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# Treatment of Services, Real Property Contracts and Exempt Entities Under State Sales Taxes

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Abstract

State sales taxes, with few exceptions, initially applied only to the sales of tangible personal property, thus excluding services. There has been a slow trend in recent decades to the taxation of services, but in most states the coverage is limited, and the contribution to revenue is small. The services that would contribute substantial revenue and improve equity are ones to which there is strong objection to taxing. A few states made the mistake of applying the tax primarily to business services.

Tax treatment of real property contracts has changed little in recent decades; in most states tax applies only to the purchase of materials, not to the labor cost.

Tax treatment of governments and nonprofit organizations varies widely from state to state, and generalizations are difficult.





TREATMENT OF SERVICES, REAL PROPERTY CONTRACTS AND  
EXEMPT ENTITIES UNDER STATE SALES TAXES

John F. Due

This paper covers taxation under state sales taxes of services, treatment of real property construction, and tax status of sales to and by governmental units and various nonprofit organizations specified as tax exempt.

APPLICATION OF THE SALES TAX TO SERVICES

The area of state sales taxation that has received the greatest attention in the last two decades is the application of the sales tax to services.<sup>1</sup> When the sales taxes were introduced initially in the 1930s, they were confined to tangible personal property, with minor exceptions. This made for simple definition of the tax base, since many services were not seen as suitable for taxation. Only two of the early states applied the tax to services generally: the gross income taxes of Hawaii and New Mexico (the former applied to many nonretail sales of commodities as well). These two levies were, and to a large extent still are, applicable to all services rendered to purchasers for a charge. But this precedent was not followed; ultimately only South Dakota expanded its tax to cover virtually all services, but the trend in other states has been to limited expansion of service coverage.

The general treatment as of 1993 reveals several categories:

Overall coverage (excluding, of course, services rendered by employees to employers and a few categories such

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<sup>1</sup>Taxation of services is stressed in the volume by William F. Fox, ed., Sales Taxation (Westport, Conn: Praeger, 1992).

as financial intermediation): Hawaii, New Mexico, South Dakota.

Relatively extensive coverage: Iowa, Minnesota and Texas are good examples of states that have added a wide range of consumer services, some of which apply at least in part to services rendered to business firms.

Massachusetts and Connecticut for a short period had added a major group of services, including professional, rendered primarily to business firms, contrary to the basic principle against taxing production inputs. These were suspended or repealed.

Limited Coverage: In addition to hotels and motels, public utility services, and rental of tangible personal property, several states have added a small number of other services, particularly repair, photo finishing, cable TV, laundry and dry cleaning.

Little or no taxation of additional services: California and Nevada traditionally have not taxed services, although a few special levies on services have been introduced.

Thus, in general, while there has been a trend toward taxing more services, the picture today is very mixed, with a wide range from virtually no taxation (except transient accommodations) to very broad coverage.

#### The Case for Taxing Services

There are several arguments advanced in favor of taxing services.

1. Revenue. At a given tax rate, extension of the tax to services will of course increase the revenue, the percentage increase depending upon the extent of service coverage, and the commodity base of the tax. It is rare, however, for the additional yield to exceed 10 percent of the existing revenue. If all services were in fact taxed, the revenue gain of course would be much greater. But the most

productive ones, such as medical care and professional services, are the ones typically not taxed.

2. Potential Responsiveness of Yield. It is widely believed, and there is some evidence to support this view, that the yield from the tax applying to services will rise more rapidly over time than that on commodities, simply because of the behavior of consumer demand. An increasing percentage of total output in society consists of services; thus the potential increase in revenue over time is more rapid than that of the tax on commodities. Household utilities, personal business services (e.g., investment counseling), health services show a high rate of growth, personal service expenditures (e.g., beauty parlor and barber shop services) relatively low).<sup>1</sup> A study by Richard F. Dye and Therese I. McGuire also show services to have a higher rate of growth, but with business services showing the highest rate, and these are less suitable for taxation.<sup>2</sup>

3. Discrimination. In terms of the logic of a sales tax as a consumption related levy, there is no general justification for taxing commodities and not services. Acquisition of each constitutes consumption expenditure; failure to tax services favors purchase of services over purchase of commodities. Persons with relatively high preferences for services are favored over persons with relatively high preferences for physical commodities.

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<sup>1</sup>William Duncombe, "Economic Change and the Evolving State Tax Structure: The Case of the Sales Tax, National Tax Journal, Vol. 45 (Sept. 1992), pp. 299-314.

