



## TAXATION AND BUDGET REFORM COMMISSION

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### Staff Analysis and Economic Impact Statement

Measure: CP 2

REFERENCE:

ACTION:

Sponsor: Commissioners McKay and  
Rouson

1. GPSC
2. FTC
- 3.

Pre-meeting

Subject: Repeal of sales tax exemptions  
and taxation of services

Date: January 16, 2008

#### I. Summary:

Constitutional Proposal 2 requires the Legislature to replace most ad valorem taxes to fund education with revenues gained from the repeal of sales tax exemptions and the taxation of services. The amount of the required local effort that must be replaced must be greater than or equal to the required local effort specified in the "2008 budget." Implementation of this measure will result in a broad-based service tax.

#### II. Present Situation:

The *2007 Florida Tax Handbook* estimates that Florida's sales tax will raise \$23,581,500,000 for fiscal year 2007-2008. The value of a 1 percent levy on the sales tax base was estimated to be \$3.9303 billion.<sup>1</sup>

##### *Sales Tax*

Florida law provides that each sale, admission charge, storage, or rental is taxable unless the transaction is specifically exempt. Florida's general sales tax rate is 6 percent. However, there is an established "bracket system" for collecting sales tax on any part of each total taxable sale that is less than a whole dollar amount. Additionally, a discretionary sales surtax is imposed by many Florida counties. To compute the Florida sales tax rate for each county, the county imposed discretionary sales surtax rate is added to the general sales and use tax rate.<sup>2</sup>

<sup>1</sup> The Florida Senate, *2007 Florida Tax Handbook: Including the Fiscal Impact of Potential Changes*, p. 114 (2007).

<sup>2</sup> Department of Revenue, Florida Sales and Use Tax, [http://dor.myflorida.com/dor/taxes/sales\\_tax.html](http://dor.myflorida.com/dor/taxes/sales_tax.html) (last visited Jan. 15, 2008).

***Discretionary Sales Surtax***

Under specific conditions, Florida counties are authorized to levy a discretionary sales surtax on most transactions that are subject to sales and use tax. A dealer who sells and delivers taxable merchandise or taxable services is required to collect the surtax at the rate imposed in the county where the merchandise or service is delivered. For motor vehicle and mobile home sales, the surtax rate of the county where the vehicle or mobile home will be registered is used to calculate the appropriate tax.<sup>3</sup>

Only the first \$5,000 of a single sale of tangible personal property is subject to a discretionary sales surtax if the property is sold as a single item, in bulk, as a working unit, or as part of a working unit. The \$5,000 limit does not apply to commercial rentals, transient rentals, or services.<sup>4</sup>

***Use Tax and Consumption***

Use tax complements, and is applied in the same manner as, sales tax. The use tax rate and sales tax rate are the same, including discretionary sales surtax, if applicable. Use tax is due on purchases made out of state and brought into Florida within 6 months of the purchase date. Also, if you purchase a product tax-exempt that you plan to sell at retail, but end up using it at your place of business, the "use" of the product is subject to tax. If you purchase materials that are "consumed" in a manufacturing process to create your end product, but are not part of the end product, those materials are subject to tax.<sup>5</sup>

The "use" component of the sales and use tax provides uniform taxation on items that are purchased outside Florida, but are used or stored in the state. If the item brought into Florida is subject to tax, a credit for lawfully imposed taxes paid to another state, a U.S. territory, or the District of Columbia is permitted. Credit is not given for taxes paid to another country.<sup>6</sup>

***Sales Tax Exemptions***

The *2007 Florida Tax Handbook* lists 246 exemptions from the sales tax.<sup>7</sup> The *Tax Handbook* states that several of the exemptions are fundamental to the structure of the tax. These structural exemptions include:

- Items purchased for subsequent resale;
- Intangible personal property;
- Tangible personal property imported or produced for export; and
- Purchases of agricultural products used in further processing for resale.

The revenue impact of the remaining exemptions is estimated to be \$12.3403 billion. However, the *Tax Handbook* notes that some of the exemptions overlap such that the

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> The Florida Senate, 2007 Florida Tax Handbook: Including Fiscal Impact of Potential Changes

repeal of all of the exemptions, excepting the structural exemptions, would yield less than \$12.3403 billion. Of non-structural exemptions:

- \$8.15 billion relate to household items;
- \$0.67 billion relate to organizations;
- \$2.16 billion relate to business items; and
- \$1.35 billion relate to miscellaneous items.<sup>8</sup>

### ***Sales Tax on Services***

In 1986, the Legislature repealed the sales tax on services, effective July 1, 1987. In 1987, the Legislature integrated the tax on services with the sales tax on tangible personal property. In a 1987 special session, the Legislature repealed the sales tax on services, effective January 1, 1988. Accordingly, the state's experience with a broad-based sales tax on service lasted six months.

