

**A PRESENTATION TO THE
HOUSE FINANCE SPECIAL
STUDY COMMITTEE
STUDYING SALES AND USE
TAX EXEMPTIONS**

**ANALYSIS OF
SALES AND USE
TAX EXEMPTIONS
IN VIRGINIA**

**VIRGINIA DEPARTMENT
OF TAXATION**

February 27, 2002

Presented by:

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Executive Tax Commissioner**

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

Revenue Impact
FY 1999
(Millions)

Group 5 Selected Service Exemptions

Accountants	
Engineers	\$23.600
Health Professionals	\$108.400
Land Surveying	\$253.500
Legal	\$7.900
Bank Service Charges	\$71.300
Nonbank Service Charges	\$18.300
Safe Deposit Box Rentals	\$0.400
Insurance Premiums	\$0.500
Barber/Beauty Shops	\$244.200
Carpet and Upholstery Cleaning	\$19.800
Funeral Services	\$1.400
Laundry and Dry Cleaning	\$9.100
Coin Operated	
Non-Coin Operated	\$2.600
Horse Boarding	\$13.200
Pet Grooming and Training	\$0.400
Tax return Preparation (for individuals)	\$0.900
Armored Car/Detective Services	\$1.800
Collection Services	\$12.400
Credit reporting	\$2.300
Janitorial and Building Maintenance	\$2.300
Landscaping and Lawn Care	\$26.200
Parking	\$20.300
Pest Control/Disinfecting	\$6.900
Security System Services	\$5.200
Telephone Answering Services	\$4.400
Appliance Repair	\$1.800
Automotive Repair	\$0.000
Auto Washing	\$0.000
Shoe Repair	\$0.000
Watch, Clock and Jewelry Repair	\$0.000
900 Number Service	\$0.000
Cable and Other Pay TV	\$0.800
	\$25.100

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

Revenue Impact
FY 1999
(Millions)

Group 5 Selected Service Exemptions (Continued)

Cellular Telephone	\$7.300
Interstate Calls	\$64.900
Intrastate Calls	\$71.700
Household Goods Storage	\$0.400
Travel Arrangements/Services	\$3.100
Cold Storage	\$1.600
Amusement Parks	\$4.900
Auto Racing Events	\$0.500
Movie Theaters	\$5.100
Bowling Alleys	\$2.600
Labor Charges	minimal
Transportation Charges	\$0.647
Alteration Charges	\$0.013
Gift Wrapping	minimal
Computer Software Modifications and Custom Programs	\$68.889
Transient Accommodations	minimal
Repair & Replacement Parts in Maintenance Contracts	
Total	\$1,116.649

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

SALES TAXATION OF SERVICES:

1996 UPDATE



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Table 1
Number of Services Taxed by Category and State

State	Utilities	Personal Services	Business Services	Computer Services	Admis./ Amus.	Prof. Services	Fabrication, Repair & Installation	Other Services	Total
Alabama	9	2	6	1	10	0	1	3	32
Alaska	0	0	0	0	0	0	0	1	1
Arizona	12	2	5	1	11	0	2	24	57
Arkansas	14	6	11	1	11	0	11	11	65
California	5	2	3	0	0	0	0	3	13
Colorado	4	0	2	1	2	0	3	2	14
Connecticut	10	11	20	6	13	0	14	13	87
Delaware*	9	20	33	6	10	8	19	37	142
District of Columbia**	10	7	11	6	6	0	13	10	63
Florida	7	4	8	2	13	0	16	14	64
Georgia	10	3	3	2	8	0	2	6	34
Hawaii	16	20	34	6	13	8	18	42	157
Idaho	0	3	4	0	11	0	6	5	29
Illinois	12	1	1	1	0	0	1	1	17
Indiana	8	4	2	2	2	0	0	4	22
Iowa	13	15	18	0	13	0	14	21	94
Kansas	10	10	9	2	13	0	16	16	76
Kentucky	10	2	4	0	6	0	3	1	26
Louisiana	12	9	5	3	8	0	13	8	58
Maine	9	1	6	3	2	0	4	2	27
Maryland	5	3	13	1	11	0	4	2	39
Massachusetts	9	1	4	0	1	0	2	3	20
Michigan	12	4	7	1	1	0	2	2	29
Minnesota	15	6	11	2	13	0	4	10	61
Mississippi	8	4	8	3	10	0	14	23	70
Missouri	8	1	2	1	11	0	0	5	28
Montana	12	0	0	0	3	0	0	4	19
Nebraska	14	6	6	3	11	0	5	4	49
Nevada	0	1	4	0	1	0	2	3	11
New Hampshire	8	1	0	0	0	0	0	2	11
New Jersey	6	2	10	0	6	0	14	12	50
New Mexico	16	20	32	6	13	8	18	39	152
New York	9	5	15	4	7	0	16	18	74
North Carolina	10	4	4	1	7	0	1	1	28
North Dakota	6	1	4	0	11	0	1	2	25
Ohio	8	7	14	3	2	0	12	6	52
Oklahoma	8	1	4	2	11	0	0	6	32
Oregon	0	0	0	0	0	0	0	0	0
Pennsylvania	8	6	17	6	1	0	15	8	61
Rhode Island	10	1	6	3	3	0	3	2	28
South Carolina	4	5	6	4	9	0	1	3	32
South Dakota	12	19	28	6	12	4	18	42	141
Tennessee	11	11	6	3	12	0	14	14	71
Texas	12	11	14	6	10	1	11	13	78
Utah	7	8	6	0	9	0	15	9	54
Vermont	3	2	4	1	10	0	2	1	23
Virginia	1	3	4	0	1	0	4	5	18
Washington*	16	20	34	6	10	8	15	43	152
West Virginia	10	17	26	4	13	1	13	26	110
Wisconsin	11	11	6	1	13	0	14	13	69
Wyoming	11	7	6	2	7	0	16	14	63
Number in Category	16	20	34	6	14	8	19	47	164

