Draft Report - SC Taxation Realignment Commission (TRAC)
Sales and Use Tax Exemption, Exclusion and Maximum Tax Recommendations to the General Assembly
September 2, 2010

TRAC undertook an extensive public review of the State's more than 120 sales and use tax exemptions, exclusions, and/or maximum sales taxes, whose value is estimated by the Board of Economic Advisors to be at least $2.7 Billion annually. TRAC's review comprised numerous public meetings including subcommittee work, public testimony from dozens of citizens and trade associations and testimony from various state, regional and national experts on areas involving sales and use tax generally, and exemptions, exclusions, and exemptions specifically. TRAC finds that:

- Pursuant to Act 81 of 2009, which established TRAC, and according to SC Code Title 12, Chapter 3, Section 10(C)(2)(a), the General Assembly specifically mandated that TRAC provide the General Assembly a "detailed, careful, and comprehensive" recommendation regarding which "sales and use tax exemptions or limitations to be retained, modified, or repealed."

- The General Assembly, at least twice during the past decade, has established its own, either joint and/or ad hoc committees, composed of legislators, to undertake a similar review as the one outlined above. However, in neither case did the work of either committee materialize The committees did not adopt or publish recommendations regarding which sales and use tax exemptions or limitations should be retained, modified, or repealed.

- One of the first charges issued by the General Assembly to TRAC was to complete this important, long discussed, but never acted upon task. Acknowledging the significance of this work, the General Assembly did not impose any parameters, restrictions, or limitations on what TRAC could, or could not recommend to the General Assembly in its final analysis regarding which sales and use tax exemptions or limitations to offer for retention, modification, or repeal.

- To ensure TRAC's impartiality and the ultimate integrity of the final product, the General Assembly imposed guidelines for lobbyist interactions with TRAC members outside of public meetings. However, as noted above, TRAC sought, accepted, and carefully deliberated extensive testimony and information provided publically, or in writing, by citizens, lobbyists, special interest groups, trade associations, and state, regional, and national experts.

- Pursuant to Title 12, Chapter 3, Section 10(C)(2)(b), the General Assembly requires TRAC to, in part, (a) assess state taxes levied that (b) "...fund the operation and responsibilities of state...government".

- Comprising 42 percent of total General Fund receipts in the fiscal year just ended (FY2009-10), the Sales and Use Tax is the single largest component of State General Fund revenue. This important component of the State's tax structure is (a) a state levied tax, and (b), the revenue it produces does fund the operation and responsibilities of state government, namely and primarily, K-12 education (pursuant to SC Code 12-36-2620, 12-36-2630 and 59-21-1010).

- It is proper for TRAC to have exhaustively studied the State's sales and use tax history, adaptations (or lack thereof) of (or to) the tax over time, structural issues, and specifically its more than 120 exemptions, exclusions, or maximum sales tax caps, which, as noted above, total an estimated $2.7 Billion annually.

- TRAC recognizes that the State's exemptions, exclusions and maximum caps to the sales tax now exceed the amount of General Fund revenue generated from the State's current sales and use tax base not exempt from the tax, thereby making a thorough review of those exemptions of paramount importance when undertaking an overall review and comprehensive analysis of the State's tax structure.

- State General Fund revenue derived from the State sales tax, having just completed its third consecutive year of revenue decline, totaled $2.19 Billion during FY2009-10. This is the same level of revenue generated in FY2003-04, or 6 years ago, and, adjusting for inflation, equates to the same level generated in FY1998-99, or 11 years ago.

- This near term and substantial decline in sales tax revenue is attributable, in part, to the recent and protracted economic downturn. This decline is also symptomatic of longer term structural issues highlighted by several factors including; a) the economy's distinct and dramatic shift away from a goods based to a services based economy, b) an increasing shift from "brick and mortar" retail transactions to e-commerce purchases, c) and direct legislative actions that have adversely impacted the tax base (eg, sales and use tax exemptions, exclusions and/or maximum tax caps which have increased, not decreased, over time).

