



THE USE TAX AND THE IMPLICATIONS OF THE USE TAX ON BUSINESS OPERATIONS

The South Dakota sales tax was implemented in 1935. The use tax was enacted a few years later to ensure that consumers did not avoid the sales tax by making tax-free purchases outside the state. The greatest difference between the sales tax and the use tax is when the taxes are applied and who is responsible for remitting the tax. Sales tax is applied at the time of the purchase and the seller is responsible for remitting the tax to the state. The use tax is applied after the purchase and the purchaser is responsible for paying the use tax. The use tax applies when the product or service is used, stored, or consumed within this state. A credit for South Dakota tax is given for sales or use tax paid at a rate equal to or greater than South Dakota's in the state where the purchase occurred. That credit is given only if the state of purchase provides a similar credit to South Dakota sales or use tax. The rate of taxation for the use tax is the same as the state and municipal sales tax.

The primary source of revenue for the state of South Dakota and its municipalities is the sales and use tax. The general sales and use tax revenue represented approximately 53 percent of the total 1998 tax revenue for the state of South Dakota and approximately 33 percent of the total 1998 tax revenue for

all states.¹ One hundred ninety South Dakota municipalities impose a sales and use tax on goods and services within the parameters granted by SDCL 10-52. The municipal sales and use tax may range from one to three percent depending on the type of goods or services being taxed and legislative limitations or exemptions allowed. The municipal sales and use tax generates approximately twice as much revenue for municipalities as the municipal property tax.

Sales Tax

The sales tax is based on the gross receipts received by retailers or service providers from the sale of tangible personal property or the provision of a service. The term, gross receipts, refers to the total amount received in money, credits, property, or other consideration of a sale at retail or the provision of a service. If a purchase includes tangible personal property that is traded-in, the tax applies only to the trade difference.

Sales of all tangible personal property and all services are taxable unless they are specifically exempted from the tax. There are three general types of exemptions: exempt buyers, exempt products or services, and products and services that are exempt because of

¹ *State Rankings 2000*. Pages 293 and 300.

how the product or service is used. Exempt buyers include the United States, this, or any other state, any public or municipal corporation, any Indian tribe, and any nonprofit charitable organization which devotes its resources exclusively to the relief of the poor. Exempt products or services include motor fuel and health, educational, social, and most agricultural services. Products and services that are exempt because of how they are used include, for example, fertilizer used for agriculture purposes and items consumed in a manufacturing process that become an integral part of the finished product.

Where the purchaser takes possession of the property determines how the sales tax applies. In most instances, possession for retail sales occurs within the store; however, it is not uncommon for possession to take place at the purchaser's residence or business. For example, furniture may be delivered to the purchaser's residence or business and the applicable sales tax is for the location where the furniture was delivered, not where it was purchased. If a retailer delivers the furniture to a destination outside this state, the applicable sales or use tax for that particular state and location is what must be paid. No sales or use tax is owed if that state does not have a sales or use tax on that item.

Use Tax

The South Dakota use tax applies when sales tax has not been paid and the taxable good is used or consumed in this state. For example, clothes purchased in Minnesota are subject to the use tax when used or consumed in South Dakota. Additional use tax is due on goods purchased in another state with a sales tax that is less than South

Dakota's sales tax rate and the good is used or consumed in South Dakota. The use tax is also due on services performed outside South Dakota but used in South Dakota, for example, accounting, consulting, legal, billing, and collection services.

The use tax is based on the purchase price of any good or service used or consumed in this state and was designed to level the playing field for in-state businesses. Any tangible personal property that is seven or less years old which was not originally purchased for use in this state but used, stored, or consumed in this state is taxed on its fair market value. If a person has proof that a sales or use tax was paid to another state, a credit is given for such tax payment. If the tax rate was not as high as South Dakota's, the person must pay the difference between the two rates. However, there is no refund if the tax paid in another state is higher than South Dakota's tax rate.

Most use tax is paid by businesses. Businesses are audited periodically by the Department of Revenue to determine if they have been collecting and remitting the sales and use tax as required. If anyone fails to pay the sales or use tax, they must pay the tax liability plus interest. A penalty of ten percent of the tax owed or ten dollars, whichever is greater, may be owed if the return is not filed. If the tax is assessed during an audit interest is one and one-quarter percent or five dollars, whichever is greater, for the first month, and one and one-quarter percent per month thereafter.

The use tax is difficult to enforce on an individual who, for instance, purchases groceries or a pair of shoes in a state that does not tax those items, unless the individual voluntarily reports the tax. The

use tax also applies to individuals who purchase items through the Internet or mail order catalogues. Many individuals mistakenly believe that the Internet Tax Freedom Act passed by Congress exempts these purchases from the use tax, but the Act does not.

Retailers do not pay sales tax when they take possession of inventory; however, retailers do pay use tax on items they take out of inventory that they purchased tax unpaid and used in the course of their business. If a retailer withdraws inventory for personal or business reasons, use tax is due and must be remitted during the same reporting period the items were consumed. Items temporarily withdrawn from inventory and used by a business are also subject to a use tax. Use tax is due on the retailer's cost of these items when used and sales tax must be charged if the item is later sold. If a manufacturer buys raw material that is to become an integral and component part of a manufactured item, the manufacturer does not owe sales or use tax on that raw material. However, if the manufacturer uses any of that raw material for its own use, then it becomes subject to use tax.