<sup>2</sup>"Growth and Variability of State Individual Income and Sales Taxes," National Tax Journal, Vol. 44 (March 1991), pp. 55-66.

4. Regressivity. It is argued that taxation of services makes a sales tax less regressive because of the progressive nature of the consumption patterns by income groups. This is undoubtedly true if all services were taxed. But with typical coverage, as shown by William Fox and Mathew Murray, this is not necessarily true. Their studies show that existing sales taxes with broad-based coverage of services have tended to be regressive up to about \$30,000 family income, and near proportional beyond.<sup>1</sup>

5. Operational Problems. Finally, taxation of services avoids some of the difficulties at present in distinguishing sales of commodities from services. The problem arises primarily with joint provision of goods and services, to determine which is the "true object" or "dominant purpose." Does one buy a diskette for the object or the information it contains? When an optometrist provides glasses, is the primary object of the transaction the glasses or the services of the optometrist? In some instances the "dominant purpose" rule is so unsatisfactory that a "community appraisal rule" is used--does the business community involved regard the activity as primarily a service or sale of a commodity?<sup>2</sup> Custom-made goods present another problem; one aspect of this is computer software, as noted below. Taxation of services avoids these problems.

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<sup>1</sup>"Economic Aspects of Taxing Services," National Tax Journal, Vol. 41 (March 1988), pp. 19-36.

<sup>2</sup>The problems are explored at length in Hellerstein and Hellerstein, State Taxation, op. cit., Vol. 2, pp. 12:09-12:36.



### Objections to Taxing Services

The most serious objection to taxing services is that under a retail sales tax it is virtually impossible to delineate services which are production inputs from those that are consumption purchases. As noted, some states deliberately centered their taxation on services rendered to business firms--completely illogical by usual standards except rate of revenue growth--and the very broad-based Florida tax on services was estimated to apply to the extent of 80 percent to business purchases. Other states have sought to concentrate on consumer services but cannot effectively eliminate all production input use. Taxation of services that are business inputs is likely to lead firms to hire service suppliers (for example, lawyers) as employees rather than acquire the services of outside firms; this change is much more feasible with services than physical commodities. Studies by John Siegfried and Paul Smith of the Florida tax show that the portion of the tax applying to business services is almost certain to be regressive (assuming forward shifting of the tax to the products of the industry).<sup>1</sup> Taxation of business services leads to strongly organized protests by various industries affected.

But even with the primarily consumer services, it is not at all clear that the taxation of services makes the tax significantly less regressive. Use of most such services in fact does not appear to be significantly progressive by income level.

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<sup>1</sup>"The Distributional Effects of a Sales Tax on Services," National Tax Journal, Vol. 44 (March 1991), pp. 41-33.



Similarly, given the services that can legitimately and politically be taxed, the additional revenue cannot constitute a high percentage of existing revenue. The major revenue potential lies in health, various professional, and business related services, and there are major obstacles 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 and political obstacles to taking them, and fear of popular adverse reaction render taxation of them unlikely. Only two states tax most professional services: Hawaii and New Mexico, and to a lesser extent, South Dakota. The argument that service production is making up a continuously higher percentage of GDP is quite correct--but the services are primarily ones that are not likely, appropriately, to be included in the tax base. Only the value-added form of sales tax can successfully distinguish effectively between business input and consumer services.

Even on the administrative side, the advantages are not entirely with taxation of services. There are numerous problems involved in the definition of the services to be taxable, problems in large measure solved by now with commodities. Additional firms must be registered (although some service firms are already registered as they are also sellers of commodities). There are major problems with interstate activities, with regard to the definition of the location of the rendering of the service and the activities that are inevitably interstate in character, if any such are made taxable. Problems arise

when services are actually rendered in one state (e.g., architectural plans) and consumed in another state, and when services produced in one state are consumed in a number of states, for example, informational services.

Application of the use tax is particularly troublesome, as the transaction is more difficult to find. Audit is more difficult, since the common audit trail through suppliers of the firms is much less clearly defined. The commodity purchases of many service establishments constitute only a small fraction of their total sales, in contrast to typical suppliers of commodities, and do not give a good lead as to correctness of reported volume of receipts from rendering services.

#### Major Types of Services Subject to Taxation

Actual taxation of services is concentrated in a relatively few groups, in terms of usage and revenue.

#### Public Utility Services

From the earliest days of the sales tax, tax applied in many states to various public utility services, and more states have included them.