*Includes the business license tax in Delaware and the business occupation tax in Washington.

**1992 data.

Source: Federation of Tax Administrators, Sales Taxation of Services Survey, 1996.

SERVICE TAXED**NUMBER OF STATES TAXING****Admissions and Amusements:**

Pari-mutuel racing events	28
Amusement park admission and rides	36
Billiard parlors	28
Bowling alleys	28
Cable TV services	24
Circuses and fairs — admission and games	34
Coin-operated video games	19
Admission to school and college sports events	25
Membership fees in private clubs	22
Admission to cultural events	31
Pinball and other mechanical amusements	21
Admission to professional sports events	35
Rental of films and tapes by theaters	8
Rental of video tapes for home viewing	45

Fabrication, Installation and Repair Services:

Custom fabrication labor	39
Repair material, generally	46
Repair labor, generally	23
Labor charges on repair of aircraft	20
Labor charges - repairs to interstate vessels	13
Labor charges - repairs to intrastate vessels	20
Labor - repairs to commercial fishing vessels	14
Labor charges on repairs to railroad rolling stock	13
Labor charges on repairs to motor vehicles	22
Labor on radio/TV repairs; other electronic equip.	23
Labor charges - repairs other tangible property	23
Labor - repairs or remodeling of real property	13
Service contracts sold at the time of sale of TPP	29
Installation charges by persons selling property	21
Installation charges - other than seller of goods	16
Custom processing (on customer's property)	27
Custom meat slaughtering, cutting and wrapping	12
Taxidermy	29
Welding labor (fabrication and repair)	31

Personal Services:

Barber shops and beauty parlors	6
Carpet and upholstery cleaning	15
Dating services	10
Debt counseling	7
Diaper service	23
Income from funeral services	15
Fishing and hunting guide services	10
Garment services (altering and repairing)	19
Gift and package wrapping service	18
Health clubs, tanning parlors, reducing salons	20
Laundry and dry cleaning services, coin-operated	8

Laundry and dry cleaning services, non-coin-operated	21
Massage services	10
900 Number services	24
Personal instruction (dance, golf, tennis, etc.)	7
Shoe repair	21
Swimming pool cleaning and maintenance	17
Tax return preparation	6
Tuxedo rental	39
Water softening and conditioning	14
Business Services:	
Billboards	4
Radio and television, national advertising	3
Radio and television, local advertising	4
Newspapers	4
Magazines	4
Advertising agency fees (not ad placement)	11
Armored car services	14
Bail bond fees	4
Check and debt collection	9
Commercial art and graphic design	20
Commercial linen supply	32
Credit information, credit bureaus	14
Employment agencies	10
Interior design and decorating	9
Maintenance and janitorial services	18
Lobbying and consulting	7
Marketing	6
Packing and crating	8
Exterminating (includes termite services)	17
Photocopying services	42
Photo finishing	44
Printing	45
Private investigation (detective) services	13
Process server fees	6
Public relations, management consulting	7
Secretarial and court reporting services	9
Security services	14
Sign construction and installation	23
Telemarketing services on contract	6
Telephone answering service	18
Temporary help agencies	11
Test laboratories (excluding medical)	8
Tire recapping and repairing	25
Window cleaning	17
Computer Services:	
Software - packaged or canned program	45
Software - modifications to canned program	34
Software - custom programs - material	27
Software - custom programs - professional serv.	16