Most services are not [currently] subject to Florida's sales tax. This lack of tax on most services is not due to an exemption from the tax, but from the fact that services are not specified as taxable. There are basically two exceptions to this. First, s. 212.05(1)(k), F.S., specifically states that detective, burglar protection, and other protective services and nonresidential cleaning and pest control services are subject to the sales tax.<sup>9</sup>

Second, the definition of "sales price" in s. 212.02, F.S., states that the amount paid for tangible personal property includes any services which are part of the sale "without any deduction therefrom on account of the cost of property sold, the cost of materials used, labor or service cost, interest charged, losses, or any other expense whatsoever." The definition also states that sales price includes "the consideration for a transaction which requires both labor and material to alter, remodel, maintain, adjust, or repair tangible personal property."<sup>10</sup>

The third component important in the discussion of sales tax on services is the exemption in s. 212.08(7)(v), F.S., relating to a professional, insurance, or personal service transaction that involves sales of tangible personal property as "inconsequential," and elements for which no separate charges are made. Thus, even though a lawyer might issue a written opinion in the performance of his or her duties, the written report is considered inconsequential to the main service of rendering the opinion.<sup>11</sup>

The *Tax Handbook* estimates that the annualized receipts from the application of the state sales and use tax on service transactions for fiscal year 2007-2008 would yield \$23.4144 billion.

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<sup>8</sup> *Id.* at 118.

<sup>9</sup> The Florida Senate, Fiscal Resource Committee, *Sales Tax Exemptions: A Tool for Lowering the Sales Tax Rate in Florida* 13 (Aug. 2000).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 13-14.

***Required Local Effort***

In accordance with s. 1011.62, F.S., the Legislature establishes in the General Appropriations Act the amount of required local effort for school districts. These funds specified by the Legislature must be collected by school districts through ad valorem taxes. The required local effort amount set by the Legislature for fiscal year 2007-2008 was approximately \$7.9 billion, not including discretionary local effort.

***NAICS Codes***

“The North American Industry Classification System (NAICS, pronounced Nakes) was developed as the standard for use by Federal statistical agencies in classifying business establishments for the collection, analysis, and publication of statistical data related to the business economy of the United States. NAICS was developed under the auspices of the Office of Management and Budget (OMB), and adopted in 1997 to replace the old Standard Industrial Classification (SIC) system. It was also developed in cooperation with the statistical agencies of Canada and Mexico to establish a 3-country standard that allows for a high level of comparability in business statistics among the three countries. NAICS is the first economic classification system to be constructed based on a single economic concept.”<sup>12</sup>

**III. Effect of Proposed Changes:**

Constitutional Proposal 2 requires the Legislature to replace most ad valorem taxes to fund education with revenues gained from the repeal of sales tax exemptions and the taxation of services. The amount of the required local effort that must be replaced must be greater than or equal to the required local effort specified in the “2008 budget.”

***Amount of Revenue to be Raised***

The amount of revenue that must be raised by this measure must be greater than or equal to the required local effort specified in the “2008 budget.” State budgets, however, begin on July 1 and end on June 30 of the next year. As such, the measure may refer to the required local effort specified in the General Appropriations Act for fiscal year 2007-2008. The total required local effort specified in that act was approximately \$7.9 billion, not including discretionary local effort. The Commission may wish to revise this measure to state either a dollar amount or to refer more precisely to the General Appropriations Act for fiscal year 2007-2008.

***Exempt Exemptions***

This measure expressly states that it does not mandate the repeal of exemptions for: food, prescription drugs, health services, and residential rent, electricity and heating fuel. These items refer to categories of exemptions, as opposed to specific exemptions identified by statute. These exemptions likely correspond to nearly the full revenue impact of the exemptions categorized as “household items” in the *Tax Handbook*. Viewed broadly, the categories of exempt exemptions may refer to the items described as

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<sup>12</sup> U.S. Census Bureau, Ask Dr. NAICS, What Is NAICS and How Is It Used?, <http://www.census.gov/epcd/www/drnaics.htm#q1> (last visited Jan. 15, 2008).

excerpted from the *Tax Handbook* below.