- The impact of this disparity between economic activity and tax structure is evident. In FY1998-99, almost 50 percent of "gross retail sales" were subject to sales tax in South Carolina. By FY2008-09, that percentage had fallen to just 38 percent - a number that continues to fall.

- More telling is the fact that, during the 10-year period between FY1998-99 and FY2007-08, while "gross" retail sales in South Carolina grew annually at a rate of almost 6 percent, "net" retail sales subject to State sales tax grew at half that annual rate, or just over 3 percent per year. This rate is less than the rate of annual growth in the State's population plus inflation.

- Another key measure illustrating this decline in State sales tax revenue relative to economic growth is the correlation between sales tax revenue and personal income. Upon initial observation, sales tax revenue appears to be reasonably stable relative to personal income.

- TRAC finds that such apparent "stability" has occurred because over time the General Assembly has increased the State sales and use tax rate to its current rate of 6 percent.

- And when adjusting for these rate increases over time, what is "unmasked" is not a stable tax, but an unstable sales and use tax system.

- According to an independent analysis, in 1981, the state sales tax comprised 2.25 percent of personal income. By 2000, that number had fallen to just 2 percent and fell yet again to 1.96 percent by 2004.

- As tax bases narrow, but cost and demand for public services grows (based on population plus inflation), upward pressure on a state's sales and use tax rate naturally results. South Carolina has been no exception. In 1969, South Carolina's sales and use tax rate was 3 percent. Today it is 6 percent.

- Absent recognition of such clear and definitive trends, and ultimately absent requisite structural change, state legislators will be faced with inevitable pressure to increase the State's sales and use tax rate just to maintain revenues.

- TRAC finds that State lawmakers need look no further than to their neighbor to the north (North Carolina) for affirmation of such pressure, where no less than twice during the last 10 years, that state has approved two "temporary" sales tax increases, the first of which became permanent, and the most recent of which, according to news reports, seems destined for permanency as well.

- Such sales and use tax rate increases do not equate to proactive tax reform, but are instead often reactive responses to economic downturns and budgetary pressures.

- The General Assembly has, to date, failed to make what TRAC will deem as necessary structural changes to the State's sales and use tax system (as illustrated by, and in relation to, the above findings), and has in some cases actually exacerbated the State's structural problems by its decisions. However, it is to be commended for not having raised our State's 6 percent sales and use tax rate in reaction to recent economic pressures.

- TRAC believes the General Assembly is well positioned to refrain from the foreseeable pressures to increase the tax rate, and instead, is in good position to implement true and long-term structural reform that will DECREASE, not INCREASE, the State's sales and use tax rate, which is currently one of the highest in the country.

Key Recommendations:

TRAC's recommendations are not based on temporary sales tax rates that rise and fall based on short-term budgetary or political pressures, but are based on long-term structural reform that will, by broadening the base and lowering the rate, promote revenue stability and most importantly, promote enhanced fairness for both individuals and businesses, who, absent reform, will otherwise face continued pressure from a tax base that continues to narrow.

A fair and transparent tax system should tax a broad basket of goods at the lowest rates possible. With little exception, fairness is attained when only final retail sales of goods and services are subject to sales tax. Likewise, sound tax policy demands key exceptions (eg "exemptions") particularly in regards to "input" transactions be enacted or retained.

That is why, with little exception, the majority of TRAC's recommendations RETAIN key exemptions for manufacturing, agricultural and other business "inputs", while entirely or partially removing many purchases considered to be end or "final" retail sales from their current exempt status.

For example, TRAC recommends retaining the sales and use tax exemption for newsprint "paper", a key process input component necessary in newspaper publication, but recommends taxing the actual retail sale of the newspaper to the end consumer (eg, the customer).

From a tax policy and fairness standpoint, this recommendation is no different than current law whereby South Carolina exempts from sales tax the rubber used to make a tire, but doesn't exempt the final product (eg, "the tire") from retail sales tax.

Taxing such business inputs, referred to in tax parlance as "pyramiding", inhibits tax neutrality, transparency and fairness.

