listed several structural weaknesses and policy issues that exist in most of California's taxes and the system overall. Subsequent reports provide further details on each of the weaknesses and issues, along with possible remedies. The purpose of this series of reports is to help promote serious discussion on the need to and the ways to bring California's tax system into the 21<sup>st</sup> century so it may best promote economic growth, be more equitable, efficiently meet state revenue needs, reduce taxpayer frustration, and be understandable and transparent. A blog accompanies these reports to enable online discussion and a website exists to access the reports and the blog:*

[http://www.cob.sjsu.edu/nellen\\_a/TaxReform/21st\\_century\\_taxation.htm](http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm)

### Introduction

Pyramiding in a tax system refers to the imposition of a tax on a tax. It typically happens with taxes imposed on goods or services. For example, in California, if a business purchases equipment, generally, it will pay sales tax on that equipment. The equipment (including the sales tax) is one of many costs factored into the price of the goods that business sells. Assuming the goods sold are subject to sales tax, in effect, a tax is paid on a tax. The situation expands when you consider that the company that manufactured the equipment also paid sales tax on its taxable purchases and factors that into the prices it charges for its goods.

The degree of pyramiding varies from state to state depending on the types of sales tax exemptions that exist. For example, California exempts purchases for resale. Several states also exempt purchases for resale as well as some or all equipment purchased by certain types of businesses or by businesses operating in certain areas of the state.<sup>1</sup> Pyramiding violates several principles of good tax policy, as discussed later in this report. However, it has been part of the California sales and use tax for years, as it has in other states. It has not been removed from any state most likely because the states have come to depend on the revenues generated from this problem.

This report notes the likely size of the pyramiding problem, why it should be eliminated as part of any plan to improve and modernize the sales tax, and possible ways to address this problem.

**Weakness:** The California sales and use tax system results in tax pyramiding where sales tax is paid on sales tax.

**Remedy:** Eliminate pyramiding by making business purchases exempt from sales tax.

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<sup>1</sup> Many states exempt manufacturing equipment as an incentive for businesses to locate and expand in the state.

## Budget Effect of Pyramiding

Estimates of revenue generated from pyramiding vary. New Mexico estimates that somewhere between 15% and 30% of its gross receipts tax revenue is generated from businesses selling taxable items to other businesses.<sup>2</sup> In 1984, the U.S. Treasury Department estimated that about 20% of state sales tax revenue was derived from taxing producer goods.<sup>3</sup> AB 2218 (2005-2006) which proposed to exempt manufacturing equipment from sales and use tax was estimated to cost the state about \$698 million per year.<sup>4</sup>

## Why Eliminate Tax Pyramiding from the Sales and Use Tax

Reasons for eliminating pyramiding in the sales and use tax include the following.

- § Pyramiding is viewed as economically inefficient and non-neutral. For example, pyramiding could encourage a business to be more vertically integrated so that it creates more of its own raw materials, lessening the transaction taxes it pays on acquired goods and services. Because the ability to vertically integrate varies among businesses based on their size and industry, pyramiding is viewed as inequitable (unfair). In addition, because the amount of inputs needed varies from business to business and industry to industry, equity is harmed by tax pyramiding. Inefficiency results from the pricing effect the sales tax has on business inputs. In addition, the location of a company's operations can affect pricing due to varying sales tax rates and exemptions from state to state.
- § Pyramiding makes the sales tax less transparent. Buyers assume that the stated sales tax on an invoice (for example, 8.25% in San Jose) is the total sales tax. Because of pyramiding, the total sales tax imposed on a taxable item is actually higher.
- § One area where the tax base should be broadened is to include services (discussed in Report #2a). Many of the problems of taxing services apply to use of services by businesses. Often when a business obtains services, they are not provided to benefit operations in a single state. Thus, some type of allocation among the states of the amount paid is needed which can cause complications (and perhaps even double-taxation if states do not use the same allocation formula). In addition, taxation of services may lead some businesses to hire employees rather than contract for services in order to avoid the tax. Such a practice prevents the tax from meeting the principles of neutrality and equity (since it is likely larger businesses that can avoid the tax in this manner). Thus, elimination of pyramiding will eliminate the business taxation problems that can arise in broadening the sales tax base.
- § Many states provide incentives to manufacturers by offering sales tax exemptions on equipment. Similar proposals have been introduced in California.<sup>5</sup> Elimination of pyramiding would eliminate the need to enact narrow sales tax exemptions in order to attract businesses to the state. Elimination of pyramiding should be viewed by businesses as a significant incentive to relocate to or expand in California.