Information services	14
Data processing services	11
Professional Services:	
Accounting and bookkeeping	5
Attorneys	5
Dentists	4
Engineers	5
Land surveying	7
Medical test laboratories	4
Nursing services out-of-hospital	4
Physicians	4
Utility Service	
Intrastate telephone and telegraph - Industrial Use	44
Intrastate telephone and telegraph - Residential Use	42
Interstate telephone and telegraph - Industrial Use	21
Interstate telephone and telegraph - Residential Use	20
Cellular telephone services - Industrial Use	40
Cellular telephone services - Residential Use	40
Electricity - Industrial Use	37
Electricity - Residential Use	24
Water - Industrial Use	19
Water - Residential Use	13
Natural gas - Industrial Use	39
Natural gas - Residential Use	24
Other fuel (including heating oil) - Industrial Use	39
Other fuel (including heating oil) - Residential Use	24
Sewer and refuse, industrial - Industrial Use	13
Sewer and refuse, residential - Residential Use	11
Other Services:	
Soil prep., custom baling, other agricultural services	4
Veterinary services (both large and small animals)	5
Horse boarding and training (not race horses)	7
Pet grooming	16
Landscaping services (including lawn care)	19
Metal, non-metal and coal mining services	6
Seismograph and geophysical services	7
Oil field services	11
Typesetting service; platemaking for the print trade	19
Gross income of construction contractors	11
Carpentry, painting, plumbing and similar trades	13
Construction service (grading, excavating, etc.)	11
Water well drilling	10
Income from intrastate transportation of persons	11
Local transit (intra-city) buses	5
Income from taxi operations	8

Intrastate courier service	6
Interstate air courier (billed in-state)	1
Automotive storage	19
Food storage	10
Fur storage	15
Household goods storage	12
Mini-storage	9
Cold storage	13
Marina Service (docking, storage, cleaning, repair)	21
Marine towing service (incl. tugboats)	7
Travel agent services	3
Packing and crating	9
Service charges of banking institutions	3
Insurance services	6
Investment counseling	6
Loan broker fees	4
Property sales agents (real estate or personal)	5
Real estate management fees (rental agents)	6
Real estate title abstract services	6
Ticker tape reporting (financial reporting)	9
Automotive washing and waxing	21
Automotive road service and towing services	15
Auto service, except repairs, incl. painting & lube	23
Parking lots and garages	20
Automotive rustproofing and undercoating	26
Personal property, short term (generally)	45
Personal property, long term (generally)	45
Short-term automobile rental	45
Aircraft rental	43
Hotels, motels, lodging houses	50
Trailer parks - overnight	28

SALES TAXATION OF SERVICES

Virginia Department of Taxation
June 5, 2002

Overview of Contents

- Background on Sales Taxation of Services in Virginia.
- Federation of Tax Administrators Nationwide Surveys of Sales Taxation of Services.
- Issues in Taxing Services.
- The Florida and Massachusetts Attempts to Impose Broad Sales Taxes on Services.
- Sales Taxation of Mixed Transactions.

Historical Basis for Limiting Sales Tax To Sales of Tangible Personal Property ("TPP")

- The sales tax was introduced in many states in the 1930's.
- At that time, the economy was focused on the production and sale of tangible property.
- Services accounted for a small portion of economic activity.
- As a result, most states' sales taxes are based on the sale of tangible property.
- Today's economy has shifted to provision of services.
- Sales tax on tangible property does not fully "capture" modern economic activity.

Services Taxed By Virginia

- Services provided in connection with the sale of personal property.

- Meals served in restaurants and hotels.
- Transient accommodations of less than 90 days.
- Fabrication of tangible personal property for consumers who furnished the materials used in the fabrication.
- Rental of tangible personal property.

Federation of Tax Administrators (FTA) Studies

- Surveys of states' sales taxation of services.
- Original 1990 survey updated in 1992 and 1996.
- Includes sales taxes and other gross receipts taxes.
- Surveyed 164 selected services in eight broad categories.
- **In general, the survey shows a trend that states that tax services have taken the approach of taxing selected services rather than imposing a broad based tax on services.**
- List of selected services surveyed by category in Appendix A.

1990 FTA Survey

- Most states taxed some types of services.
- Extent of service taxation varied considerably among the states.
- Hawaii, New Mexico, and South Dakota had general sales tax systems with broadly defined bases that tax the bulk of the enumerated services.

- Delaware and Washington State imposed no general sales tax, but assessed business privilege gross receipts taxes on most businesses which are similar to general sales taxes.
- Several other states taxed a large number of selected services, except for professional services.
- Some states, including Virginia, taxed comparatively few services.

Trends Apparent from the 1992 FTA Survey

- States were taking a more incremental approach to broadening the sales tax base.
- States continued to have take the approach of taxing additional selected services rather than imposing a broad based tax on services.