Electricity for Residential Use. As of 1993, 17 states tax residential electric power under the sales tax, and nine states tax under a separate utility tax, comparable to the sales tax (but not necessarily with the same rate). But there are a variety of exceptions. For example, Minnesota and Wisconsin do not tax electricity used for heating in the winter months. Arizona exempts the first 500 kWh for

persons with annual incomes under \$12,000. Maine exempts the first 750 Kwh of household use.

Telephone Services. As noted in Chapter IV, local telephone services are taxable in 31 states at the regular sales tax rate; 18 also extend the tax to long distance calls.

Cable TV: Taxed by the sales tax in 19 states.

Only Arizona and New Mexico tax all utility services, including intrastate passenger transportation. Several others tax most utility services; transportation and water are the chief exceptions.

Logically all utility services rendered to consumers can be included in the scope of the tax.<sup>1</sup> There are no significant enforcement problems if all uses of a service are taxed. Problems are obviously created if only services to households are taxed, but the problem is less serious than with many goods because separate metering is usual; only with farmers and other small businesses are there any particular operation problems.

#### Hotel and Motel Service

Transient accommodations are universally taxed, though in California and Nevada by local governments rather than by the state, and in five (Alabama, Illinois, Massachusetts, Texas, and Vermont) under separate levies, some with rates different from the sales tax rate.

The tax is limited to short term accommodations, defined in most states as those provided for periods of less than 28 or 30 days or one

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<sup>1</sup>An exception is surface passenger transportation, in view of the desire to lessen traffic congestion and the problem of collecting correct tax on urban transit fares.

month. The aim is to exclude permanent accommodations. But ten states tax if the period is for less than 90 days, and Florida, less than six months, including apartments.

Taxation of hotels and motels has the political advantage of in part reaching nonresidents of the state; beyond this, there is the merit that relatively little burden is placed on the lowest income groups. A considerable portion is borne directly by business firms, but this is much less serious than with most business inputs; much of the service involves provision of "luxury" bonuses to employees whose costs are paid by the firm.

#### Rental or Tangible Personal Property

All except three states tax rental of tangible personal property; the exceptions are Alabama, Illinois and Maine. Alabama imposes a separate rentals tax similar to the sales tax, and Illinois taxes short-term rental of motor vehicles. Some states allow rental firms the option of paying tax on the purchase of the items to be rented or collect and pay tax on the rentals rather than contracting it out to independent repairers.

#### Repair of Tangible Personal Property

While fabrication activity is universally subject to tax, only slowly have the states come to taxing repair activities. As of 1993, a total of 23 states tax repair of tangible personal property, though there are some exceptions. Eleven of these states also tax repair of real property. In the states not taxing repair, the repairing firms may



charge tax on parts going into the repair operations, but not on the labor, so long as the charges are separately stated on the invoice.

There is strong justification for taxing repair services for households; there is objection to taxing those for business firms, as with all production inputs. If repair is not taxed, a major problem is that of distinguishing between taxable fabrication and nontaxable repair; decisions made are frequently arbitrary. Taxing only the materials encourages firms to charge relatively more for the nontaxable labor, less for the taxable items. But taxation of repair does encounter the problem of distinguishing consumption and business input use, and typically no attempt is made to confine the tax to repair for consumption purposes. Firms are given incentive to perform repair with their own employees.

#### Repair of Real Property

A small number of states tax most real property repair--Hawaii (under the contractors excise tax), Kansas, Louisiana, New Jersey, New Mexico, New York, South Dakota, Texas, Washington, West Virginia). Otherwise, tax applies only to the purchase of materials. There is no inherent objection to taxing real property repair labor other than that of the problem of excluding business input repair, but this distinction is difficult to implement. If repair work is exempt and fabrication and construction taxable, serious delineation problems arise.



### Admissions

Fourteen states do not apply their sales taxes to any form of amusements or admissions. The other states do in varying degrees, in several only local taxes applying.

There is little justification for the failure to tax amusements. Likewise, membership in country clubs and similar organizations can justifiably be included in the scope of tax, and would almost certainly make the tax less regressive.

### Professional Services

Most states have been reluctant to tax professional services, primarily for reasons of social policy--the desire to avoid increasing the costs of medical care, for example. Others are rendered primarily to business firms as production inputs. Only Hawaii and New Mexico tax all professional services, and South Dakota taxes most. Financial intermediation, including insurance, are not taxed, in part as there is no "sale" for which payment is directly made. Only a few states tax real estate and other brokers.

### Other Services Taxed in Some States:

Table v-1 lists the services taxable in Iowa, typical of a state that has extended the tax to most consumer services, and some production input services. Most of these are clearly consumer services; there never has been any good reason, for example, for not applying the sales tax to beauty and barbershop services. But still only a few states do.

