South Dakota Legislative Research Council

Issue Memorandum 96-10

MUNICIPAL SALES TAX: IMPLEMENTATION AND VARIANCES

Introduction

South Dakota municipalities may impose a sales and use tax on goods and services within the parameters granted by SDCL 10-52. The state's broad sales and use tax base provides municipalities access to a considerable source of revenue. The municipal sales and use tax may range from one to three percent depending on the type of goods or services being taxed, legislative limitations or exemptions, and whether the municipality can earmark the tax revenue for expenditures allowed by the Legislature. An additional one percent tax may be adopted by a municipality if it has a warranted indebtedness which is fifty percent or more of its current budget.

The municipal non-ad valorem tax is permissive in nature allowing each community to tailor its tax structure to accommodate the local economy, i.e., tourism expenditures. In fiscal year 1997, one hundred seventy local governments will levy sales and use taxes. Many of these local governments have different tax schedules and exemptions depending on the purpose for which these funds are used, the character of the sales and use tax base, and the willingness of the local governmental body and people to impose and accept the tax. The exemptions may vary from one local government to another due to the alternatives offered under SDCL 10-52 and the grandfather clauses that were allowed to remain after changes in the legislation were adopted from 1969 to 1983.

Tax rates and remittances are based on the delivery site of goods and services. Therefore, retailers and other businesses delivering goods and services outside their local jurisdictions must be familiar with the tax rates imposed and exemptions allowed by other municipalities.

The table below provides a brief summary of the number of municipalities using this tax alternative, the amount of revenue, and the rate of revenue growth in comparison to the state sales and use tax revenue growth.

Fiscal Year	Number of Municipalities	Total Municipal Revenue	Municipal Percent Change	State Percent Change
1990	138	76,213,000	13.51%	7.29%
1991	144	86,854,000	13.96%	17.28%
1992	151	87,958,000	1.27%	-1.54%
1993	153	97,390,000	10.72%	5.85%
1994	162	109,269,000	12.20%	10.70%
1995	169	119,810,000	9.65%	5.86%

Municipal Sales Tax Referendums

Municipal sales tax may be adopted by ordinance by the local governing body, and collections may only begin on January 1 or July 1. Municipal sales tax increases or the initial imposition of the tax is periodically referred by the people in the manner provided in chapter 9-20. Any legislative decision of a local governing body is subject to a referendum. The referendum petition shall be signed by at least five percent of the registered voters residing in the municipality. The result takes effect upon the completion of the canvass of the election returns if it receives a majority of the votes cast.

Municipal Tax - First Penny

Municipalities may impose a general sales and use tax which is often referred to as the “first penny” and conforms to items taxed by the state under SDCL 10-45 and 10-46, unless specifically exempted under SDCL 10-52. The exemptions include farm machinery and irrigation equipment including parts or repairs, agricultural animal health products and medicine, veterinarian services, animal speciality services, intrastate trucking, garbage collection and hauling, and air transportation. Municipalities levying the tax at one percent may by local option enact an exemption for food as defined by the federal Food Stamp Act.

The first penny of sales tax may be used for general fund purposes of a municipality and may be spent and obligated for the general operation of the local government. This is the most commonly levied sales and use tax in the state. All but one of the one hundred seventy communities levy the first penny tax. The town of Blunt, which will begin levying a tax on alcoholic beverages on July 1, 1996, and will not be levying a tax on any other good or service.

Municipal Tax - Second Penny

The provision for a second penny sales and use tax was enacted in 1983 and may only be used for capital improvements. Capital improvements are defined as lease-purchase agreements of realty, land acquisition, fire fighting or emergency response vehicles and equipment, public hospitals or nonprofit hospitals with fifty or fewer licensed beds, other public health care facilities, the transfer to the special 911 fund authorized by SDCL 34-45-12, and debt retirement. This list has been expanded three times since its initial passage.

Municipalities levying the tax at a rate greater than one percent must exempt from the second penny of tax the gross receipts of food as defined by the federal Food Stamp Act, unless it was grandfathered in 1983. Custer and Keystone, for instance, levy a two percent tax on the gross receipts of food as granted by SDCL 10-52-2.5. On the other hand, Mitchell, Pierre, Rapid City, and Spearfish levy a general sales and use tax rate of two percent, but exempt food as defined by the federal Food Stamp Act from any tax as permitted by SDCL 10-52-2.9. Otherwise, the exemptions which apply to the first penny also apply to the second penny. Previously, farm machinery and equipment as well as animal health products were taxed by municipalities under the same conditions as food, but a total exemption from municipal taxation for these products was passed during the 1995 Session.

