
REVENUE IMPACTS OF TAX COMMISSION DECISIONS

A REPORT TO THE
EXECUTIVE APPROPRIATIONS COMMITTEE

OFFICE OF THE LEGISLATIVE FISCAL ANALYST
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I. EXECUTIVE SUMMARY

A recent Utah State Tax Commission decision regarding sales tax collection on textbooks sold at colleges and universities raises questions about what impact Commission decisions might have on overall state revenue. Had the decision been considered by the Legislature as a bill – which it had been in the past – the bill most likely would have carried a fiscal note that would have been accounted for in the state’s balanced budget. This report examines whether Tax Commission rulings and interpretations in total should be controlled for in the Legislature’s revenue estimating process.

Range of Impact Commission Decisions Have Upon the General/Education Funds			
	Low	High	Expected
Fiscal Impact	(\$4,200,000)	\$8,000,000	\$1,900,000

Figure 1

II. INTRODUCTION

Over the past 10 years, the Utah State Tax Commission has made approximately 22,000 decisions related to, *inter alia*, sales tax, income tax, corporate income tax, severance tax, and cigarette and tobacco tax. Although most of decisions made by the Commissioners have no direct, measurable revenue impact, some do affect revenue. By the very nature of the office, Commissioners must make decisions regarding audits, appeals, and licensing – and, depending upon the historical character of the respective revenue, the conclusions reached by the Commission will have fiscal impact, where fiscal impact is defined as being a change from historical revenue patterns. For example, suppose initially revenue from a given source had been considered part of the sales tax base for the past five years. Upon appeal, the Commission comes to the conclusion that a given entity must not pay sales tax. Thus, the fiscal impact is that of a sales tax base decrease. On the other hand, suppose initially revenue from a given source is considered part of the sales tax base. Upon appeal, the Commission upholds that an entity must remit sales tax. Clearly in this case there is no fiscal impact because there is no change in the sales tax base. While rarely would any one ruling have a significant impact on the state’s \$5.5 billion General and Education Fund budget, a question arises as to whether, in total, Tax Commission rulings significantly impact revenue. **The overall conclusion is that Commission decisions, on average, increase revenue to the General and Education Funds by \$1.9 million, with the range for any given year being from a loss of \$4.2 million to an increase of \$8.0 million.** The conclusion was arrived at using statistical sampling methodology at the 95% confidence level.

III. PURPOSE OF THE STUDY

House Bill 220 of the 2005 General Session provided for a sales and use tax exemption for sales of a textbook for a higher education course by a person admitted to an institution of higher education. The bill failed to pass the Legislature. The following year the same bill, House Bill 273, was defeated in the 2006 General Session. A similar bill, H.B. 196, numbered without title or substance, was introduced during the 2008 General Session. All three of these bills had or would have had a fiscal impact of decreased revenue to the General Fund¹. H.B. 220 of the 2005 General Session had a fiscal note of decreased revenue to the General Fund of \$2.8 million for FY 2007. H.B. 273 of the 2006 General Session had a fiscal note of decreased revenue to the General Fund of \$3.5 million in FY 2008.

¹ Because H.B. 196 of the 2008 General Session was without substance, it is unknown what the revenue impact would have been.

On March 11, 2008 it was reported in the press that the Utah State Tax Commission deemed textbook sales at campus book stores to be part of the educational mission of a college or university. Students will now purchase textbooks free of sales tax given that the textbooks are purchased at the campus bookstore. By interpreting statute in the aforementioned way, the Commission is reducing ongoing revenue to the General Fund. Given that the Commission makes a number of interpretations over the fiscal year, the textbooks decision raised the question – what can we expect, on the aggregate, to be the fiscal impact of Commission decisions and, should this be included in balancing? These questions are addressed in the following pages.

IV. BACKGROUND

A. WHAT TYPES OF DECISIONS DO THE COMMISSIONERS MAKE?

In broad categories, the Commission resolves issues through the use of private letter rulings, administrative rules, general Commission decisions, appeals finalizing, and audit decisions. By practice, Commissioners inform economists at the Utah State Tax Commission, the Legislative Fiscal Analyst, and the Governors Office of Planning and Budget of possibly large fiscal impact decisions. Examples in the past have included sales tax refunds for carpet installation and severance tax refunds. With regard to these two decisions, revenue estimates have been adjusted down in the past.

A1. PRIVATE LETTER RULINGS - Private letter rulings represent non-binding decisions of the Commissioner’s interpretation of statute or administrative rule. These rulings usually deal with unusual circumstances of the taxpayer. All private letter rulings are kept confidential.