Line No.	Exemption	Revenue Impact (in \$ m)	Type
17	Rent charges paid by certain long term occupants.	4.0	Household
18	Rent charges paid by certain full-time students.	33.1	Household
19	Rent charges paid by active military personnel.	32.0	Household
20	Rent charges paid by permanent residents.	1,259.2	Household
21	Charges for rent in certain mobile home parks.	3.3	Household
22	Rent charges for living accommodations in migrant labor camps	13.1	Household
99	Groceries purchased for human consumption.	2,651.5	Household
100	Food purchased with food stamps.	1.2	Household
101	Prescription drugs.	896.0	Household
102	Non-prescription drugs.	199.0	Household
103	Eyeglasses and other corrective lenses.	44.3	Household
104	Medical supplies and products such as syringes and prosthetics.	114.8	Household
160	Charges for hospital meals and rooms.	603.2	Household
161	In-facility meals purchased by residents of homes for the aged.	22.2	Household
162	Purchases of power & heating fuels by residential households.	2,178.9	Household
200	Nonprofit cooperative hospital laundries.	0.1	Business
207	Complimentary food items.	0.8	Business
208	Food or beverages donated to nonprofit organizations.	<u>0.3</u>	Organization
		8,057.0	

The maximum amount of revenue that may be gained by the repeal of all non-structural sales tax exemptions is \$12.3403 billion.<sup>13</sup> The most that the Legislature will be able to recover from the non-exempt exemptions to offset the required local effort is slightly more than \$4 billion. As a result, the Legislature will have to raise at least \$4 billion through a sales tax on services, and even more to the extent that the Legislature declines to repeal sales tax exemptions for business items, nonprofit organizations, and miscellaneous items.

### ***Review of Services***

Paragraph (2) of subsection (c) of this measure refers to a “public purpose review of each service that is mandated in subsection (b).” However, subsection (b) does not clearly mandate a “review.” Perhaps, subsection (b) was intended to mean that all services are taxable, unless exempt. Thus, a review would occur when the Legislature creates an exemption from the sales tax on services by a bill containing the single subject-matter of a single exemption approved by a three-fifths vote of each house of the Legislature. Alternatively, subsection (b) may require a review of exemptions created after the implementation of this measure.

### ***Creation of Exemptions***

This measure requires sales tax exemptions, including exemptions for sales tax on services, to be created by the Legislature in a bill containing the single subject-matter of a single exemption approved by a three-fifths vote of each house of the Legislature. The

<sup>13</sup> The *Tax Handbook* states that some exemptions overlap. As a result the repeal of all exemptions would generate less than \$12.3403 billion.

bill must also include a statement that the exemption advances or serves a public purpose. Services exempted must be identified by reference to at least the first four digits of the corresponding NAICS code.

***Repeal of Exemptions or Taxation of Services***

This measure may create an incentive for the Legislature to tax services, rather than repeal existing exemptions. If the measure taxes all services except those made exempt, then the default mechanism to raise revenue is the sales tax on services. Historically, perhaps due to political pressure, the Legislature has reviewed exemptions, but has chosen not to repeal them. Moreover, this measure creates a logistical hurdle to create new exemptions, including exemptions from the sales tax on services. Exemptions must be created in a bill containing the single subject-matter of a single exemption that is approved by a supermajority vote of the Legislature. Accordingly, the bulk of the revenues generated by this measure appear likely to be generated by a sales tax on services.

***Duration of Replacement of Required Local Effort***

This measure requires the Legislature to replace the ad valorem millage for required local effort prior to July 1, 2009. The structure of the measure, however, does not clearly indicate whether the duration of this replacement must be a one time event or a permanent replacement. If this measure refers to a one time event, the Commission may wish to revise the measure to apply to assessments for ad valorem taxes in a specific year. Under such circumstances, the measure could also provide that it expires after the assessment year. If this measure is designed to create a permanent replacement for required local effort, the Commission may wish to repeal the authority of school districts to impose taxes in section 9 of article VII and section 4 of article IX of the Florida Constitution.

This measure will take effect on November 4, 2008.

**IV. Constitutional Issues:**

**A. Constitutional or Legislative Matter:**

The imposition of a sales tax on services was previously accomplished by the Legislature by statute.

**B. Other Constitutional Issues:**

If this measure makes all services subject to the sales tax unless they are exempt, then this measure may be governed by section 7 of article XI of the Florida Constitution. That section states in part:

no new State tax or fee shall be imposed on or after November 8, 1994 by any amendment to this constitution unless the proposed amendment is approved by not fewer than two-thirds of the voters

voting in the election in which such proposed amendment is considered.

