POTENTIAL IMPACTS OF SALES TAXATION OF SERVICES ON THE REAL ESTATE SECTOR

A report from the Research Division of the NATIONAL ASSOCIATION OF REALTORS®

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The proposals to apply the sales tax to services, including real estate services, might appear to offer states an opportunity to increase revenues and increase equity in the tax system at the same time. As with most goods and services, instituting a tax on an economic activity is equivalent to raising the price and thus reduces the quantity demanded. Because of the many services related to the transfer of real estate, applying taxes to real estate services is likely to reduce housing demand and related economic activity. In addition, the administration of sales tax deviates significantly from the theoretical and thus the equity is not necessarily advanced because many services would be excluded from the new taxes and expanding the base of the sales tax does not significantly reduce the regressivity of this tax when a fuller definition of income is used. Thus, including real estate services in the sales tax is more likely to dampen economic activity without much impact on equity.

ECONOMIC IMPACT

Applying the sales tax to real estate services is likely to reduce the demand for housing by effectively increasing the cost of purchasing a home. The total impact is based on several reinforcing effects:

- Increased closing costs on the transfer of existing residential and nonresidential property
- Increased cost of operating a brokerage business
- Increased cost of new single family and multifamily housing

Increased Closing Costs

The sales tax on services can have a direct impact on the costs of transactions involving existing housing and other real estate. There are many services are associated with the transfer of real estate and could be taxed as part of a sales tax on services

While there is no research on closing costs that would allow us to conduct a precise measurement of the effect of new taxes on real estate transaction, we can provide a stylized example that can approximate the effect. For a benchmark home costing $125,000, closing costs could count as much as $10,900 as shown in Table 1 below.

At an estimated 6 percent tax rate, the cost of a real estate transaction would increase by $621, effectively increasing the cash needed at settlement by this amount. The median priced home is $176,000 – almost 30 percent higher than the benchmark home. Thus, most homebuyers would have higher closing costs and the impact of the tax would be larger as well.

Sales Taxes on Services

Table 1.

Real Estate Service	Amount	Additional Tax
Administration fee	$413.46	$24.81
Application fee	$266.40	$15.98
Appraisal	$269.31	$16.16
Attorney or settlement fee	$373.71	$22.42
Brokerage Commission	$6,250	$375.00
Commitment fee	$268.00	$16.08
Credit reports	$36.53	$2.19
Document preparation	$162.22	$9.73
Flood certification	$22.21	$1.33
Funding fee	$125.57	$7.53
Local Tax Stamps/ Intangible Tax	$557.50	0.00
Mortgage broker fee	$344.17	$20.65
Pest & other inspections	$86.07	$5.16
Postage/courier	$44.73	$2.68
Processing	$302.71	$18.16
Recording fee	$72.27	$4.34
Survey	$226.59	$13.60
Tax Service	$72.09	$4.33
Title insurance	$460.23	$27.61
Title work (searches & plat)	$220.37	$13.22
Underwriting	$279.93	$16.80
Wire transfer	$55.27	$3.32
TOTAL	$10,909	$621.11

Source: Bankrate.com, NAR calculations

Increases of this magnitude are likely to impact the ability of new and current homebuyers to purchase a home. An increase of $621 in the purchase could prevent more than 200,000 households from purchasing a home every year – or 2 million fewer home purchases over a decade.[1] This increase is equivalent to an increase in mortgage rates of 0.75 percent.

[1] In 2001, the median home price was $147,800. We assume:

10 percent down payment
90 percent mortgage
Mortgage interest rate = 6.25%
Mortgage payment = 25 percent of the household income

These yield a required household income of $39,313 before the imposition of a sales tax on real estate services. Increasing the mortgage amount by $621 increases the required income to $39,494. Based on the 2001 income distribution, 203,000 the number of households who would have the required income before the tax was imposed, but would not have the higher income necessary after the tax.

Sales Taxes on Services

This impact is not spread evenly across the country. These additional fees could decrease the number of homebuyers each year in selected states.

Table 2.