Computer Software. There was a long period of uncertainty over the tax status of computer software, as to whether it is tangible

Table 1-1

## Services Taxable in Iowa, 1991

Alteration and garment repair	Private employment agencies, excluding services for placing a person in employment where the principal place of employment of that person is to be located outside of the state;
Armored car	Sewage services for nonresidential commercial operations
Automobile repair	Sewing and stitching
Battery, tire and allied	Shoe repair and shoeshine
Investment counseling	Sign construction and installation
Service charges of all financial institutions	Storage of household goods, mini-storage, and warehousing of raw agricultural products
Barber and beauty	Swimming pool cleaning and maintenance
Boat repair	Taxidermy services
Car wash and wax	Telephone answering service
Carpentry	Test laboratories, except tests on humans and animals
Roof, shingle and glass repair	Termite, bug, roach, and pest eradicators
Consultant services	Tin and sheet metal repair
Dance schools and dance studios	Turkish baths, massage, and reducing salons
Dating services	Weighing
Dry cleaning, pressing, dyeing and laundering	Welding
Electrical and electronic repair and installation	Well drilling
Rental of tangible personal property, except mobile homes which are tangible personal property	Wrapping, packing, and packaging of merchandise other than processed meat, fish, fowl and vegetables
Excavating and grading	Wrecking service
Farm implement repair of all kinds	Wrecker and towing
Flying service	Pay television
Furniture, rug, upholstery repair and cleaning	Campgrounds
Fur storage and repair	Carpet and upholstery cleaning
Golf and country clubs and all commercial recreation	Gun and camera repair
House and building moving	Janitorial and building maintenance or cleaning
Household appliance, television, and radio repair	Lawn care, landscaping and tree trimming and removal
Jewelry and watch repair	Pet grooming
Limousine service, including driver	Reflexology
Machine operator	Security and detective services
Machine repair of all kinds	Tanning beds or salons
Motor repair	Water conditioning and softening
Motorcycle, scooter, and bicycle repair	
Oilers and lubricators	
Office and business machine repair	
Painting, papering and interior decorating	
Parking facilities	
Pipe fitting and plumbing	
Wood preparation	
Licensed executive search agencies	

personal property and thus taxable, or if it is a service. As of 1993, however, canned software is taxable in all states except Alabama. But there is still substantial variation on custom software designed for particular users--the question centering around the issue of whether the purchaser is acquiring a commodity or a service. In one-half the states, custom software is not subject to tax, but the exact scope of the exemption varies by state.<sup>1</sup> Exemption has arisen mainly from court decisions.

#### Services Rendered in Conjunction with Sale of Tangible Personal Property

Questions have arisen since the earliest days of the tax about whether or not charges for certain services rendered in conjunction with the sale of a commodity are subject to the tax. Examples include warranty, financing and transportation. These services in general are not taxable if rendered independently of sales of commodities. The general rule is that if the charges for these services are quoted separately to the buyer they are excluded from the taxable price, but if they are not separated they are included in the taxable figure. This is not universal; for example, they are not excludable in Hawaii. There is a greater tendency to make transportation charges taxable even if financing charges are not, and frequently even when transport charges can be deducted, this is allowed only if the buyer pays the charge directly to the transport firm.

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<sup>1</sup>Custom software is taxed only in Arkansas, Connecticut, Georgia, Hawaii, Maine, Mississippi, Nebraska, New Mexico, Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, West Virginia, Wyoming, and the District of Columbia.



### Approach to Service Taxation

One question remains: should the services to be taxed be enumerated, or should all services (other than labor services by employees to employers) be taxed except those specified as exempt? The former approach has been used in most states. The latter has the merit of avoiding unintended leakages from coverage, particularly of new services. Neither approach is foolproof, but the latter may be simpler.

### REAL PROPERTY CONTRACTORS

Real property contract work has been almost universally singled out for special treatment under state sales taxes. The entire contract could of course be defined to be a retail sale, but this was not the rule except in rare instances, for at least three reasons. First, this would have significantly raised the amount of tax on construction of new homes and other housing facilities such as apartments. In terms of society's standards of equity, this was considered to be undesirable. Less consideration was given to the fact that full taxation of the contract price would have raised the cost of new real investment. The second reason appears to have been the desire not to register property contractors. Many of them, particularly general contractors, are small, with limited record systems. Accordingly, special treatment was established--with the inevitable consequence of adding new complications to the operation of the tax. A third reason was, especially in the earlier years of the tax, the desire to avoid applying sales tax to labor services--which of course the work performed on the contract is.