On the other hand, one could argue that this measure does not create a new tax, but makes the existing sales tax applicable to a currently untaxed service transaction. Case law has not defined what constitutes a “new State tax.”

Additionally, constitutional amendments governed by section 7 of article XI of the Florida Constitution must be approved by at least “two-thirds of the voters voting in the election,” rather than two-thirds of the *voters voting on the amendment*. Thus, non-votes are effectively “no” votes.

The term “drop-off rate” is used to describe the percentage of voters who turn out, but decline to vote, on a ballot measure. In the 1996 General Election, approximately 12 percent of the voters in the election did not vote on the first constitutional amendment. Thus, a constitutional amendment subject to section 7 of article XI of the Florida Constitution may require approval by a substantially higher percentage of the voters on the measure to offset the drop-off rate.

## **V. Economic Impact and Fiscal Note:**

### **A. Tax/Fee Issues:**

This measure will shift funding for a substantial portion of the public education system from an ad valorem tax to a sales tax on services. Service industries tend to grow faster than other segments of the economy. As a result, sales tax revenues on services may grow faster than the sales tax on the sale of tangible personal property.

### **B. Private Sector Impact:**

This measure will shift funding for a substantial portion of the public education system from an ad valorem tax to a sales tax on services. Most household exemptions are exempt from this measure, but few business items are exempt. Service taxes appear to apply more to business services, rather than household services. As a result, businesses will be responsible for funding a greater percentage of the cost of government.

### **C. Government Sector Impact:**

The Department of Revenue will likely have to hire additional staff to administer and enforce a sales tax on services. In addition, local school districts may become less relevant and less influential as the state revenues funding education increase relative to local revenues.

## VI. Technical Deficiencies:

This measure requires the Legislature to repeal a sufficient number of sales tax exemptions and tax a sufficient number of services to generate revenues “not less than the amount appropriated in the General Appropriations Act as the required local effort for all school districts in the state fiscal year 2008 budget.” A state fiscal year begins on July 1 and ends on June 30 of the following year. The measure should be amended to refer to the 2007-2008 fiscal year. Alternatively, the references to the budget year and the General Appropriations Act could be replaced with approximately \$7.9 billion, the required local effort set by the Legislature in the last General Appropriations Act.

Paragraph (2) of subsection (c) of this measure refers to a “public purpose review of each service that is mandated in subsection (b).” However, subsection (b) does not clearly mandate a “review.” Perhaps, subsection (b) should be amended to clarify the intent of the measure sponsors.

The measure provides that it must be implemented by the Legislature prior to July 1, 2009. Due to the fact that this measure cannot be presented to the voters until November, 2008, the Legislature will have a short period of time to conduct a review of exemptions and services and draft implementing Legislation. The Legislature should have more time to conduct a review and implement a measure of this magnitude. Accordingly, the implementation date of this measure should be pushed back to 2010 or 2011.

## VII. Related Issues:

For ease of compliance by the Legislature, the Commission may wish to identify the sales tax exemptions that may not be used to reduce the required local effort based on their names or statutory reference, rather than broad categories of exemptions. There are other measurement scales, such as the one used by the Federation of Tax Administrators, which could be considered.

The measure directs the Legislature to focus its revenue raising efforts on repealing exemptions that are “determined not to advance or serve a public purpose” and the “taxation of services whose exclusion from sales taxation is determined not to advance or serve a public purpose.” One could argue that nearly all exemptions, and the exemption of most services from a sales tax on services, serve some public purpose. Perhaps, the measure should be revised to direct the Legislature to focus on exemptions and services that fail to serve a public purpose *sufficient to justify an exemption*.

The measure provides that a bill creating a sales tax exemption must include a “legislative finding that the exemption advances or serves the public purpose of: encouraging economic development and competitiveness; supporting educational, governmental, literary, scientific, religious, or charitable initiatives or institutions; or securing tax fairness.” In contrast, subsection (c) of section 24 of Article I of the Florida Constitution requires the Legislature “state with specificity the public necessity justifying [a public records] exemption.” Perhaps, the Commission may wish to revise the measure



to more closely follow the statement requirements for the creation of a public records exemption. Otherwise, bills creating a tax exemption may contain the boilerplate statement that the exemption “advances or serves the public purpose of: encouraging economic development and competitiveness; supporting educational, governmental, literary, scientific, religious, or charitable initiatives or institutions; or securing tax fairness.”