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<sup>2</sup> McNichol and Lav, *Illinois' Proposed Gross Receipts Tax*, Center on Budget and Policy Priorities (May 2007); available at <http://www.cbpp.org/5-3-07sfp.htm>.

<sup>3</sup> Treasury Dept., *Tax Reform For Fairness, Simplicity, and Economic Growth, Value-Added Tax*, Vol. 3 (Nov. 1984), p. 32.

<sup>4</sup> Committee on Appropriations analysis of AB 2218 (2005-2006); [http://www.leginfo.ca.gov/pub/05-06/bill/asm/ab\\_2201-2250/ab\\_2218\\_cfa\\_20060524\\_152231\\_asm\\_comm.html](http://www.leginfo.ca.gov/pub/05-06/bill/asm/ab_2201-2250/ab_2218_cfa_20060524_152231_asm_comm.html).

<sup>5</sup> For example, AB 2218 (2005-2006) would exempt manufacturing equipment from sales and use tax. In its analysis of the bill, the Committee on Appropriations noted that the revenue loss could be offset with base broadening. "A more pragmatic approach might be to offset the state General Fund revenue loss of nearly \$700 million annually by broadening the sales and use tax base to include certain services." See [http://www.leginfo.ca.gov/pub/05-06/bill/asm/ab\\_2201-2250/ab\\_2218\\_cfa\\_20060524\\_152231\\_asm\\_comm.html](http://www.leginfo.ca.gov/pub/05-06/bill/asm/ab_2201-2250/ab_2218_cfa_20060524_152231_asm_comm.html).

## Challenges

The biggest obstacle to eliminating tax pyramiding is the reality that California generates revenue from the pyramiding that has always existed in the sales tax. However, other improvements needed to the California sales and use tax could generate the revenue to offset the revenue generated from pyramiding.

Another challenge is the perception that making businesses exempt from paying sales tax on purchases will be a significant tax break to businesses. Elimination of pyramiding will require taxpayer education to illustrate that those taxes are ultimately really paid by individuals. Also, pointing out the hidden nature of the sales tax paid by businesses should also help. For example, while food purchased at the grocery store is exempt from sales tax in California, this is not really true because pyramiding results in prices that include sales tax because sales tax was paid by the companies in the production and distribution chain that enabled that food to get to the consumers. Elimination of pyramiding would make the sales tax more transparent.

Yet another challenge is distinguishing between business and personal expenditures. For large and established companies, this is rarely a problem. For closely-held corporations and sole proprietorships, it can be a problem. Some business owners may be inclined to try to call a personal purchase a business one so as to avoid sales tax. Also, if an asset is purchased with the intent of multiple use, such as a car or computer owned by a sole proprietorship, what mechanism will be put in place to be sure sales tax is charged on the cost attributable to personal use?

## Implementation Recommendations

Possible ways to move the California sales tax towards a more efficient and neutral tax – one without pyramiding, include the following.

1. Identify industries where pyramiding is likely to be greatest (data exists on the likely number of times certain items are taxed in the production process for different industries).<sup>6</sup> Gradually enact exemptions for taxable items purchased by businesses in these industries.<sup>7</sup> These changes should be enacted along with changes in broadening the sales tax base (see Report #2a). Alternatively, a refundable credit could be provided to businesses based on the value of taxable purchases. The credit could be increased gradually each year, again with the revenue offset by base broadening. The credit approach would likely be simpler because businesses would not need to redo their sales tax compliance processes. They would still charge businesses on their taxable sales until such time that the refundable credit is equal to 100% of the sales tax collected by businesses on their taxable purchases.<sup>8</sup>
2. Completely eliminate pyramiding at once (rather than gradually) and replace the revenue by broadening the sales tax base (with a rate reduction, as noted in Report #2a) enough to offset the revenue. The benefit of this approach would be simplification as there would be no need to gradually increase sales tax exemptions or create a new refundable sales tax credit. Additional advantages would be reduced compliance costs for businesses that only sell to businesses and reduced administrative work by the BOE (due to fewer business sales tax returns filed) which would provide resources for the BOE to help businesses that must start collecting sales tax due to the expanded base applicable to consumer purchases. Also, a benefit of eliminating pyramiding all at once rather than gradually is that the positive impact to businesses would be very easy to

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<sup>6</sup> For example, see Chamberlain and Fleenor, *Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes* (Dec. 2006), The Tax Foundation; available at <http://www.taxfoundation.org/files/sr147.pdf>.