### The Usual Rule: Taxation Only of Purchase of Materials

The most common rule is to exclude general contractors and subcontractors (electric, plumbing, painting, etc.) not engaged in retail selling from the registration requirement. Thus sales tax applies when the contractor purchases materials for construction, but not to the contract price. The result, of course, is to give favorable treatment to this major element in consumer expenditure (but also to lessen the tax on this form of business input).

If, however, as is common with larger contractors, some purchases are made from out of state, the firm must register--under consumer use tax if the state has such registration--but it does not have a sales tax registration number that it can use to make tax free purchases in-state, assuming it does not make sales at retail.

If the firm also makes sales at retail, it must, as any such vendor, register under the sales tax. This is particularly common among subcontractors; many electrical contractors, for example, also operate retail stores, or at least sell some items (e.g., stoves) to the customers distinct from the contract work. In most states, such a firm may make all purchases free of tax by issuance of a resale certificate, and then apply tax on its retail sales and account for tax (usually on a cost rather than marked up figure) on items used for the contract work. A few states try to ensure that only purchases the firm knows will be sold at retail are bought tax free, but this is not easy to enforce. Most states such as California, Nevada, and Wisconsin, allow all purchases to be made tax free if the firm is registered as a retailer.



There are, however, exceptions to this general rule. In Idaho and Wisconsin, for example, if the firm is registered, it pays tax on the selling price on retail sales, on cost on the items going into real property construction. If a firm buys primarily for contract work, it pays tax on all purchases, and then receives credit against tax due on retail sales it makes, thus paying, net, only on the margin between cost and retail selling price.

Nebraska and Minnesota have more precise rules about purchasing tax free. In Nebraska, only if retail sales constitute more than 80 percent of total transactions can the firm buy tax free. In Minnesota, a 50 percent figure is used; if 50 percent or more of the sales are made at retail, the firm may buy all tax free, if under, it pays tax on all purchases. Missouri has a somewhat similar rule without a percentage; these firms buy tax paid even if they sell at retail.

Washington has a special rule for speculative building: if the contractor owns the land it pays tax on the full sales figure, otherwise on the materials.

Several states apply tax to the full contract price, but with some adjustments representing labor cost:

Arizona: All contractors must be registered, and are taxable on the contract price less 35 percent, representing labor cost.

South Dakota: All contractors are registered. Under the sales tax, on contract work, they pay tax on the purchase of all materials, technically as use tax. In addition, under a separate levy, they pay a 2 percent tax on the gross receipts from contracts, except on payments on contracts by subcontractors to prime contractors. The rate is

1½ percent on contracts with public utility companies. If the contractors also sell at retail, they buy materials tax free and account for tax on the retail sales.

Mississippi: On all contracts over \$10,000 the contractor pays a 3½ percent tax on the contract figure. On smaller contracts, the contractor pays tax on purchase of materials, at the basic 7 percent sales tax rate.

Hawaii: Real property contracts are taxed at the basic 4 percent rate, with some exceptions for low cost housing.

New Mexico: Contracts are fully taxable, but not contracts by subcontractors with prime contractors.

Texas: This is the only state that uses a system more common in the past: on lump sum contracts, the contractor pays tax on purchase of materials. On labor and materials contracts, the contractor buys tax free and charges tax on the materials. If use is not known at time of purchase, the contractor may buy tax free.

#### Special Problems Relating to Contract Work

The diverse nature of contracting work gives rise to several problems not encountered with the usual retail sale; it is not feasible to describe these in detail.

#### Contractor-Retailers

As noted above, many subcontractors also sell at retail. As noted, the usual approach is to register such firms regularly selling at retail; they can buy tax free, and account for tax when they sell at retail (on the actual selling price) and when they take materials from

stock for use in contract work (on the basis of cost). But as noted above there are a number of exceptions to this rule, and numerous interpretative questions.

Manufacturing Contractors - Some types of contractors, mainly subcontractors in the sheet metal field, both manufacture products in their shops for use in contracts (and often also for over the counter sale) and manufacture on the site. The general rule now is to apply tax to the purchase of the materials, whether fabrication is done on site or in the shop, and thus not tax the fabrication labor, to avoid discrimination against shop work. The tax applies to the selling price if sales are made over the counter. There are some exceptions to this general rule.

