Tax-on-Services

Position

The [State Society] opposes any effort to enact a state sales or use tax on accounting, tax or other professional services. Application of such a tax penalizes individuals and businesses seeking to comply with state law, generates an administrative burden for the business community and creates an economic disadvantage for businesses to move to the state or supply services within the state.

Background

States typically impose sales and use taxes on the sale of tangible personal property and selected personal services. Only three states – Hawaii, New Mexico and South Dakota - broadly tax services, including accounting services. In addition to the traditional accounting and tax services, accounting firms may also provide services that could be construed as “data processing services,” “information services,” and “management services,” which are taxable in several states.

As states explore a variety of solutions to budget constraints, some policy makers have explored combining a tax on accounting and other professional services with a reduction in a state’s personal income tax as a means to make the state more attractive for businesses; current research and past precedents do not support this position. In the past quarter-century, numerous states have considered expanding the services exposed to a sales and use tax (expanding the base), but only five – Florida, Iowa, Maryland, Massachusetts and Michigan – have actually passed such legislation. Each of those states quickly repealed the offending provision either before or shortly after implementation.

Negative implications for tax policy

- **Economists Agree that Business Inputs Should Not be Taxed.** A majority of accounting, auditing and other professional services are business-to-business transactions. There are a number of “good tax policy” reasons why these sales should not be taxed:

  - The sales tax is designed to be a tax on consumption; when business-to-business services are taxed, it becomes a tax on production.
  - Such taxes are particularly harmful to, and disadvantage, small businesses.
  - These taxes impede overall economic development and put the state at a competitive disadvantage, especially with professional services firms that operate in a state without such taxes – which is most states

- **Taxing personal income tax services is an unfair taxation on the very services necessary to comply with tax law.** Both individuals and businesses depend on accounting services to comply with federal and state tax laws – taxing compliance with these laws compounds the tax burden borne by individuals and businesses. It also discourages individuals from using professional advisors, thus resulting in poorer accuracy of returns and lower state revenues due to higher enforcement costs.

- **Taxing personal tax return preparation would likely face significant taxpayer backlash**, similar to what occurred in Michigan when it considered such a proposal. Taxing services that the consumer has to purchase because of complex laws and regulations will seem like double taxation to the taxpayer.

- **Sales taxes on accounting, auditing and tax preparation services may drive consumers to use out of state professionals.** With today's internet world, many services, such as personal tax return preparation, can be performed anywhere regardless of where the individual resides. Moreover, while rules can be written to attempt to minimize the loss of such services to out of state providers, enforcement will be required which is timely and costly to the state.

<u>Current state sales tax environment</u>

- Although many states tax some services, **there is no trend of state laws expanding the sales tax base to include professional services**. Even at the height of the recent recession, most states looking at a sales tax on professional service rejected the idea as inherently unworkable. In 2013, 15 states saw 40 bills containing tax on service language introduced in their respective legislatures; only one became law and it was repealed 2 months after passage. In 2014, that number fell to four states and eight bills with no passage of a tax expansion.

- **There is no major industrial state that levies a sales tax on professional services.** While Hawaii, New Mexico and South Dakota have broad tax system covering accounting services, their populations average less than 1.5 million residents and each has different revenue resources driving their tax systems.

    - South Dakota does not have an income tax for its population of fewer than 1 million residents.
    - New Mexico and Hawaii enacted a gross receipts tax rather than a sales tax - all receipts are taxable – as a means of supplementing state revenue. They did not specifically target the business community.

- **An alternative approach for states seeking to smooth out state revenues is to make the personal income base as broad as possible, and with as few deductions as possible.** In that way, it is less vulnerable to changes in personal income as the base is much broader. This approach also does not have the negative impact on business development and expansion.

- **In addition to income taxes, most states also tax the sale of tangible personal property, thus also providing a broader tax base.** This has helped preserve the states' competitive business environment.

<u>Concerns with implementing a tax on services</u>

- While many states have talked about using a broad based services tax to 'smooth out' state revenues and eliminate the peaks and valleys in personal income tax collections resulting from changes in the economy, there is no evidence that this would work given that no state of any significant size has attempted broad-based services taxation.

- **It is extremely difficult to source where "sale" of professional services occurs.** It is often difficult, if not impossible, to determine where the "sale" of accounting services occurs – creating the likelihood that the same service could be subject to tax in multiple jurisdictions.

- **Moving to significantly reorder a state's tax and revenue systems is a major undertaking that can have very dramatic implications** – especially if done precipitously, quickly or rashly. If the state's effort to shift to a services tax and eliminate its income tax was unsuccessful or only partly successful - and estimates were wrong and significant revenue was lost, the state would have to make up potentially hundreds of millions of lost revenue within the same fiscal year. This would disrupt many major programs, and harm the state's reputation with the same constituency that it is attempting to attract – business. The loss in revenue would likely trigger discussion about another round of tax increases and/or expansion of the services being cut. For example, eliminating business-to-business services from a services tax would eliminate a huge amount of revenue. This likely would be put back on the table, and/or a significant tax rate hike on existing services. At a minimum, this concern argues for a 'go slow' approach in whatever is adopted.

- **It is not clear how state bond rating agencies would treat a state if it proceeded with largely substituting income for service taxation.** Even a slight downgrade due to uncertainty in revenues could cause the state – and municipalities - millions in higher bonding costs.

- **Changes in political control of the legislature could result in the rollback of any deal involving a reduction of the personal income tax in exchange for a tax on accounting services.** There is nothing to keep a legislature from increasing or instituting a personal income tax in the future while maintaining a burdensome services tax.

- **Failure to meet, or quickly collect, revenue expectations from a services tax could result in significantly increased tax rates or reestablishment of previously repealed taxes.** Difficulty in accurately predicting service tax revenue (questions on sourcing, collection problems, unexpected reduction of taxable services) may result in a state failing to offset revenue lost from other sources (i.e. repeal of income tax) and needing to find additional money.

Tax on services legislative failures

- In Michigan, Massachusetts and Florida the major challenges of implementing a broad based tax on services and concerns about unfairly impacting in-state services providers vs. out of state providers, resulted in each repealing their sales taxes on services either before or shortly after implementation.

- In 2013, Massachusetts approved legislation expanding the definition of services to include computer software and design services. If fully implemented, the law would have had a negative impact on the growth of Massachusetts technology sector, a vital segment of the state's economy. The new tax faced immediate backlash from the tech and services community resulting in the Governor signing legislation repealing it 2 months later.

- In October 2007, Michigan enacted a broad tax on services; a taxpayer coalition was quickly formed to repeal it, worried that it would negatively affect jobs. The tax was repealed 17 hours after it became effective.

- In 1990, Massachusetts passed a tax on services that applies only to services provided to businesses; the state repealed the tax 2 days after it took effect because of the fear of economic harm and potential job loss.

- Florida passed a sales tax on services in July 1987; 6 months later, they repealed it because it put in-state businesses at a competitive disadvantage to out-of-state counterparts.

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