Argument against supporting a sales tax on services offset by state income tax reduction

The concept of taxing services and in particular professional services such as accounting continues to be debated in the states – though where done so, in nearly every case has been rejected. Only three states have sales and use tax on professional services, Hawaii, New Mexico and South Dakota. The issue of expanding such taxes to professional services usually becomes active during periods of low tax revenue as states seek to fill their coffers by broadening the numbers of those who are taxed. More recently state officials have suggested a new reason for such taxes, as a means of offsetting the cost of personal income tax reductions. The past several years saw dozens of states consider taxes on professional service, and the expectation is that trend will remain steady.

Policy makers have tried to make taxing professional and other services more palatable by pairing such taxes with the elimination or significant decrease in a state's personal income tax. The most prominent underlying argument for combining a tax on accounting and other services with a reduction in a state's personal income tax has been that reduction or elimination of a personal income tax will make the state more attractive for businesses to either expand or locate in the state. An often unstated but clearly implied reason for linking the two is the increased attraction politically which a decrease in income tax may have, enough so to offset or at least split opposition to taxation by those (CPAs, lawyers, doctors, etc) whose services would have otherwise been taxed.

Some states that are considering combined services tax expansion and income tax reduction proposals are in differing positions about exempting from taxation those services which are purely provided to business (business to business services). Part of the hesitation to exempt business to business services is that doing so would severely decrease the amount of revenue that a services tax proposal may generate, and thus either limit the amount of the income tax reduction, require additional taxes to be raised to compensate, or necessitate a very high tax level on services – all undesirable politically.

The accounting profession as a whole, though the AICPA and nearly every state CPA society, has strongly objected to taxing accounting services. These objections include concerns about the negative impact of business to business pyramiding, the disproportionately larger impact of service taxes on smaller sized CPA firms and businesses, and that the taxes are complicated to administer and are regressive. These points are stated in greater detail below.

In our view, combining a tax on accounting services with a personal income tax reduction will not change the negative impact of the problematic aspects of services taxation, including the negative impact on a state's competitiveness – which is touted as a prime reason for the income tax reduction. We believe there is as strong if not greater likelihood that broadening a services tax particularly to include accounting and other professional services will more than offset any potential benefits that a lowered personal income tax may provide.

We also believe that if states feel that lowered income taxes may result in a better climate for attracting and retaining businesses, they should take such a step, though without the likely negative offsetting effects of taxing professional services such as accounting.

We observe that in the 100 plus years of states adopting personal income taxes in this country, once established states tend to increase taxes and not reduce them. As a result, it would be our concern that even should a state eliminate or reduce their personal income tax as part of a combined broadening of their sales tax, history shows that the likelihood of the income tax increasing in the future is a very real threat. Thus, the worst of all words could occur – a services tax on professional services coupled with a personal income tax.

The profession should continue to advocate against state service tax proposals and emphasize that sales and use taxes on professional services are detrimental because a tax on accounting services:

- **Is very complicated to administer** for states and taxpayers, as the multi-state nature of customers and service providers often makes it difficult to determine where, when, and how the services take place. In fact, three states (Florida, Massachusetts, Michigan and Iowa) enacted and then swiftly repealed sales taxes on services, in part because of the complexity in administering the taxes.
- **Creates a competitive disadvantage** for the state (compared to other states that do not tax services) by discouraging relocation and expansion, which negatively impacts economic growth and development.
- **Discriminates against small businesses** because small and emerging firms often have a need to use outside services that would be taxed, while larger companies with in-house expertise would not be subject to a tax for such services.
- **Is regressive,** as sales taxes affect everyone at the same tax rate, regardless of the individual's income level.