A special problem arises with prefabricated housing, where the units going into the house are produced in the firm's factory and transported to the building site. Mobile home construction is a similar example; many of these are immobilized on the site. The problem is that if the sales are fully taxed, this form of housing is discriminated against compared to on-the-site construction, for which in most states construction labor cost is excluded from tax. Many states now provide an adjustment, taxing only a portion of the sales price, or applying a lower tax rate. For instance, Maryland taxes the first sale of a mobile home on 60 percent of price and West Virginia taxes mobile homes sold to be principal residences at a 3 percent rate. The problem is basically a product of the failure to tax construction of real property housing at the full rate, including labor costs. Another problem arises with the

resale of mobile homes that are still mobile; if they are taxed while sales of permanent structures are never taxed, discrimination results.

#### Contract Work for Exempt Purchasers

Another special problem relates to contract work for governmental units, charitable and religious and educational institutions when they are exempt purchasers. If special rules are not provided on contract work, the exempt entity must purchase the materials in its name to avoid tax. Over half the states (28), however, do not permit pass through of the exemption to the contractors, while the others have special rules allowing pass through, some very restrictive, e.g., Tennessee only for construction of churches.

#### Installation Contracts and Fixtures

Suppliers of many consumer durables install them in or on real property, or the installation may be done by contractors. Examples include stoves, blinds, awnings, drapes, carpeting, and the like. The majority of states do not tax installation charges per se; thus such charges are not taxable as long as they are quoted separately, but are of course included in the taxable figure if not quoted separately. Currently some 18 states tax installation charges,<sup>1</sup> but there are some exceptions in these states.

California has excluded a category called fixtures from the usual rule on contractor purchases, requiring the contractor to charge and pay tax on the selling price, not the purchase price. These are items which

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<sup>1</sup>Florida, Hawaii, Indiana, Kansas, Mississippi, New Jersey, New Mexico, New York, Ohio, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Washington, West Virginia, Wisconsin and Wyoming.



legally become a portion of the real property but retain their identity, such as light fixtures, built in ovens, hot water heaters, furnaces, etc. Pennsylvania follows a similar rule.

#### EXEMPTION OF SALES TO GOVERNMENTS AND SPECIFIED NONPROFIT ORGANIZATIONS

There is substantial variation in the extent to which the states tax sales to themselves and local subdivisions, and sales to various nonprofit organizations.

##### Sales to the Federal Government

Direct sales to the Federal government are exempt from tax, by requirements of the Federal constitution. Sales to national banks are now taxable. On contract work, the states may tax the purchase of materials for use on Federal contracts, but several states specifically exempt these.

##### Sales to the State and Local Governments

There is so much variation that no simple explanation on sales to state and local governments is possible. Only eight states generally apply tax to sales to the state and local governments: Arizona, Arkansas, California, Hawaii, North Carolina, South Carolina, and Washington. There are exceptions in some of these states. South Carolina exempts sales to textbooks to schools, and North Carolina allows refunds of tax paid on materials going into the construction of buildings of specified local governments.

The issue of whether governmental units should apply tax on their own purchases is one to which there is no clear-cut answer. Taxation



does lessen evasion, but it involves a substantial amount of activity that yields no net returns. Partly this is a budget matter since if a certain amount of money is required to accomplish the desired objectives, more funds must be provided if the purchases are taxed. But in fact this may not occur, and thus taxation reduces total sales spending. Taxation tends to favor units whose activities are particularly labor intensive. If the government activity competes with taxable private sector activity there is strong justification for taxing.

#### The Treatment of Nonprofit Organizations - General Principles<sup>1</sup>

Nonprofit, or more correctly, not-for-profit organizations, have increased in importance in the economy over recent decades. The organizations are of two general types: philanthropic, raising most of their revenues from contributions and providing services furthering the objectives of government, and service organizations, including private schools providing services which are sold to the public in much the same fashion as private sector firms. The latter have grown in importance in recent decades.

As a general rule, nonprofit organizations should be treated the same as private sector firms except when a case can be made that governmental objectives, such as assistance to the poor or the desire to finance various activities by contributions rather than either charges or taxes warrant favorable treatment. Otherwise, such treatment results in discrimination against private sector firms, and will distort

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<sup>1</sup>John L. Mikesell, "Sales Taxes of Nonprofit Organizations," in Fox, ed., Sales Taxation, op. cit., Chapter 8.

relative outputs of goods provided by the nonprofit organizations, and increase the share of the nonprofits compared to private firms. The nonprofits are given incentive to undertake additional activities directly competing with private firms. The exception is the situation in which there is deliberate desire to increase the role of the nonprofit organizations in the interests of the welfare of society.