<sup>7</sup> An exemption for printers' aids is noted by the Legislative Analyst's Office as existing to alleviate excessive pyramiding in this industry. LAO, *California's Tax Expenditures Program: Sales Tax* (1999), page 156; available at <http://www.lao.ca.gov/1999/tax%5Fexpenditure%5F299/tep%5F299%5Fsales%5Ftax.pdf>.

<sup>8</sup> The credit approach is used in New Mexico to alleviate pyramiding for certain businesses.

measure and tax savings might be put into new investment or lower prices. Finally, California would become the only state to eliminate pyramiding which might lead businesses to start or expand operations in the state.

3. Replace the sales and use tax with a value-added tax (VAT). VATs are used in all industrialized countries except the U.S. A VAT is different from a sales tax in that pyramiding does not exist. For example, under a credit invoice VAT (commonly used in the EU), businesses pay VAT on all purchases and collect VAT on all sales. At the end of each reporting period, a business adds up the VAT paid and collected and remits the excess of VAT collections over payments to the government. If instead, payments of VAT exceed VAT collections, the business receives a tax refund from the government. In addition to eliminating pyramiding, commonly cited advantages of a VAT over a sales tax include:
  - a. Improved chance of collection because the VAT is collected at each stage of production and distribution, rather than just at the final sale to the retail consumer. Also, under a credit invoice VAT, each purchaser is likely to demand an invoice from a seller in order to claim a credit for the VAT paid. This mechanism can be a self-regulating feature of a credit invoice VAT that is not present with the sales tax.
  - b. Elimination of the seller's burden to determine and document whether a buyer is exempt from sales tax. Under a VAT, unless the item transferred is zero-rated or the seller is exempt, VAT is charged on the sale of the good or service; it is up to the buyer to obtain a credit if they are entitled to one.
4. Replace the sales tax with a different form of consumption tax that consumers calculate on their own (rather than having vendors compute it and collect it). For example, consumption can be measured annually as: Income less savings. An advantage of this system is that it eliminates various problems with the sales tax such as the difficulties of collecting the use tax from consumers and pyramiding. However, additional recordkeeping would be needed for individuals to track savings, borrowings and repayments.<sup>9</sup>

### Tax Policy Analysis<sup>10</sup>

The following chart explains how the elimination of pyramiding would satisfy the principles of good tax policy. The rating in the last column indicates how elimination of pyramiding would improve the current system.

Principle	Application and Analysis	Rating
<b>Fairness</b>		
<b>Equity and Fairness</b> Similarly situated taxpayers should be	The Center on Budget and Policy Priorities notes that pyramiding may pose more of a burden for low-income taxpayers. Items exempt from taxation, such as food and utilities, actually have sales tax included in the	+

<sup>9</sup> For additional background information on forms of consumption taxes, see [http://www.cob.sjsu.edu/nellen\\_a/ConsumptionTax.html](http://www.cob.sjsu.edu/nellen_a/ConsumptionTax.html).

<sup>10</sup> This analysis uses a document prepared by the American Institute of Certified Public Accountants (AICPA) Tax Division and altered to the above format by Joint Venture: Silicon Valley Network. The AICPA document, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001) is available at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>. The Joint Venture workbook is available at <http://www.jointventure.org/PDF/taxworkbook.pdf>. The principles laid out in these documents are frequently used tax policy analyses ones. For more information see Nellen, *Policy Approach to Analyzing Tax Systems*; available at [http://www.cob.sjsu.edu/facstaff/nellen\\_a/Policy%20Approach%20to%20Analyzing%20Tax%20Systems.pdf](http://www.cob.sjsu.edu/facstaff/nellen_a/Policy%20Approach%20to%20Analyzing%20Tax%20Systems.pdf). Note: The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.