Trends Apparent from 1996 FTA Survey

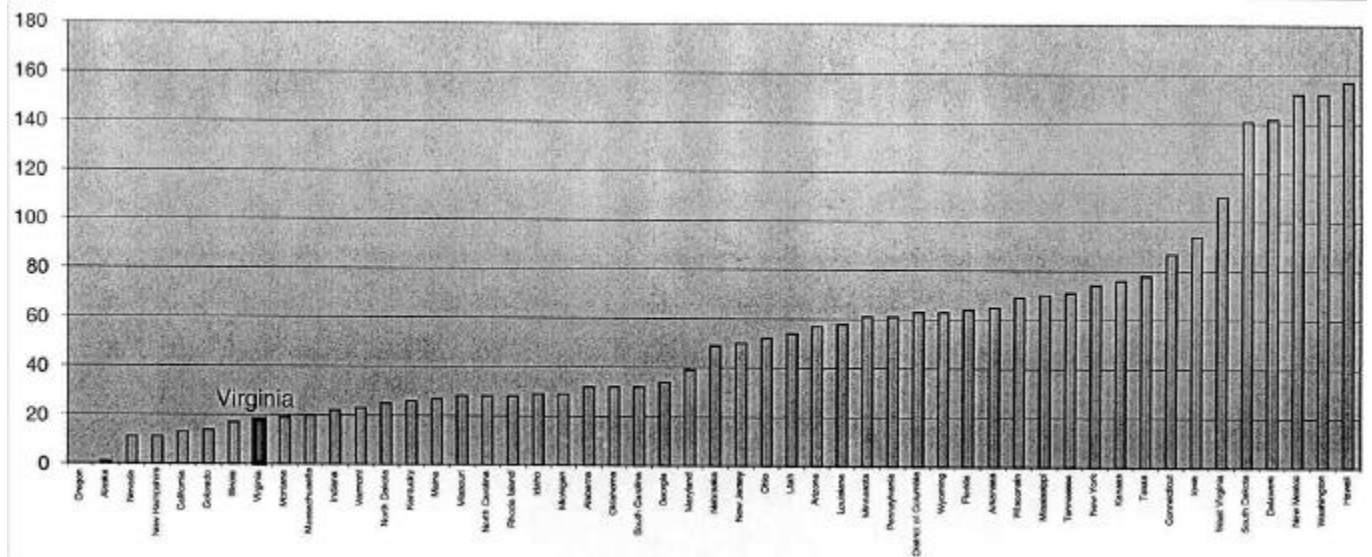
- The rate of expansion of the sales tax base to include services has declined.
- With improvement in the economy, states were reluctant to impose tax increases or new types of taxes.
- No state has undertaken a broad-based expansion of the sales tax to services.
- Fewer states enacted legislation expanding the sales tax base to selected services than in earlier years.
- Most of the activity during both periods is in the business services category .The next most common category was personal services. No state added any new professional services to their sales tax base during either period.

How Does Virginia Compare to Other States in Taxing Services?

- The number of services taxed by states in the FT A survey ranged from a low of zero to a high of 157 services.

- Of the states surveyed, Virginia ranked 44th in the number of services taxed.
- Only 7 states tax fewer services.
- The majority of states tax more services than Virginia.
- The graph on the next page depicts where Virginia ranks among the states regarding total number of services taxed.

Total Number of Services Taxed by States



Categories of Services Surveyed

- The 164 services surveyed by the FTA were placed in one of eight broad categories:
 - ❑ Admissions and Amusements
 - ❑ Repairs, Custom Fabrication and Installation
 - ❑ Personal Services
 - ❑ Business Services
 - ❑ Computer Services
 - ❑ Professional Services
 - ❑ Utility Services
 - ❑ Other Services

Admissions and Amusements

- Survey examined 14 admissions and amusement services.
- Admissions and amusements is the most widely taxed service category in the survey.
- However, some states still tax very few services in this category.
- Videotape rentals are the most widely taxed service in the category.
- Other amusement services covered include pari-mutuel betting, billiard parlors, bowling alleys, circuses, video and pinball machines, and membership fees for private clubs.

Repairs, Custom Fabrication and Installation

- Survey examined 19 services.
- Widely taxed because of the close relationship to tangible personal property.

Personal Services

- Survey examined 20 different personal services.
- The number of states taxing each service varied widely.
- Generally, services involving TPP are taxed by a greater number of states.

Business Services

- Thirty-four business services were examined in the survey.
- Despite the revenue potential, many states still leave business services largely untaxed because of concern over raising business costs.

Computer Services

- Survey examined 6 computer services.
- Computer software, programming, and related data processing services have presented a problem for traditional sales taxes.
- The problems stem from the intangible nature of programming instructions, the lack of need for a tangible medium for providing information, and the nature of the data and information processing services performed with computers, as well as the professional nature of the programming design and development services.
- States have, however, begun to tax certain services associated with computers.

Professional Services

- Survey examined 8 professional services.
- Most discussions of taxing services end up focusing on certain professionals such as lawyers, accountants, engineers, and doctors.
- For various reasons, most states have avoided this area.