Thus the case for favorable sales tax treatment is strongest for the philanthropic type of organization, and for those service types selling to the public where there are important positive externalities. Public transit which lessens street congestion is an example. With the philanthropic group, governmental provision of the activities may be the only alternative, and may be less efficient than the nonprofit organizations. The case is also stronger for activities which society wishes to encourage but government provision is not considered appropriate--for example, religion.

A final consideration relates to effective operation of the sales tax; any special provision tends to create complications, and so the treatment needs to be developed with consideration of operational aspects.

Actual policies vary substantially among states, and are frequently complex, making simple summary impossible. Appropriate treatment is somewhat different for purchases by and sales by these organizations.

### Sales to Nonprofit Organizations<sup>1</sup>

The majority of the states, 27, have a general exemption of sales to nonprofit educational, hospital, religious, charitable, and similar organizations. While other states do not, almost all of them do specify certain groups of purchases as exempt: Alabama, Arkansas, California, Idaho, Iowa, Louisiana, Maine and Oklahoma. The others are more restrictive. Special exemptions are provided for hospitals and related health organizations in Oklahoma and Kansas, for example. Schools (nonprofit) are exempt in Arkansas, Colorado, Georgia, Idaho, Kansas, North Dakota, South Dakota, Virginia, and Washington, churches in Virginia, historical societies in some states.<sup>2</sup> Some of the exemptions are very obscure in terms of origin.<sup>3</sup>

These exemptions are always a source of a certain amount of nuisance and evasion. On small purchases made from regular retailers, the exemption may not be applied correctly, and there is a temptation toward evasion. On the larger purchases under contract, there is much less danger of evasion, but it may occur. Given the very limited audit coverage, most evasion, deliberate or otherwise, will never be detected. Some states require these organizations to provide certificates to their suppliers as evidence of the exemption, but most do not. Some states,

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<sup>1</sup>John L. Mikesell, "State Taxation of Nonprofit Organizations: Purchases and Sales," in Fox, ed., Sales Taxation, op. cit., Chap. 8.

<sup>2</sup>Those with no general exemption are Alabama, Arizona, Arkansas, California, Hawaii, Idaho, Iowa, Kansas, Louisiana, Maine, North Dakota, Oklahoma, South Dakota, Virginia, and Washington.

<sup>3</sup>In Arkansas, there is specific statutory exemption for purchases by the Arkansas Poets Roundtable. State tax officials do not now know exactly how, when, or why the exemption appeared nor what the group is (or was).



e.g., Utah, Wisconsin, Illinois, Minnesota, South Dakota, require the exempt organizations to register with the revenue department to be able to buy tax free. Alternatively, as in Nevada and Missouri, the organization must obtain a letter of authorization from the revenue department to buy tax free.

#### Sales by Exempt Organizations

Regular selling activities of taxable goods by exempt organizations and by governmental units are typically subject to tax, with the organization or governmental unit registered and collecting tax, filing returns and remitting tax. There are, however, exceptions to this rule, including in some states sales in school cafeterias.<sup>1</sup> Table V-2 provides details by state. School lunches and meals served in hospitals are almost universally exempt.

This is a difficult issue to resolve. Certainly, in general, when these organizations are in competition with private enterprise there is strong justification for taxation, unless there are important social policy reasons to the contrary. This is a topic that causes tax departments some continuing embarrassment, often involving Girl Scout cookies, and may become more difficult as charitable organizations expand beyond their traditional sources to obtain revenue.

Casual sales are not, in most states, subject to tax whether by governmental unit, exempt institutions or regular vendors. Thus

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<sup>1</sup>Broad exemption is provided in Arizona, Iowa, Missouri, Nevada, New Jersey, New Mexico, New York, North Dakota, South Carolina, and Vermont. But there are restrictions, particularly if the organization is in business for a profit or competing with private business.



**TABLE 2**  
**State Sales Taxes and Nonprofit Organization Sales**

STATE	General Exemption for Sales and Special Provisions
Alabama	No. But many organizations exempt by specific legislative action.
Arizona	Yes.
Arkansas	Yes, unless church or charitable organization in business for profit.
California	No. Limited exemptions
Colorado	No.
Connecticut	No. Exempt sales up to \$20 by schools and youth organizations.
District of Col.	Yes.
Florida	No.
Georgia	No. Exempt religious papers sold by religious institutions, religious organization fund raisers (30 days in calendar year) if proceeds used for purely charitable purposes.
Hawaii	No.
Idaho	No. Exempt incidental sales by religious corporations or societies.
Illinois	No. Exempt sales to members or sales not of a kind made by for-profit business.
Indiana	No. Exempt sales during not more than 30 days in calendar year.
Iowa	Yes, if proceeds used for purposes relating to exempt activity without deduction for expenses.
Kansas	No.
Kentucky	No. Exempt school groups when net benefits school or its students.
Louisiana	No. Exempt admissions or fund-raising events only.
Maine	No. Exempt sales by schools if profits used to benefit school.
Maryland	No. Exempt religious organization sales for its general purposes.
Massachusetts	No. Exempt sales at fairs, picnics, etc. to extent of two events of day's duration in year, unless organization registered as vendor.
Michigan	No.
Minnesota	No. Exempt nonprofit organization fundraisers, no more than 24 days per year.
Mississippi	No. Tax sales in competition with private business (Girl Scout cookie sales specifically exempt).
Missouri	Yes.