TRAC affirms this important policy position and commends the General Assembly for many of the key exemptions it has codified for various manufacturing, agricultural, and business inputs in industries that are vital to the State's current and future economic development.

Iin its effort to recommend long-term and sustainable structural reform, TRAC makes thoughtful decisions by continuing full exemptions on certain items, imposing substantially lower rates on others, and fully exempting certain segments of the population from tax liability out of a desire to achieve the difficult balance between a system that is fairer for all South Carolinians on the whole, while not overly burdening the most vulnerable portions of our populace.

Key Highlights

Broaden the Base:
Broaden the State's sales and use "tax base" by repealing, amending, or modifying dozens of the State's sales and use tax exemptions, exclusions, and/or maximum tax caps.

Note: Based on unofficial staff estimates (official BEA estimate pending), the proposal would "broaden" the State's sales and use tax base by an estimated $10.1 Billion, generating an estimated $611 Million in revenue annually.

Lower the Rate:
Utilize 100 percent of the estimated revenue to be generated ($611 Million) for a dollar-for-dollar, commensurate, and permanent reduction in the State's 6% sales and use tax rate, which, at 6%, is currently one of the highest state sales and use tax rates in the country.

Based on initial and unofficial staff estimates, this proposal would lower the State sales and use tax rate from 6% to 5.06%. While slightly revenue negative, TRAC recommends the General Assembly "round down", and as such, set the rate at 5%.

Note: This recommendation assumes the official BEA estimate (still pending) comes in between 5 and 5.06%. If the official estimate comes in below 5%, the recommendation is to adopt the lower (and revenue neutral, not negative) rate.

It is important to note that a rate reduction from 6% to approximately 5%, which is almost a 20% reduction, would improve the State's national sales tax ranking by roughly 18 full spots.

It should also be noted that this rate reduction, while substantial, should move lower still, pending TRAC's adoption of the final version of its "Services and Intangibles" recommendations. Like this proposal, TRAC recommends that the General Assembly utilize 100 percent of whatever revenue is estimated to be generated by the services/intangibles recommendations for further dollar-for-dollar rate reduction. Note: While we believe this to be a valid assumption, it nevertheless requires BEA analysis for verification and/or correction.

TRAC is Sensitive to Regressivity and Economic Concerns:

Car Tax Cap. South Carolina's $300 maximum sales tax cap on motor vehicle purchases is truly unique among the 50 states. The cap, entirely appropriate and necessary in 1984, 26 years later, represents one of the most regressive aspects of the State's entire sales and use tax code today.

As case in point, a resident purchasing a $6,000 car pays an effective sales tax rate of 5% - a rate that is 10 times HIGHER than a resident buying a car that costs $56,000, whose effective tax rate in South Carolina is just 0.54% - a tax rate 10 times less on a car that costs 10 times more. That is the definition of a regressive tax.

TRAC therefore recommends repeal of South Carolina's outdated and regressive sales tax cap on cars.

HOWEVER, sensitive to the current economic climate, and desiring the state's residents and automobile dealers ample time to adjust to this necessary change, TRAC recommends a gradual increase in the current cap over a period of years, as follows:

July 1, 2011: $600 cap
July 1, 2012: $1,000 cap
July 1, 2013: $1,200 cap
July 1, 2014: No cap

Residential Electricity/Natural Gas. Currently, residential electricity and natural gas is exempt from sales and use tax liability in South Carolina, while electricity purchased by business and industry (unless used in a manufacturing or similar 'input' process) is taxed at 6%*.

TRAC recommends expanding the sales and use tax base to include residential electricity and natural gas purchases.

HOWEVER, sensitive to regressivity concerns, especially regarding our State's most needy and/or elderly residents, TRAC recommends RETAINING a 75 percent exemption on residential electricity and natural gas for all residents (regardless of income or age).

That equates to an effective sales and use tax rate of no more than an estimated 1.25%. That rate is 70 percent less than Georgia (4%) and 58 percent less than North Carolina (3%). In addition to Georgia and North Carolina, more than 20 other states tax residential electricity and natural gas.