States	Households	2002 Total Home Sales	% Decline in Total Home Sales
California	14,200	696,000	2.0%
Florida	11,800	578,100	2.0%
Maine	1,000	39,300	2.5%
New York	11,200	191,100	5.9%
Texas	16,000	593,100	2.7%
Virginia	3,700	160,400	2.3%

Source: NAR calculations

In addition to the personal and social consequences fewer home sales, the cumulative effect of this decline in economic activity is significant. The resources expended and income generated from 200,000 home sales included payments for services rendered to real estate agents, home inspectors, attorneys, as well as loan origination fees – all of which are included in the measure of total production of goods and services known as the Gross Domestic Product or GDP. Conservatively these serviced are value at 9 percent of the price of the home sold. Reducing the number of homes sold by 200,000 would reduce economic activity by $2.7 billion.

The economic impact does not end with the impact on home sales. Because of the tendency of homebuyers to purchase additional goods and services such as furniture and home improvement, the housing industry has a ripple effect on other industries. According to the Joint Center for Housing Studies at Harvard University, a typical first-time homebuyer spends $3,500 on household goods and services in the year following a home purchase. Trade-up buyers spend even more – $5,000 – following the move to a new home. The loss of these expenditures due to fewer home purchases would depress GDP another $900 million. In addition, this economic activity produces a multiplier effect because income earned in the housing sector is re-circulated into the economy as it gets spent, generating another round of income and purchases. The reverse is also true; a decline in home sales will reduce GDP by more than the value of the services foregone. In the first year of a tax on real estate services, the national impact could range from $4.8 billion to $5.8 billion or $50 billion dollars over a 10-year period.[2]

Some homebuyers may choose to purchase a less expensive home rather than not purchasing a home at all at the margin. However, this does not change the impact of the tax. First, this decision assumes that a lower priced home is available. Second, while a reasonable accommodation, these homebuyers will receive a lower level of housing services for the same payment. Finally, by purchasing a lower priced home, they are competing for these homes with others who may then be pushed out of the market.

[2] The size of the multiplier depends on the degree of monetary policy accommodation and the crowding out effect. The NAR Research economic model suggests that a change of one dollar in housing activity will increase GDP by $1.34 to $1.62.

Increased Cost of Operating a Brokerage Businesses

A sales tax on services would apply not only to the real estate transaction, but to the business expenses of the brokerage as well. Given that real estate brokerage is a service business, these firms are likely to face higher costs than some other firms. Real estate brokerage firms would experience higher costs due to sales taxes paid on newly taxed services. The costs would either be absorbed by business owners, be shifted forward to customers in the form of higher commissions, or be shifted backwards to employees in the form of lower commission shares or salaries.

Earlier research on the impact of a sales tax reveals that real estate businesses purchase services extensively in the course of conducting their businesses. According to the report by the Washington National Tax Services of Price Waterhouse[3], the percentage of the operating expenses of brokerage businesses that would be subject to tax, on average, under a broad-based sales tax that included business services would equal to 41.5 percent of company dollar, on average. (Company dollar is gross income less the commissions and fees). Assuming a 6 percent sales tax rate, the sales tax on broker's operating expenses would equal 2.5 percent of company dollar. Major items contributing to this tax cost are advertising and rent. The significant burden of the sales tax on real estate operations would lead to upward pressure to maintain or increase commission rates.

In addition to the tax itself, real estate brokerages will incur the cost of compliance necessary to calculate, submit, document and defend the amount of amount owed to the government for the taxation of real estate services.

Real estate brokerage firms may be unable to shift the burden of the tax and the cost of the compliance and thus would face a reduced revenue stream from the real estate brokerage business. While the volume of real estate transaction has increased over the last decade, the profitability of real estate brokerage firms has not necessarily followed this trend. In 1998, 59 percent of residential real estate brokerage firms indicated that profitability had increased that year, but by 2000 only 49 percent of firms responded that profits had increased. Explanations for this trend include rising expenses in the form of commission splits for sales agents, technology investments and regulatory compliance costs.