Example of private letter ruling: A taxpayer requests whether charges, on which sales tax is imposed, include locally imposed fees. The request is to not include the local fees in the tax base. The Commission rules that the local fees are included, and thus, taxable. However, because the statutory language appears to be confusing and, as a result, no taxpayers have been collecting the full tax, the ruling is prospective only. Additional taxes will be collected in the future.

A2. ADMINISTRATIVE RULES - Administrative rules deal with clarification of formal practice. A number of rules are adopted each year to ensure fair and equitable administration of tax law and to clarify statute.

Example of an administrative rule: Suppose an entity sells tangible personal property, where the income-producing activity is performed in and outside the state. The determination of whether a greater proportion of the activity occurs in the state is made on a “cost of performance” basis. Over the past 50 years, Utah has moved toward a service based economy. Because of this, “cost of performance” has been adopted years ago to include activity based upon where the market of the services was performed².

A3. GENERAL COMMISSION DECISIONS - General Commission decisions are final agency decisions issued from informal or formal hearings.

Example of a General Commission decision: Hot water heaters have traditionally been treated as real property. Senate Bill 89 of the 2006 General Session inadvertently included hot water heaters as tangible personal property attached to real property. This was not the intent of the Legislature. Because

² Note: this has since been converted to statute.

of this oversight, the Tax Commission agreed to continue to tax hot water heaters as real property until statute was changed³.

A4. AUDITS AND APPEALS - The Tax Commission conducts a number of audits in a given year. A small percentage of these audits are appealed. Commissioners finalize policy relating to appeals and audits by clarifying policy through either upholding an audit or altering the initial finding of the auditors. The Commissioners heard 1,751 appeals over FY 07.

Example of an appeal ruling: Suppose a bank is attempting to avoid corporate income tax by setting up an offshore REIT, thus being eligible for the fifty percent income exclusion under Utah law. The REIT is controlled entirely by a corporation in the United States, and all essential functions for the REIT are performed within the United States by the bank and its subsidiaries. The Commission may uphold the Audit Division decision to disallow the foreign operating company⁴.

B. SOME NUMERICAL ESTIMATES OF COMMISSIONER DECISIONS

The following represent some numerical examples of decisions made by the Commissioners, most of which have had a fiscal impact.

Appeal Number/Private Letter Ruling Number	Issue ^E	Amount in Question ^E	Type of Tax	Fiscal impact
03-0506	Purchases of construction materials on behalf of institutions of higher learning (17 appeals with the same issue)	(\$1,200,000)	Sales	Yes, refund granted
"	Interest paid by purchasers of construction materials	(\$260,000)		
05-0226	Facility - reimbursement of tax by customers ^A	\$500,000		No, audit sustained ^D
PLR 02-036	Sales tax on lease of rail cars - exemption	(\$500,000)	Sales	Uncertain ^B
PLR 04-001	Sale of certain facilities to be exempt from sales tax	(\$1,617,500)	Sales	Uncertain ^{B,C}
04-1485	Question of domicile	\$150,000	Income	Appeal still open
AR 865-19S-85	Definition of manufacturing machinery and equipment to include gas, water, supply lines	(\$75,000)	Sales	Yes
Commission Ruling	Allowance of telecommunication carriers to use FCC safe-harbor percentage to tax telecommunications rather than requiring them to track interstate calls	(\$2,000,000)	Sales	Yes
Audit	Disallowed exemptions for building material	\$260,000	Sales	No, audit sustained
Audit	Leasing of rail cars	\$240,000	Sales	No, audit sustained

^AAppeal pending Supreme Court decision
^BTransaction not verifiable; amount in question is broad estimate
^CAmount in question is an average of possible fiscal impact
^DThere is no fiscal impact because the audit was upheld. The historical revenue will continue to be collected.
^EBecause certain decisions must be kept confidential, the "Issue" is a broad description and the "Amount in Question" is an estimate.

Figure 2

V. DISCUSSION AND ANALYSIS

A. REVENUE IMPACTS

Reviewing over 22,000 cases would have required significant time and manpower to accomplish the desired results. Because of this limitation, econometric techniques of random sampling, analysis of variance (ANOVA), and bootstrapping were used to test assumptions of the likely distribution of Commissioner decisions. Analysis of Variance (ANOVA) is a statistical method used to test whether

³ Senate Bill 124 of the 2008 General Session changed the statutory language to include hot water heaters as real property.