Utility Services

- Survey examined 16 utility services.
- With the exception of four states, all states tax some form of utility services either through a sales tax or a gross receipts tax.
- Due to deregulation, Virginia changed the manner in which electricity and gas services are taxed.
- Beginning in 2001, Virginia started imposing a consumption tax on electricity and gas based on volume.

Other Services

- The survey examined several other categories including such items as agriculture, industrial mining, construction, transportation and storage, finance, insurance, and real estate, automotive, and leasing and rental services.
- These areas tend to be relatively untaxed (except for the leasing and rental area) except in states that tax a large number of other services or those that impose a gross receipts tax on most enterprises.

Florida Sales Tax on Services

- In 1987, Florida enacted the broadest taxation of services in the country.
- Tax imposed on all services, including most professional services and advertising.
- As Florida already taxed many personal services, it was mainly an expansion of existing sales tax to business services.
- Tax imposed on all services performed more than 50% in Florida. Later legislation proposed a use tax on services performed outside of the state for an in-state customer.

Repeal of Florida Sales Tax on Services

- Massive opposition, including advertising campaigns and boycotts of state by service industries, media and media customers.
- Tax Executives International President described it as "bad tax policy" and "an administrative nightmare."
- 77% of public opposed tax. 60% preferred raising general sales tax rate.
- Tax operational for 6 months.
- Repealed effective January 1, 1988.

- Replaced with a higher sales tax rate.

Massachusetts Sales Tax on Services

- Enacted in 1990.
- Imposed tax on services provided to businesses.
- Exemption for businesses purchasers employing five or fewer individuals.
- \$20,000 exemption for purchases of professional services.

Repeal of Massachusetts Sales Tax on Services

- Professionals led fight to repeal tax.
- Tax repealed (retroactively) two days after its effective date in 1991 in exchange for massive cuts in state educational and human services spending.

Selected Issues in Taxing Services

- Should service providers receive an exemption for their purchases of TPP?
- Should service providers receive an exemption for their purchases of taxable services?
- Should governmental and non-profit purchasers receive an exemption for their purchases of taxable services?
- Should in-state service providers collect tax on services performed for out of state customers?
- Should in-state customers pay a use tax on services performed by out of state service providers?
- How should services performed partly in one state and partly in another be treated?

- How should mixed transactions be treated?

Mixed Transactions

- Mixed transactions are a significant issue in the retail sales & use tax.
- A mixed transaction is a sales transaction that includes both the provision of taxable tangible personal property and the provision of an exempt service.
- To apply the retail sales and use tax to mixed transactions, states have adopted the "True Object Test."

The "True Object Test"

- If the "true object" of a transaction is the tangible personal property conveyed, the transaction is taxable;
- Likewise, if the true object of the transaction is the provision of an exempt service, the transaction is exempt.

Variants of the "True Object Test"

- The true object test is a fact-based test.
- There are numerous variations among the states on how the test is applied.
- For example, in a District of Columbia court decision, the court ruled that because the value of the tangible personal property only amounted to 10% of the value of the transaction, the transaction was exempt.

State Courts Opting Out of the True Object Test

- When interpreting a case involving the true object test, some state courts have developed different lines of reasoning to opt out of the test on a case by case basis. Some courts have chosen to opt out of the test if:

- ❑ The sale is one of service with only an incidental transfer of tangible personal property;
- ❑ A service or intangible personal property is purchased and the tangible personal property is merely the form in which the service or intangible is embodied;
- ❑ The tangible personal property has value to no one but the purchaser; and
- ❑ After use, the tangible personal property is valueless.

Virginia's True Object Test

- "In order to determine whether a particular transaction which involves both the rendering of a service and the provision of tangible personal property constitutes an exempt service or a taxable retail sale, the "true object" of the transaction must be examined. If the object of the transaction is to secure a service and the tangible personal property which is transferred to the customer is not critical to the transaction, then the transaction may constitute an exempt service. However, if the object of the transaction is to secure the property which it produces, then the entire charge, including the charge for any services provided, is taxable." 23 VAC 10-210-4040(D)

Examples of the True Object Test in Virginia

- **Exempt transaction:** A transaction, which includes the electronic transmittal of current stock market quotations via a terminal. The object of the transaction is to obtain information. The tangible personal property included serves only as a medium for securing the service.
- **Taxable transaction:** A portrait painted by an artist. While the majority of the charge by the artist is for his service and expertise as an artist, and the actual "cost" value of the tangible personal property is de minimis, the true object of this transaction is the finished product, i.e., the portrait.