Implication of Use Tax on Contractors

State law says that contractors are the users and consumers of all materials and supplies purchased for use in their contract work and contractors should pay sales tax when purchasing materials and supplies. A contractor may not furnish a supplier a use tax license number or contractors excise tax license number at the time of purchase to exempt such purchases from sales tax. If any materials and supplies are purchased from an out-of-state supplier not licensed to collect and remit South

Dakota sales tax, the contractor must report and pay use tax. The use tax is on the purchase price or fair market value, whichever is greater. The use tax is reported and paid on the excise tax return during the period the materials and supplies entered the state. The amount of South Dakota use tax due on materials and supplies brought into the state is reduced by the amount of any sales or use tax legally paid by the taxpayer to another state or its political subdivision if that state grants the same privilege to South Dakota businesses.

The distinctions and application of the sales and use tax laws become complicated when a business functions as a retailer, manufacturer/fabricator and contractor or some combination of those business types. A manufacturing business can purchase raw material exempt from sales and use tax because the material is fabricated into a product that may ultimately be subject to the sales tax when it is sold to its final consumer. However, state law says that a contractor is the consumer of all materials and supplies and must pay sales or use tax on all materials. Most states have laws and regulations defining contractors as the user of the materials and supplies purchased and as the entity responsible for paying taxes.

A multi-faceted business may purchase materials as a manufacturer and make such purchases exempt from sales tax. However, the application of the tax changes when that material is used in a project where that same business is acting as a contractor; the material is now subject to sales or use tax. This issue becomes more complex when the business fabricates the materials and installs or uses it in a project located in another state, especially if the fabricated product is installed in a project that is

owned by an entity that is exempt from that state's sales or use tax. The issue then involves who is considered the actual user of the materials, and in South Dakota, like many other states, the contractor is considered the user of the materials, not the building owner. It is difficult to estimate the consequences if South Dakota changes this law and has an interpretation that differs from what is used in most states.

If a contractor takes a tax-unpaid product from inventory in South Dakota, then fabricates the product into another product and installs that product in a project located in another state, the product is subject to use tax in South Dakota. The tax applies regardless of whether or not the contractor's customer is taxable. Even though the tax-exempt entity eventually takes possession of the fabricated product, the contractor is the user and consumer of the raw materials and the contractor owes use tax on the raw material.

During the 2000 Legislative Session, Senate Bill 69 was introduced to address this unique situation where a manufacturer/contractor takes material out of inventory, fabricates the material, and installs that material in a construction project for a tax-exempt project in another state. That legislation failed. The proposed legislation provided a use tax exemption for the raw material used to fabricate tangible personal property used in the performance of contract by a contractor or subcontractor when the property becomes part of a realty improvement contract outside the state that is owned by an entity that is exempt from that state's sales and use tax. The proposed legislation failed in part because the economic impact was unknown and because of the precedent it may establish. The business could avoid these taxes by conducting their

business differently, for example, by fabricating the material on the construction site. However, the proponents of the legislation argued that this alternative for avoiding the tax may result in lost employment in South Dakota.

Contractors' Excise Tax

The contractors' excise tax is unique to South Dakota and is imposed upon the gross receipts of contractors who are engaged in realty improvements in South Dakota and applies to all realty improvements for public and private entities. The tax applies to the total contract price, including all labor and material, for all projects and improvements for public and private entities. The tax was imposed as one of the means to replace the repeal of personal property tax. The contractors excise tax does not apply to South Dakota contractors doing realty improvements outside the state. However, the requirement that contractors are subject to sales or use tax on raw material used in the fabrication of product within the state, even when the contractor transports the fabricated product to another state, predates the contractors' excise tax by fifteen years.

Conclusion

The use tax was implemented to ensure fairness to South Dakota businesses so that it was not possible to avoid taxes by purchasing taxable goods and services from an out-of-state vendor. However, in realty businesses are the primary payers of the use tax because individuals often avoid the use tax by not reporting purchases. The U.S. Supreme Court has prohibited states from imposing use tax collection responsibilities on out-of-state

businesses because of the Due Process and Commerce Clauses provided in the United States Constitution. These clauses require that a business have nexus with the state before the state may require the business to collect the tax. Nexus means that a business has a physical or other substantial presence within the state that is requesting the business to collect and remit the sales tax. The Supreme Court ruled in *Quill v. North Dakota* that Congress possesses the authority to define the nexus provision which could clear up many tax issues, but Congress has not yet acted on this issue. Congress has not passed legislation that would permit states to tax goods and services delivered to their state when the business does not have a physical presence in that state.

Businesses generally understand their use tax obligations; however, sometimes businesses are not aware of certain circumstances or exceptions that may apply to a particular situation. That

misunderstanding makes them responsible for paying a use tax that may not have been planned or considered in the original bid. A business may feel that the tax application is unfair or especially burdensome when the unpaid tax is found in an audit. Businesses do have the opportunity to formally appeal decisions in contested cases pursuant to SDCL 1-26.

The contractors' excise tax does not apply to projects located outside the state, but that does not prevent the sales or use tax from applying to portions of the materials used in the project. Even if Congress changes its definition of nexus for determining who collects the sales tax or who remits the use tax, it would have little impact on how use tax is determined on the construction industry. Only changes in South Dakota statute can address that situation.

This issue memorandum was written by Fred Baatz, Senior Research Analyst for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.