⁴ Senate Bill 204 of the 2008 General Session dealt with this issue. S.B. 204 was later incorporated into H.B. 359, 3rd Substitute of the 2008 General Session.

decisions over successive years can be explained by common factors (common means) or unexplained factors. The results are indicated in the following figures. They indicate that Commission decisions are consistently centered around a common mean. Overall, this means that one can assume that private letter rulings, administrative rulings, general Commission decisions, audits, and appeals decisions, on average, increase revenue to the General and Education Funds by \$1.9 million, with the range for any given year being from a loss of \$4.2 million to an increase of \$8.0 million. A dot plot of decisions is represented in Figure 3.



Figure 3 – Dot Plot of the Cases Considered (All Years). Note that most cases result in a net zero fiscal impact.

A couple of notes on the methodology – first, to ensure consistency, a randomized list was sent to the Tax Commission from which to draw the cases. The Tax Commission matched its grouping of cases against the list sent from LFA; these are the cases that were chosen for review. Second, the fiscal impact estimates were static, and third, the estimates include likely impact of a decision on all possibly affected parties. For instance, a taxpayer with a successful audit appeal may receive a refund of \$5,000.

Assuming the individual had been paying this amount for the past ten years and that conditions of the appeal are that no retroactive refund will be given, the fiscal impact would be an ongoing loss of \$5,000. If, due to the aforementioned audit, others also brought similar cases, then the ongoing loss would be much larger. In such a case, we considered the effect not only on the refund of the one taxpayer, but on all likely refunds. Figure 4 depicts the quartile range and the mean for each fiscal year sampled.

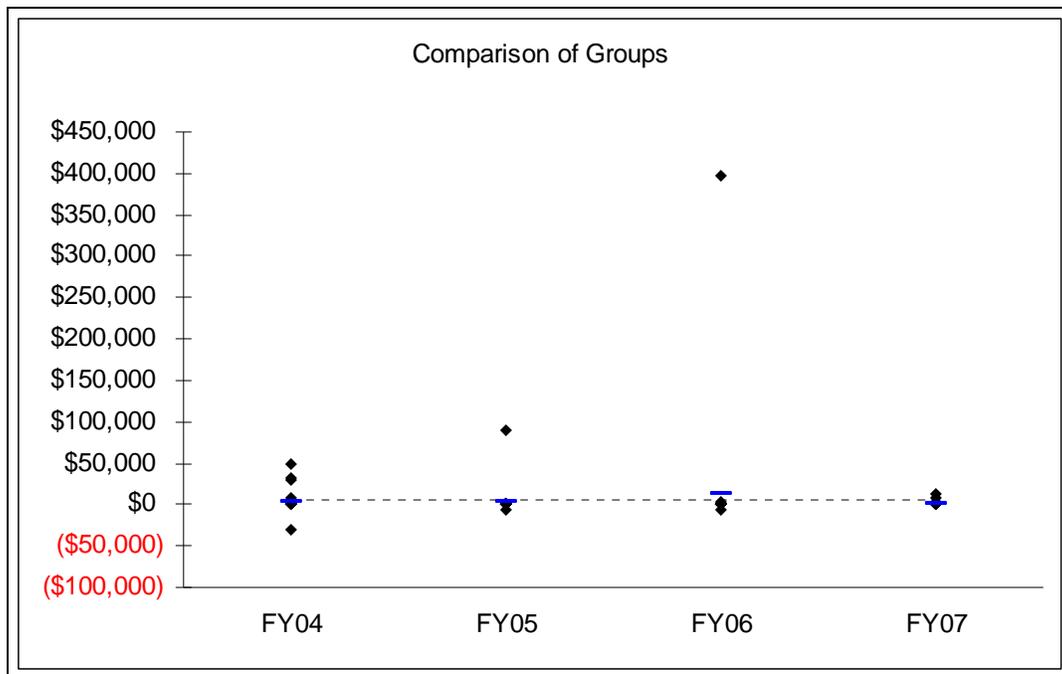


Figure 4 – Comparison of the range of impact and means. Note that the above graph only includes sampled data.

VI. CONCLUSIONS

Because Commission decisions have fiscal impact, individuals responsible for forecasting revenue must know the expected impact Commission decisions will have upon the taxable base and revenue. This paper represents an initial estimate of the likely aggregate fiscal impact of Commission decisions; the expected impact is a positive \$1.9 million to the General and Education Funds. Because Commission decisions only slightly increase revenue to the General Fund and Education Fund, it is not significant enough to warrant changes in our forecasting model. With that said, since the range can be between a loss of 0.07% and a gain of 0.14% on any given year, it is of importance that Commissioners continue to inform the Office of Legislative Fiscal Analyst of large fiscal impact decisions and any likely changes to the taxable base.