taxed similarly.	prices due to pyramiding, yet the items are described to consumers as tax-exempt. <sup>11</sup>  Larger companies are more likely to be able to vertically integrate to lessen the impact of pyramiding. However, the ability to engage in vertical integration can vary from industry to industry.	
<b>Transparency and Visibility</b> Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Pyramiding hides the true amount of sales tax on all purchases, including ones labeled as tax-exempt. For example, most food purchased at the grocery store is “tax-exempt.” However, the store pays sales tax on its taxable purchases (although sales for resale are exempt) and factors that cost into the price of groceries. In addition, manufacturers and distributors of the food paid sales tax on their taxable purchases and factored that cost into the prices they charge the grocery store. Elimination of pyramiding will greatly increase the transparency of the sales tax because the true amount of the tax will be the amount indicated on the sales receipt given to the consumer.	+
<b>Operability</b>		
<b>Certainty</b> The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Elimination of pyramiding will result in the elimination of special exemptions that only apply to business purchases. Such exemptions can sometimes cause problems for sellers and buyers in determining if a particular exemption applies. With the elimination of pyramiding, all businesses purchases will be tax exempt; no special definitional rules would be needed.  A potential problem with the elimination of pyramiding is that some individuals will attempt to label some personal purchases as business purchases so the seller will not charge sales tax. The BOE will need to increase enforcement efforts to avoid this and the legislature should include harsh penalties for intentionally misclassifying the purpose of any purchase.	+ / -
<b>Convenience of Payment</b> A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Elimination of pyramiding will result in businesses no longer paying sales and use tax. It will have no effect on the timing of payment by non-business taxpayers.	No effect
<b>Economy in Collection</b> The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Elimination of pyramiding will remove sellers from the tax system who only sell to other businesses. This will reduce the compliance costs of some businesses and administrative costs of the BOE. Compliance costs for businesses with taxable sales will also be reduced because when they sell to a business, there will be no need to obtain a resale certificate or review the Revenue & Taxation Code to see if the sale is exempt.	+
<b>Simplicity</b> The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Removal of many taxpayers from paying a tax and reduction in return filings will make the law simpler. There will no longer be a need to interpret rules on exemptions because all sales to businesses would be tax-exempt.	+
<b>Minimum Tax Gap</b> A tax should be structured to minimize non-compliance.”	A concern with exempting all purchases by businesses is that some individuals will tell sellers that a personal purchase is really for their business to avoid sales tax. Additional administrative procedures will be needed at the BOE to address these situations and new enforcement	-

<sup>11</sup> Mazerov, Michael, *Expanding Sales Taxation of Services: Options and Issues* (June 2003), p. ix; available at <http://www.cbpp.org/6-19-03sfp.pdf>.

	mechanisms likely needed in the law. If elimination of pyramiding is accompanied with a broadened base, all businesses would have to be registered sales tax collectors (because everything they sell, unless they only have business customers) would be subject to sales tax. The broadened base will help to identify more businesses in the BOE database; but will not be enough to address this problem. Increased penalties for evading the sales tax would likely help compliance.	
<p><b>Appropriate Government Revenues</b></p> <p>The tax system should enable the government to determine how much tax revenue will likely be collected and when.</p>	Government data on purchases by businesses and consumers is available and revenues can be estimated. Pyramiding should not have an appreciable effect on revenue estimation although prices could go down and more businesses could enter the state. Given the significant revenue generated today from tax pyramiding, it can only be eliminated with offsetting tax increases. However, other improvements needed to the sales and use tax system can provide that revenue and elimination of pyramiding by making all business purchases tax-exempt, may increase business activity in the state which would increase other tax revenues.	No effect
<b>Appropriate Purpose and Goals</b>		
<p><b>Neutrality</b></p> <p>The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	Elimination of pyramiding will remove the sales tax from business decisions as to whether to purchase goods or to manufacture them in-house. The change should not have any effect on consumer purchase decisions.	+
<p><b>Economic Growth and Efficiency</b></p> <p>The tax system should not impede or reduce the productive capacity of the economy.</p>	Elimination of pyramiding should make the system more efficient in that tax will not be charged on a tax.	+

### Additional Reading

Chamberlain and Fleenor, *Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes* (Dec. 2006), The Tax Foundation; available at <http://www.taxfoundation.org/files/sr147.pdf>.

Mazerov, Michael, "Expanding Sales Taxation of Services: Options and Issues," *State Tax Notes*, 7/21/03. Also available at <http://www.cbpp.org/3-24-03sfp.htm>.

McLure, Charles, "Sales Tax Exemptions for Business Purchases and Economic Incentives," [http://www.utahtaxpayers.org/reports/mclure\\_sales.tax.exempt.pdf](http://www.utahtaxpayers.org/reports/mclure_sales.tax.exempt.pdf).