Nebraska	No. Exempt sales by schools (K-12) if authorized school function.
Nevada	Yes.
New Jersey	Yes, unless organization in substantial competition with private business.
New Mexico	Yes, but to social organizations.
New York	Yes, unless from shop or store operated by the organization.
North Carolina	No. Exempt sales as annual fund-raiser for only 60 days.
North Dakota	Yes, unless organization has store front or sale is in public building. Does not apply to regular sales in direct competition with retailers.
Ohio	No. Exempt six sales in any calendar year, no more than one in any calendar month.
Oklahoma	No. Exempt church when not engaging in business for profit competing with persons engaged in similar business; exempt fundraising group sales for public or private schools.
Pennsylvania	No. Exempt when isolated (less than three times per year or less than seven days for one event and not conducted at same location as other vendors).
Rhode Island	No. Exempt youth or school organization sales prices below \$3 each.
South Carolina	Yes, if proceeds used for exempt purposes and no benefit inures to any individual.
South Dakota	No. Exempt sales for three days or less; items purchased for sale taxed on purchase.
Tennessee	No. Exempt if not sold on regular basis or sold only during temporary sales period.
Texas	No. Exempt one sale per year for one day for religious, educational, charitable entities.
Utah	No. Exempt sales of religious or charitable institutions in course of regular functions or activities.
Vermont	Yes.
Virginia	No. Some organizations specifically exempt.
Washington	No.
West Virginia	No.
Wisconsin	No. Exempt if sales event limited to 20 days per year or taxable receipts do not exceed \$15,000 per year; entertainment must not be involved and organization cannot hold sellers permit.
Wyoming	No. Annual religious or charitable bazaars and similar events are exempt.

SOURCE: Correspondence with state tax departments and Commerce Clearing House. *State Tax Reporters*, looseleaf service.

Reproduced from Fox, ed.,  
Sales Taxation, op.cit., pp.127-2

churches are virtually never subject to tax on church dinners served for church members on an occasional basis.

#### OTHER CASUAL SALES

Casual sales are typically defined as sales by persons other than those regularly offering goods for sale in the course of business--thus excluding "garage sales" and similar activities. State laws differ in their precise definition of casual, usually defining in terms of numbers of days during the year in which sales are made. Business firms are typically, but not in all states, free of tax on sales of equipment, etc., not normally carried in the business, and in some but not all states, sale of assets in the event of close out or mergers. The overall picture is very confusing.<sup>1</sup>

An exception to the casual sales rule is applied to motor vehicles; typically tax applies to all motor vehicle sales, and the ownership and registration of vehicles cannot be transferred without evidence of payment of tax.

#### CONCLUSION

The net conclusion to be reached from the discussion of services would appear to be as follows: it is important not to expect too much from service taxation if the services to be taxed are selected on a rational basis. This statement relates to additional revenue, to improved equity, and to simpler and more effective administration. But this is not an argument against taxing an appropriate group of services,

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<sup>1</sup>Peter L. Faber, "The Sales Taxation of Mergers and Acquisitions," in Fox, ed., Sales Taxation, op. cit., Chap. 7.

ones provided primarily to consumers, not to business firms, and excluding ones which contemporary society regards as inappropriate for taxation. Expenditures on services constitute consumption expenditures just as much as those on commodities; the earlier sharp dichotomy make little sense.

The usual tax treatment of real property contracts has the presumably intended effect of favoring housing over other consumer purchases, justified by governments on the grounds of encouraging improved housing and, while seldom mentioned, lessening tax burden on real property production inputs. But as with almost any form of special treatment, question can be raised about the desirability of favoring this form of consumption expenditures.

The area of taxation of sales by and to governments and various non profit organizations, and particularly the latter, is one of great complexity and differences among the states, but reflects in part the desire of the states to encourage forms of activities provided by such organizations. But the piece meal approach and the nonuniformity among states inevitably create operational problems.







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