Increased Cost of New Single Family Housing

The labor component of construction services is a major source of additional tax revenue in many proposals to extend the sales tax to services. Most states tax building materials used in construction under the general sales tax on tangible property or goods. However, only a few states apply the sales tax to the full contract price of construction projects, including labor.

According to the Price Waterhouse research, if the sales tax is applied to the full contract price of construction, including labor, the sales tax increases the home price by 4.8 percent compared to no sales tax. This analysis assumes that land costs are 20 percent of the total purchase price and that the builder passes the sales tax through to the homebuyer. In this example, the principal and interest

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[3] *Analysis of the Sales Tax on Services*, Prepared for the NATIONAL ASSOCIATION OF REALTORS®, November 1, 1991 by Price Waterhouse Washington National Tax Services.

payments are increased by $42 per month or $505 annually. Over the life of a thirty-year mortgage, homebuyer P&I payments would increase by $15,150 in nominal dollars.

Increased Cost of Rental Housing

The sales tax applies to construction of rental housing as well as owner-occupied single-family housing. While residential rent is not directly subject to sales tax, builders of multi-family housing are required to pay sales tax on the contract price of newly-constructed rental housing under a broad services tax. Builders will either absorb this cost and experience a reduced return on investment or will raise rents in order to cover this additional cost.

The Price Waterhouse real estate tax model was used to simulate these effects for a prototype rental housing development. If rents were held constant, the after-tax return on investment would be reduced form 11.85 to 10.47 as a result of the application of a 5 percent sales tax.

EQUITY CONSIDERATIONS

In public finance theory, a sales tax is a consumption tax and all goods and services consumed by the household should be subject to tax; services that are purchased by a business (as a business input) should be excluded from sales taxes. The reasoning is that real estate services are consumer services and should be taxed.

Sales Taxation of Services – Theory and Reality

However the political process has produced a reality very different from the theory. Sales taxes are established by state and local governments and vary widely in both the rate applied and the items subject to tax. Currently 45 states and the District of Columbia have a sales tax. Among those who have a sales tax, the rate varies from 2.9 percent in Colorado to 7.5 percent in California. Some states, apply the sales taxes to many services: of the 164 services, Hawaii taxes 157, New Mexico taxes 152 and South Dakota taxes 141 as of 1996.[4] However, all states with a sales tax have an exemption for prescription drugs and many states exempt food, but 32 states exempt or partially exempt purchases of food from the sales tax.[5] The states that exempt clothing from sales taxes are magnets for bargain hunters. Some states exempt personal or consumer services. In comparison, some states, including Delaware, tax a substantial amount of business spending.

In Table 3 below, a comparison between the theory and the reality of sales taxes on services reveals that extending sales taxes to real estate services is not likely to enhance the equity of sales taxes.

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[4] *Sales Taxation of Services: 1996 Update*, Federation of Tax Administrators, Research Report No. 147, April 1997, p. 1.

[5] *State Sales Taxes – Food and Drug Exemptions*, Federation of Tax Administrators, http://www.taxadmin.org, August 21, 2003.

Table 3.

Theoretical Arguments in Favor	**Reality**
1. The long-term growth potential of the sales tax would be enhanced if it captured the increasing share of service sector activity.	1. While adding more services to the sales tax base would increase the growth potential, rapidly growing health care expenses are generally not included in the proposals. In addition, a substantial share of the services industry output is sales to other industries and thus exempt from retail sales taxes.
2. Sales tax revenue would be a less volatile if services were included in the base since consumer expenditures on services are less sensitive to the business cycle than are expenditures for durable goods.	2. Residential real estate is characterized by strong cycles. Home sales volume declined by 50 percent from the late 1970s to early 1980s. In early 1990s, sales again fell by 20 percent. Thus, real estate services would not provide a stable source of revenue if history were our guide.
3. The horizontal equity or fairness of the sales tax would be enhanced because exemption of services results in uneven tax burdens depending upon the preference of consumers for services relative to taxable goods.	3. Applying horizontal equity to a consumption tax implies that households with equal consumption expenditures should pay the same tax. However, there are many deviations from horizontal equity principles. Household purchases for health care are typically exempt from tax and will result in inequities. Including business purchases will also create inequities for those who purchasing goods whose intermediate products were taxed. Young people, who move much more frequently, would be taxed more than similarly, situated older households.
4. Including services in the base would reduce the regressivity of the sales tax.	4. Including services would reduce the regressivity of the sales tax IF the analysis were based on annual income. When the analysis is based on a fuller measure of income, then adding services to the sales tax base does not significantly alter the sales tax regressivity