*Note: Because TRAC's proposal is to lower the State's overall sales and use tax rate, the current 6% sales tax due on business purchases of these commodities would be reduced by almost 20% under this proposal, as the overall rate is expected to drop from 6% to approximately 5% under this proposal.

Water. Similar to residential electricity and natural gas, water is currently exempt from sales tax in South Carolina. Currently, 12 states impose a tax on water sales at an average rate of 4.98%.

Sensitive to regressivity concerns, especially regarding our State's most needy and/or elderly residents, TRAC recommends RETAINING a 75 percent exemption on water, yielding an effective sales and use tax rate of no more than an estimated 1.25% on such purchases; a rate 75 percent less than the average state currently taxing water.

Prescription medicines. Currently, prescription medicines purchased at a retail pharmacy are exempt from sales tax liability in South Carolina. TRAC recommends:

RETAINING the full exemption for prescription medicines bought at a retail pharmacy by Medicaid and Medicare beneficiaries.

RETAINING the full exemption for certain medicines sold directly to medical providers for treatment of cancer, lymphoma, leukemia (and related diseases), rheumatoid arthritis, respiratory syncytial virus, viscosupplementation therapies, and medicines sold to Nursing Homes for use by Medicare Part A patients. The General Assembly specifically enumerated these exemptions and in TRAC's final analysis recommends that they be retained. Note: Medicines sold directly to medical providers but not currently exempt would remain taxable under this proposal but would benefit from an almost 20 percent tax savings compared to current law as the overall sales and use tax rate will drop from 6% to approximately 5%.

RETAINING the full exemption for free samples of prescription medicine distributed by its manufacturer.

RETAINING the full exemption for medicine donated by its manufacturer to a public institution of higher education for research or for the treatment of indigent patients.

RETAINING the full exemption for prescription medicine sold to health care clinics and/or charitable hospitals where medical care is given free of charge to all its patients (ie, "free clinics")

RETAINING a 75 percent exemption on prescription medicines bought at a retail pharmacy by NON Medicaid and Medicare beneficiaries. As such, 25 percent of the gross proceeds of the sale of such prescriptions to non Medicaid/care beneficiaries would be taxable.

That equates to an effective sales tax rate of no more than 1.25%.

In addition to the sensitivity TRAC has shown to issues of regressivity by maintaining full exemption for Medicaid and Medicare beneficiaries, and by imposing an effective sales tax rate that is 80 percent less than the State's current 6% sales tax rate, TRAC is still concerned about potential excessive sales tax burden on residents with chronic and costly conditions.

That is why TRAC also recommends a MAXIMUM sales tax liability on total prescription drug purchases of $100 ($8.33 month maximum liability) annually.

Residents with annual sales tax liability on prescription drug purchases of more than $100 would be entitled to, and would receive, a full rebate for any sales tax paid over $100.

The rebate would be in the form of a refundable income tax credit and would be available to all residents regardless of income tax liability. Residents with no income tax liability would be able to file for, and receive, their refund for sales taxes paid over $100.

Groceries. TRAC recommends partial restoration of a "grocery tax", but sensitive to regressivity concerns, especially regarding our State's most needy and/or elderly residents, TRAC recommends RETAINING a 41 percent exemption on grocery sales.

Based on an expected sales tax rate of approximately 5%, that means an effective tax rate on groceries of no more than 2.95%, a rate less than the State formally imposed on groceries in the past.

In addition, out of deference to concerns for the needy, TRAC recommends that groceries purchased with food stamp benefits remain fully exempt as under current (and prior) law.

Note: Of the 14 states that currently tax groceries, the average tax rate in those states is 3.79%. Of the 7 states that tax groceries at lower sales tax rates than their state's general rate, the average is 2.6%, making TRAC's proposal very much in line with tax policy in peer states that tax groceries.

E-Commerce. TRAC recommends that the General Assembly recognize and respond to the ever changing technology and digital landscape and its impact on the economy, state and local revenue, and most importantly, main street businesses with brick and mortar invested in and across every town in South Carolina. TRAC's specific recommendations regarding ecommerce are attached.

*Note: Please see the attached for the full list of recommendations.

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