Municipal Tax - Third Penny

Any municipality may impose an additional sales and use tax upon: (1) gross receipts from hotel, motel, campsites, or other lodging accommodations for periods of less than 28 consecutive days; (2) sales of alcoholic beverages as defined in SDCL 35-1-1; (3) establishments which serve prepared food for immediate consumption; or (4) admissions to places of amusement or athletic or cultural events. Appendix A illustrates that one of the most common differences between municipalities is caused by which of these four items they choose to tax. The tax revenue from the "third penny" must be used for the purpose of land acquisition, promotion of the city and its attractions and activities, architectural fees, construction costs, payments for civic center, auditorium, or athletic facilities, including their maintenance and operation costs.

The rate of taxation for lodging and meals in South Dakota is much less than the large metropolitan centers found in this region as shown in the next table. Generally, the sales tax rates for large metropolitan cities range from nine percent to fifteen percent for lodging or one and one-half times the rate found in Rapid City. Many of these communities have additional surcharges to support the costs of large infrastructure expenses such as sports or entertainment facilities.

	Hotel/Lodging Tax	Restaurant Tax
Chicago	14.86%	8.75%
Columbus	15.75%	5.75%
Denver	11.80%	7.80%
Kansas City	11.98%	8.23%
Minneapolis	12.00%	10.00%
Rapid City	8.00%	7.00%
St. Louis	13.85%	8.10%
Sioux Falls	9.00%	7.00%

Variances of Rate and Exemptions

The Department of Revenue does not track the variances of the sales tax rate schedules and applications to the goods and services for municipalities, but it is apparent that there are several when reviewing the *Municipal Tax Information Bulletin*. Two common differences among communities are the exemptions and rates

used for food and construction materials delivered outside the city limits. The rates for these items do not necessarily correspond to the rate used for other taxable items in each city. Another optional exemption which was removed in 1995 allowed communities to choose whether to tax or exempt farm machinery and equipment under the first penny. When communities select various items from the menu of taxable goods and services to tax or exempt, it may make it burdensome for some businesses to track and comply with the collection of taxes.

Other examples of unique exemptions: Brandon exempts long-distance phone calls, Isabel exempts enrolled members of the Cheyenne River Sioux Tribe from having to pay sales and use tax, and Wall exempts gas, electric, and communication services. Edgemont and Hot Springs tax construction materials delivered to a truck of a construction company for use outside city limits at the rate of one percent while taxing other goods and services at two percent. Most communities either exempt these construction materials from tax or fully tax at the rate of other goods and services. In 1995, Lemmon enacted an additional tax increasing the rate from one percent to one and one-half percent. Lemmon is the only South Dakota community levying a fraction for the sales and use tax rate.

These varying tax rates and exemptions may eventually make it difficult for out-of-state businesses which sell merchandise through catalog sales to comply with any possible initiative by the state or federal government to require payment of such tax. Currently, no state has the authority to force an out-of-state business to collect its tax, unless the business has taxable presence ("nexus") within the state. Normally, taxable presence exists when a business has a store, warehouse, or a sales representative with the authority to accept orders in the state. One solution to this potential dilemma of the variable rate of taxation by municipalities, if this ever becomes a reality, is to only allow the state to tax catalog sales.

Municipal Sales Tax Revenue

The importance of municipal sales tax revenue is illustrated by comparing the revenues produced from sales tax to property tax for municipalities, which on a statewide basis is approximately $120 million by sales and use taxes to about $58 million by property taxes in FY 1995. There are number of municipalities which have enacted the maximum sales tax allowed by statute while many communities use less than one-third of the maximum rate allowed under property taxes. Some municipalities may consider implementing or increasing the local sales tax revenue, if additional funds are needed in lieu of increasing property taxes because of the recent property tax limitations established by the Legislature. Below is a table of communities receiving the most sales and use tax revenue and a comparison of the respective property tax revenue for FY 1995.

	FY 1995 Sales Tax	%	FY 1995 Property Tax	%	Ratio of Property to

	Remittances		Levy		Sales Revenue
Sioux Falls	40,265,726	42.5 %	15,303,587	46.5 %	38.0%
Rapid City	20,332,783	21.4 %	5,668,490	17.2 %	27.9%
Aberdeen	7,268,772	7.7%	2,836,179	8.6%	39.0%
Watertown	6,010,865	6.3%	1,282,127	3.9%	21.3%
Mitchell	3,993,547	4.2%	1,721,950	5.2%	43.1%
Yankton	3,731,630	3.9%	933,385	2.8%	25.0%
Huron	3,258,278	3.4%	2,168,510	6.6%	66.6%
North Sioux City	3,090,110	3.3%	167,200	0.5%	5.4%
Spearfish	2,569,864	2.7%	636,002	1.9%	24.7%
Brookings	2,236,271	2.4%	874,045	2.7%	39.1%
Pierre	2,072,510	2.2%	1,309,969	4.0%	63.2%
Total	94,830,356	100%	32,901,444	100%	34.7%

Motor and Special Fuels Tax

Municipalities of the second and third class have the alternative to levy a tax not to exceed one cent per gallon on motor and special fuel. These tax proceeds may only be used for highways, streets, and bridges. No municipality may impose both a motor fuels tax and a sales tax pursuant to SDCL 10-52-2.3. Although this alternative has been available since 1980, it has never been implemented.