Taxation of Business Services

Following the theory that a sales tax is a consumption tax, it is clear that purchases by businesses should not be subject to any sales tax. However, when revenue generation and equity considerations are combined, it can be tempting to tax business purchases as well as consumer purchases. It is very important to distinguish between business and consumer or personal services when evaluating sales tax proposals or the equity of the tax system can be **increased**. Taxation of business services increases the horizontal inequity of the sales tax because some businesses purchase services from another firm and some firms use services produced internally. As a result, effective tax rates vary among consumers depending upon the extent to which they purchase services that are subject to multiple taxation or "pyramiding."

A simple example illustrates this point. Assume that a property management firm purchases computer programming and data processing services from an outside vendor and that this service is subject to tax at a 6 percent rate. The sales tax on the computer services will be embedded in the price of the property management firm's services. Assume further that the property management services are subject to the sales tax. The result is an overall sales tax rate of 12.36 percent on the purchased computer services as follows:

Computer Services Price		$100.00
		x (.06)
Sales Tax Paid by Management Firm	=	$6.00
Cost Included in Management Fee		$106.00
		x (.06)
Tax On Embedded Cost	=	$6.36
Total Sales Tax	=	$12.36

Businesses that purchase services are placed at a competitive disadvantage in relation to businesses that perform the same functions internally. The taxation of business services thus creates a bias against smaller businesses, including real estate firms that are less likely to have in-house data processing; legal or other support services personnel on staff. At the margin, businesses are encouraged to provide services internally even when it would be more efficient (absent the sales tax on services) to purchase the services from an outside vendor. As a result:

1. Small businesses are disadvantaged because they are more likely to purchase legal, accounting, data processing and other business services than are larger firms that can perform these functions with in-house staffs and thus avoid multiple taxation.
2. The economic efficiency of the sales tax is reduced because the uneven application of the sales tax to business purchases alters relative prices and distorts production decisions and consumer choices.
3. Barriers to economic development in states that tax business purchases of services are created because effective tax rates on new investment are higher in comparison with states that are alternative locations for investment.

SUMMARY

Instituting a tax on an economic activity is equivalent to raising the price and typically reduces the quantity demanded. Because of the many services related to the transfer of real estate, applying taxes to real estate services is likely to reduce housing demand and related economic activity. The impact could be that 200,000 fewer homes are purchased each year with a total economic impact of more than $50 billion over 10 years.

Sales Taxes on Services

In addition, the administration of sales tax deviates significantly from the theoretical and thus the equity is not necessarily advanced because many services would be excluded from the new taxes and expanding the base of the sales tax does not significantly reduce the regressivity of this tax when a fuller definition of income is used. If services purchased by businesses are subject to the sales tax, the horizontal inequity of the tax could be increased.

The proposals to apply the sales tax to services, including real estate services, might appear to offer states an opportunity to increase revenues and increase equity in the tax system at the same time. The impact of a sales tax on services is different from the way it first appears:

- Sales taxation of real estate services increase closing costs and the cost of homeownership and reduce the demand for housing.
- Housing has a multiplier effect on the economy and thus the total economic impact is larger than the direct impact.
- Many real estate transactions are already subject to tax as a result of the real estate transfer tax.
- Housing costs will increase if the labor component of construction is included in the sales tax base.
- The costs of operating real estate brokerages will increase if the sales tax is applied to services purchased by brokerage firms such as legal, accounting and data processing.

Including real estate services in the sales tax is likely to dampen economic activity without much positive impact on equity.

Sources

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