History of the True Object Test in Virginia

- Virginia statutes do not set forth the true object test.
- Prior to 1977, the true object test was only used in administrative rulings of the Department of Taxation.
- Virginia's use of the true object test was based primarily on rulings of the Ohio courts, a state with very similar of the sales and use tax statutes.
- In 1977, the Virginia Supreme Court, in WTAR Radio-TV v. Commonwealth, 217 Va. 877,234 S.E.2d 245 (1977), upheld the use of the true object test as a determining factor as to the taxability of mixed transactions.
- The courts provided in WTAR Radio-TV v. Commonwealth that when tangible personal property provided in a mixed transaction is inconsequential to the service rendered, the transaction constitutes an exempt service, and vice versa.
- Other states with similar sales tax statutes to Virginia have also successfully incorporated the true object test in determining the tax application to mixed transactions.
- In 1985, the Department of Taxation revised its Services regulation to specifically include the true object test as the department's method of determining the tax applications to mixed transactions.
- The regulation expounds on the true object test to provide that when the service and the tangible personal property are critical to the transaction, the department will look at the degree of customization, uniqueness or specific services provided in determining the appropriate tax application.

Rulings of the Department of Taxation

- The Department of Taxation has issued a large number of administrative rulings that address the taxation of mixed transactions. In each case, the true object test was used to determine how the transaction was taxed.
- In the past five years, TAX has issued approximately 85 administrative rulings that contained issues related to the true object test.

Recurring Issues in Rulings

- It is because the true object test is a fact-based test that the department has received many ruling requests on this subject.
- When requesting a ruling on the true object test, taxpayers strive to differentiate their fact scenario from the already established rulings of the department.
- This practice leads to multiple rulings on the same subject matter but does not necessarily indicate that the true object test is a major area of controversy.
- The following is a list of some common issues noted in the department's rulings and the department's position on each issue.
- **Government Contractors:** The overall contract governs true object determination; separate task orders or work orders under the contract do not change the overall treatment of the contract. If contract does not state the overall purpose, individual task orders, work orders, etc. may be used to determine the true object on a separate basis.
- **Security Systems:** Charges for monitored security systems are an exempt service. Charges for non-monitored systems are retail sales.
- **Electronic Information Services:** Information services are generally an exempt service under the true object test. Such services include stock quotation services,

marketing information services, real estate listing services, credit reporting services, and ticket ordering services.

- **Mailing Lists:** Customized mailing lists generated to conform to customer specifications are an exempt service. Standard lists are taxable sales if provided in a tangible format. If transmitted electronically, standard lists are an exempt service.
- **Equipment with or without Operators:** Charges for equipment that includes one or more operators is an exempt service. Equipment rentals or leases without the provision of operator(s) are taxable sales.
- **Home Health Care Services:** The provision of home health care is an exempt service. Purchases made by the provider of the service are generally taxable although tangible personal property may be transferred to the patient.
- **Funeral Homes:** Funeral homes are providers of exempt services. However, itemized charges for caskets, vaults, flowers, cards, and clothing are considered retail sales.
- **Drawings and Blueprints:** Professional drawings and blueprints produced by architects, engineers, patent artists, etc., are exempt services. Charges for copies of the drawings or blueprints are retail sales.
- **Video and Audio Tapes:** The production of a master video and audio tapes or recordings are retail sales. Production costs such as recording, editing, filming, dubbing, studio time and similar services that are included in the charge are taxable.
- **Training Classes and Seminars:** Charges for seminars and training are exempt services. Tangible personal property such as training manuals, books, ID badges, and other materials provided with the training class or seminar are not retail sales. If these items are sold separately, the transaction is a retail sale.
- **Cable and Satellite Television:** Providing cable and satellite television is an exempt service. Charges for tangible personal property provided as part of the

service are not retail sales. Cable and satellite television equipment sold without the provision of the television service is a retail sale.

- **Photographs:** Slides, photographs, transparencies produced from camera film are retail sales.
- **Prepaid Phone Cards:** Prepaid phone cards are considered an exempt service. The true object is the phone service, not the card. An exception is collectible phone cards, which have value beyond the phone service itself .
- **Portable Toilets:** Charges for the use of portable toilets are retail sales although the charge may include waste disposal services.
- **Linen Services:** Charges for the use of linens, uniforms, and surgical gowns are taxable rentals or leases although the items are picked up and cleaned.
- **Motor Vehicle Painting:** The painting of motor vehicles is an exempt service.
- **Creative Works:** Charges for creative works such as portraits, artwork, play scripts and musical scores are taxable retail sales when a tangible product is provided to the customer.
- **Word Processing:** Charges for word processing are exempt services when an original document is produced. Charges for additional copies of documents are retail sales.

Estimated Revenue from Expanding the Sales and Use Tax Base to Include Selected Services*

by John L. Knapp, Ph.D.

This paper provides an estimate of the additional revenue if the sales and use tax were expanded to include selected services. This is a very rough estimate based on data from the most recent economic census.