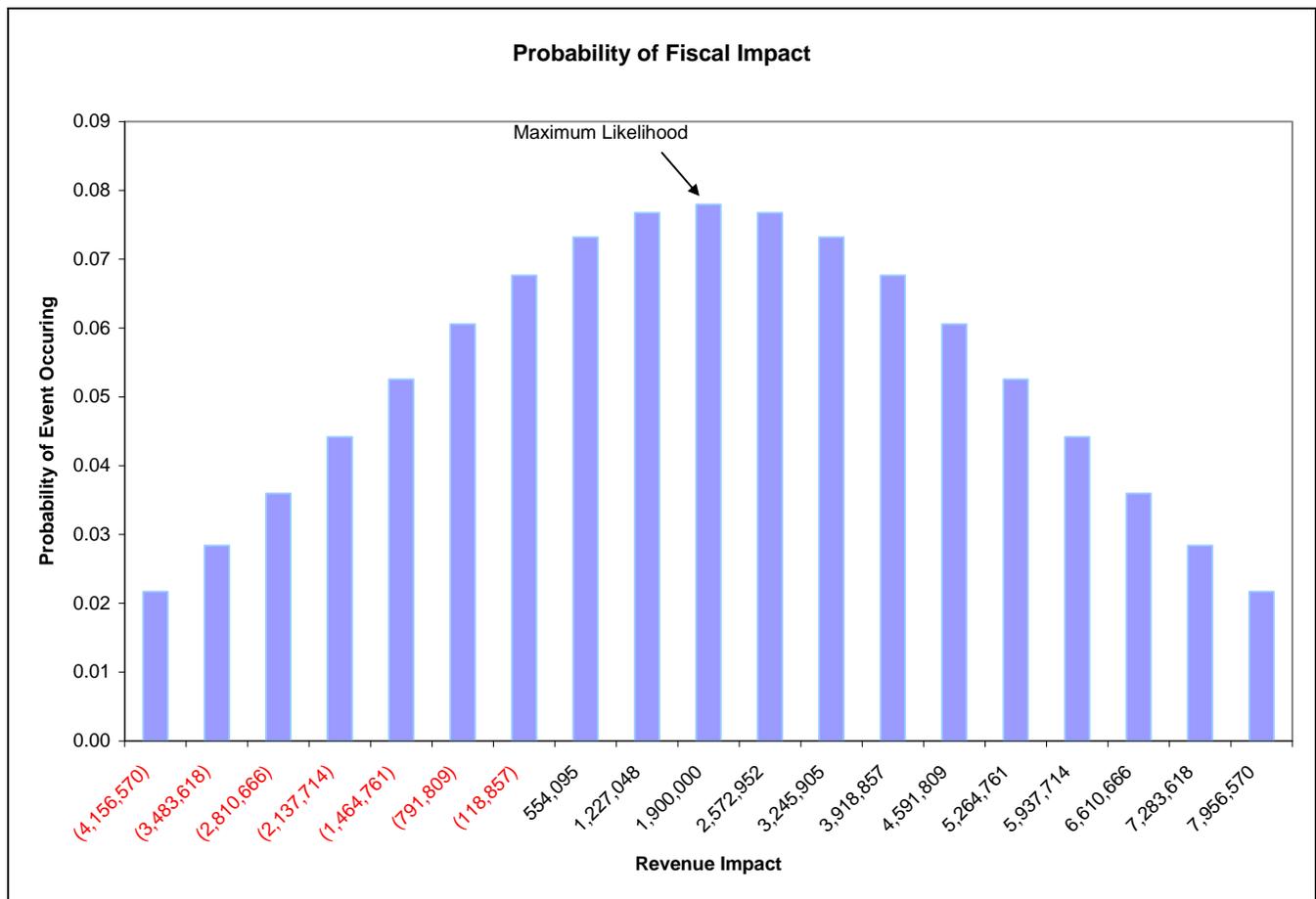


Figure 5 – Range of aggregate fiscal impact; range is from a loss of 7 basis points to a gain of 14 basis points

VII. ANALYST RECOMMENDATIONS

1. The Analyst recommends that the Commission determine fiscal impact of administrative decisions that might have an impact of greater than \$1,000,000 and report this to the Office of Legislative Fiscal Analyst and the Governors Office of Planning and Budget.
2. Analysts, in conjunction with the Commission, should update the likely fiscal impact of final decisions by the start of each legislative session for both one-time and ongoing impacts.
3. If the Commissioners are aware of a decision that may have been a legislative bill, the Analyst recommends that the Commissioners inform Legislative leadership of the decision.