Refund of Sales Tax on Capital Assets

Municipalities may by ordinance provide a refund of the sales and use tax to certain manufacturers and processors for purchasing capital assets. No municipality currently offers such a refund, nor has this option been used over the last few years.

Uniform Taxes by Municipalities

Municipalities have adopted sales and use taxes imposing different tax schedules on similar products with a variety of exemptions. When examining the municipalities which collect eighty percent of the sales tax remitted to municipalities, it is evident that taxes reflect the basic authority granted to them, but also reflect individual exemptions which allow for variances between municipalities. Some of these variances reflect the current standards permitted, while others reflect grandfather clauses. It would be a relatively simple matter to standardize the

exemptions for each municipality and retain the local decision on the percentage of tax to be collected. This could simplify compliance for businesses which deliver or send goods to several communities. Another alternative offered by the Department of Revenue was introduced in SB 64 during the 1996 Session which allowed retailers to elect to report and pay all municipal sales and use taxes either at the nonuniform rates adopted by the various municipalities or at a uniform rate equal to the highest rate permitted by a municipality pursuant to SDCL 10-52-2. The tax revenue would be distributed by a formula prescribed by the proposed legislation based on the municipality's proportionate share of the reported gross receipts.

Retailers who deliver goods and services to a number of communities may prefer to simplify the municipal sales tax program by offering two basic options: (1) first and second penny, all the same exemptions, or (2) first, second, and third penny, all the same exemptions. Unifying of the sales and use tax base may simplify compliance and collection. The Legislature, Department of Revenue, and local governments have worked to improve the uniformity of property assessments and the uniformity for municipal sales and use taxes is mechanically easier to achieve.

Conclusion

The municipal sales and use tax after it was first initiated has been amended and expanded several times. Some communities may be accessing this revenue alternative in recent years in lieu of increasing property taxes to meet budget needs. As communities continually expand the use of sales tax revenue for government operations and to complete infrastructure projects, it has led to a complex matrix of taxes with more and more variances in the system.

The current tax system may provide some benefits to the buyer by furnishing the opportunity to purchase products in communities with the least sales and use tax, but this benefit may be minimal unless there are frequent and costly purchases. A uniform tax, however, may provide certain benefits to the seller, especially if the seller delivers or sends products to customers in a number of South Dakota municipalities.

The primary focus of recent legislation has been to make changes to the exemptions for the state sales and use taxes and collection allowances. In some instances corresponding changes were made exempting these items from the municipal non-ad valorem tax while in others it allowed items to be subject to municipal taxation; however, no recent legislation has been passed addressing the issue of tax uniformity between municipalities.

This issue memorandum was written by Fred Baatz, 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.

Appendix A

	General Sales and Use Tax Rate	Food as Defined by the Food Stamp Act	Lodging	Eating	Alcoholic	Admissions	Statewide Exemptions	Optional Exemptions
Aberdeen	2%	1%	3%	3%	3%	3%	1 to 7	8
Brookings	1%	1%	2%	1%	2%	1%	1 to 7	
Huron	2%	1%	3%	3%	3%	2%	1 to 7	8
Mitchell	2%	0%	3%	3%	3%	2%	1 to 7	8
North Sioux City	2%	1%	2%	2%	2%	2%	1 to 7	
Pierre	2%	0%	3%	3%	3%	3%	1 to 7	
Rapid City	2%	0%	3%	3%	3%	3%	1 to 7	8
Sioux Falls	2%	1%	4%	3%	3%	3%	1 to 7	8
Spearfish	2%	0%	3%	3%	3%	3%	1 to 7	
Watertown	2%	1%	3%	3%	3%	3%	1 to 7	8
Yankton	2%	1%	3%	2%	2%	2%	1 to 7	8

Lodging	Lodging Accommodations
Eating	Eating Establishments
Alcoholic	Alcoholic Beverages
Admissions	Ticket Sales or Admissions to Places of Amusement, Athletic, and Cultural Events

1	Farm Machinery and Irrigation Equipment
2	Parts or Repairs for Farm Machinery
3	Agricultural Animal Health Products and Medicine
4	Veterinarian Services and Animal Specialty Services
5	Intrastate Trucking
6	Air Transportation
7	Garbage Collection and Hauling
8	Construction Materials Delivered to a Truck of a Construction Company for Use Outside City Limits