The latest survey of state sales taxation of services was conducted by the Federation of Tax Administrators in 1996.¹ The organization's survey covered 164 categories of services aggregated into eight major categories. The results of the survey are summarized below. A more detailed tally is provided in Table 1.

Category	# in Category	Average # Per State	Ratio of Avg. # Per State to # in Category	# in Virginia	Ratio of # in VA to # in Category
Utilities	16	8.8	55%	1	6%
Personal services	20	6.1	31%	3	15%
Business services	34	9.5	28%	4	12%
Computer services	6	2.2	37%	0	0%
Admissions/amusements	14	7.5	54%	1	7%
Professional services	8	0.7	9%	0	0%
Fabrication, repair, & Installation	19	7.7	41%	4	21%
Other services	47	11.0	23%	5	11%
Total	164	53.5	33%	18	11%

The average number of services covered per state was 53.5 (33 percent of the categories). In Virginia only 18 (11 percent of the categories) were taxed. Nationally, the most taxed major categories were utilities and admissions/amusements

Among the major categories of services, personal services, admissions/amusements, and fabrication, repair, and installation services offer the most opportunity for sales taxation in Virginia. Utilities or their customers are subject to significant local utility taxes. Business services is not a good category to tax because many business services are inputs of other firms. This would involved pyramiding of taxes and would discourage firms from outsourcing. A similar argument applies to computer services. Professional services are not fertile ground for sales taxation. John Due and John Mikesell, nationally recognized experts on sales taxation have written:

The major revenue potential [from taxing services] lies in health, various professional, and business-related services, and there are major obstacles

* Information prepared by John L. Knapp, UVA Cooper Center, at the request of Chairman Thomas R. Morris for the Commission to Study Virginia's State and Local Tax Structure for the Twenty-first Century. November 15, 2001.

¹ Federation of Tax Administrators, *Sales Taxation of Services: 1996 Update*. Research Report No. 147 (April 1997).

to taxation of them, including, in most states, political considerations. Health services expenditures, broadly defined, are probably progressive relative to income, and taxation of them might check their rapid increase (net of tax). But concern for universal health care, political obstacles to taxing such services, and fear of popular adverse reaction render taxation of them unlikely.²

The estimates of expanding the sales tax in Virginia to cover personal services, amusements, and repair services are based on data from the 1997 Economic Census. Since goods sold by these industries are already subject to the sales tax it was necessary to estimate the portion of sales not taxed. For example, television repair establishments already tax parts with the labor portion of the bill not taxed. To estimate the portion not taxed I used national Internal Revenue Service data on cost of goods sold in relation to business receipts. I assumed that the goods portion of receipts was already taxed. This procedure overstates the untaxed portion of sales since it does not allow for the business mark-up added to the sales price of parts. On the other hand, the Economic Census understates total sales because businesses whose predominant activity falls under another industry category are not included. A prime example is the repair business of auto dealers. Since the sale of vehicles is their predominant business, repair activity is not reported separately in the Economic Census. The estimate does allow for reduced sales of services because of higher prices caused by the added tax nor does it allow for how the added revenue would be used by the Commonwealth.

I estimate that adding personal services, amusements, and repair services would have increased calendar year 1999 state sales and tax revenue by \$146 million or 6.5 percent above actual collections of \$2.2 billion.

² John F. Due and John L. Mikesell, *Sales Taxation, State and Local structure and Administration, Second Edition* (Washington, D.C.: The Urban Institute Press, 1994).

Table 1
Number of Services Taxed, 1996

State	Utilities	Personal Services	Business Services	Computer Services	Admissions/Amusements	Professional Services	Fabrication, Repair & Installation	Other Services	Total
Number in category	16	20	34	6	14	8	19	47	164
Alabama	9	2	6	1	10	0	1	3	32
Alaska	0	0	0	0	0	0	0	1	1
Arizona	12	2	5	1	11	0	2	24	57
Arkansas	14	6	11	1	11	0	11	11	65
California	5	2	3	0	0	0	0	3	13
Colorado	4	0	2	1	2	0	3	2	14
Connecticut	10	11	20	6	13	0	14	13	87
Delaware	9	20	33	6	10	8	19	37	142
District of Columbia	10	7	11	6	6	0	13	10	63
Florida	7	4	8	2	13	0	16	14	64
Georgia	10	3	3	2	8	0	2	6	34
Hawaii	16	20	34	6	13	8	18	42	157
Idaho	0	3	4	0	11	0	6	5	29
Illinois	12	1	1	1	0	0	1	1	17
Indiana	8	4	2	2	2	0	0	4	22
Iowa	13	15	18	0	13	0	14	21	94
Kansas	10	10	9	2	13	0	16	16	76
Kentucky	10	2	4	0	6	0	3	1	26
Louisiana	12	9	5	3	8	0	13	8	58
Maine	9	1	6	3	2	0	4	2	27
Maryland	5	3	13	1	11	0	4	2	39
Massachusetts	9	1	4	0	1	0	2	3	20
Michigan	12	4	7	1	1	0	2	2	29
Minnesota	15	6	11	2	13	0	4	10	61
Mississippi	8	4	8	3	10	0	14	23	70
Missouri	8	1	2	1	11	0	0	5	28
Montana	12	0	0	0	3	0	0	4	19
Nebraska	14	6	6	3	11	0	5	4	49
Nevada	0	1	4	0	1	0	2	3	11
New Hampshire	8	1	0	0	0	0	0	2	11
New Jersey	6	2	10	0	6	0	14	12	50
New Mexico	16	20	32	6	13	8	18	39	152
New York	9	5	15	4	7	0	16	18	74
North Carolina	10	4	4	1	7	0	1	1	28
North Dakota	6	1	4	0	11	0	1	2	25
Ohio	8	7	14	3	2	0	12	6	52
Oklahoma	8	1	4	2	11	0	0	6	32
Oregon	0	0	0	0	0	0	0	0	0
Pennsylvania	8	6	17	6	1	0	15	8	61
Rhode Island	10	1	6	3	3	0	3	2	28
South Carolina	4	5	6	4	9	0	1	3	32
South Dakota	12	19	28	6	12	4	18	42	141
Tennessee	11	11	6	3	12	0	14	14	71
Texas	12	11	14	6	10	1	11	13	78
Utah	7	8	6	0	9	0	15	9	54
Vermont	3	2	4	1	10	0	2	1	23
Virginia	1	3	4	0	1	0	4	5	18
Washington	16	20	34	6	10	8	15	43	152
West Virginia	10	17	26	4	13	1	13	26	110
Wisconsin	11	11	6	1	13	0	14	13	69
Wyoming	11	7	6	2	7	0	16	14	63
Average	8.8	6.1	9.5	2.2	7.5	0.7	7.7	11.0	53.5
Median	9.0	4.0	6.0	2.0	9.0	0.0	4.0	6.0	49.0

Source: Federation of Tax Administrators, *Sales Taxation of Services, 1996 Update*. Research Report No. 147.
(Washington, D.C., April 1997)

Table 2
Estimated Revenue from Adding Selected Services to the State Sales and Use Tax Base, 1999

Item	Business Receipts	(Receipts minus Cost of Goods Sold)/ Receipts*	Business Receipts Not Already Taxed	Tax @ 3.5%
1997				
Personal & laundry services	\$ 1,551,592,000	0.766	\$ 1,188,519,472	\$ 41,598,182
Amusement & rec. services	\$ 1,397,864,000	0.660	\$ 922,590,240	\$ 32,290,658
Repair & maintenance	\$ 2,845,600,000	0.569	\$ 1,619,146,400	\$ 56,670,124
Total	\$ 2,845,600,000		\$ 1,619,146,400	\$ 130,558,964
Current tax				\$ 1,996,673,036
Selected services % of current tax				6.5%
1999				
Current tax				\$ 2,242,400,139
Selected services % of current tax				6.5%
Estimated revenue from taxing selected services				\$ 145,756,009

Source of business receipts data: U.S. Bureau of the Census, 1997 Economic Census:
<http://www.census.gov/epcd/www/econ97.html>

Source of current taxable sales: Virginia Department of Taxation, *Taxable Sales in Virginia Counties & Cities Based on Retail Sales Tax Revenues, Annual Report, 1999* (Richmond, n.d.)

*See Table 3.

Table 3
IRS National Data Used to Estimate Portion of Business Receipts Not Already Subject to Sales Tax

Item	Business Receipts (\$000)	Cost of Goods Sold* (\$000)	(BR-C)/BR
Nonfarm Individual Proprietorships, 1997			
Personal & laundry services	31,286,346	3,360,618	0.893
Amusement & rec. services	16,011,240	1,424,059	0.911
Repair & maintenance	33,696,184	10,708,321	0.682
Partnerships, 1997			
Personal services	3,586,509	942,198	0.737
Amusement & recreation services	26,677,247	8,675,230	0.675
Auto repair & other services; misc. repair services	7,156,877	2,626,157	0.633
Corporations, 1996			
Personal services.	44,449,184	14,230,528	0.680
Amusement & recreation services	123,675,070	46,452,780	0.624
Auto repair; miscellaneous repair services.	104,495,083	49,329,743	0.528
Aggregate			
Personal services.	79,322,039	18,533,344	0.766
Amusement & recreation services	166,363,557	56,552,069	0.660
Auto repair; miscellaneous repair services.	145,348,144	62,664,221	0.569

Source: IRS Statistics of Income: http://www.irs.ustreas.gov/prod/tax_stats/index.html

*Purchases for nonfarm proprietors

Overview