TAX ON SERVICES

Background

As states continue to explore a variety of solutions to budget constraints, they are often returning to the idea of taxing professional services as a potential source of financial relief. The issue of expanding such taxes to accounting services (amongst others) 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. The past several years saw dozens of states consider taxes on professional service, and the expectation is that with the current poor economic climate, the trend will remain steady.

"Broadening the base" – expanding which services or goods in a state are taxed - has some political appeal especially when coupled with a trade-off on reduction of corporate or 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.

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. Additional details about these objections as well as the more common misunderstandings about a professional services tax are outlines below.

Position Statement

The profession should oppose a tax on service in all instances and should not accept tradeoffs, including a reduction in income tax. Reasons against accepting a tradeoff include, (1) the risk that future legislatures may reinstate or increase the income tax rate they provided (2) tax on services are an administrative nightmare for the business community to implement and (3) states that face higher than expected costs, difficulty in implementing the tax or lower than expected revenue, may seek additional tax changes that negatively affect the profession and business community.

2014 State-of-play

While elections dampened the number of tax-related measures introduced during 2014 legislative sessions, legislators in four states still introduced eight tax-on-service related bills. In addition, one state had a negative measure on the November ballot while two others carried over legislation from 2013. None of the measures was enacted.

- 1 state (Nevada) had an initiative on the November ballot that would create a broad margins tax; voters overwhelmingly rejected the measure.
- 1 state (Pennsylvania) had tax on services legislation carried over from 2013; the bill failed to advance.

- 1 state (Virginia) introduced legislation that would direct the state's Treasury Department to conduct a study on tax restructuring; that bill has carried over to 2015.
- 2 states (Missouri and South Dakota) had legislative threats that either failed to pass before adjournment (SD – an increase in existing rates on professional services) or saw negative language removed (MO - profession exempted from services tax).
- 2 states (Iowa and New Jersey) had legislation broadening exemptions from state sales taxes failed in Committee (IA – exempting investment-counseling services) or received a recommendation not to act (NJ - exempting services performed to prewritten software).

The limited legislative activity marks an extensive drop from 2013, when 15 states saw 40 tax on service bills introduced – including the passage and repeal of a tax in Massachusetts. While 15 out of 48 jurisdictions responding to the AICPA's 2014 Annual Survey anticipated negative tax on service activity, only 7 saw action.

With the elections behind us and states still suffering from budget deficits, 2015 will be a year in which we see a sizable increase in the number of tax on service proposals. Already policy makers in California, Idaho, Illinois, Nevada and South Carolina have introduced legislation or mentioned expanding taxed services as a means of tax reform and revenue raising. TAC will continue to work with the State Societies and our task force to project and prepare for states that may introduce negative tax legislation during the 2015 legislative sessions.

Talking Points

Key points

- 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. And 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.

Current state sales tax environment

- Although many states tax some services, there is no strong 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.

- There is no major industrial state that levies a sales tax on professional services. South Dakota, New Mexico and Hawaii are examples of states with broad tax system that cover accounting services; they have a population averaging less than 1.5 million residents and much different revenue resources driving their tax systems.

    - South Dakota does not have an income tax for its population of under 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.

Myths and concerns with implementing a tax on services

- 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 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 which 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 'glow 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.

- Accepting a reduction or elimination of the personal income tax in exchange for a tax on accounting services is akin to making a 'deal with the devil'. There is nothing to keep a legislature from increasing or instituting a personal income tax in the future – especially where there is a change in party or leadership. Indeed, experience over many years has shown that is that it is nearly impossible to reduce a tax and much, much easier to increase one or create one.

- The likelihood of an income tax being reestablished or increased once it is reduced is also very high if the revenues needed to offset the lost income tax revenues do not occur, or do not occur quickly enough. Alternatively, the rate of the services tax could be increased significantly.

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 those states repealing their sales taxes on services either before or shortly after they were implemented.

- In 2013, Massachusetts approved legislation expanding the definition of services to include computer software and design services. The new tax faced immediate backlash from the business community resulting in the Governor signing legislation repealing the tax 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.

Effectively engaging in the debate

- Many state CPA societies, while opposing service taxes, seek to remain relevant in the tax and revenue debates in their states. They have offered to be independent 'neutral analysts' to legislatures and executive offices – taking no position on tax and revenue proposals while they are being developed – but reserving the right to object once the proposal has been formally proposed. Thus, they are involved at a crucial stage – development of a proposal – and can later on oppose the proposal if it turns out not to be favorable.

- Taking the 'independent' analyst role also helps state CPA societies avoid being put in a box, i.e. the position that politicians seek to place those that they anticipate will object to tax proposals – and that is, 'If you don't like the way we are raising revenue then come up with a replacement means to do so".

Being in this position then puts the onus on the CPAs to determine the 'losers and winners' in the tax and revenue arenas, which is always a losing proposition.

- Another approach taken by CPA societies during discussions on services and other taxes is avoid taking a 'pro' or 'con' position, but to set out broad based 'principles' to help guide the legislators and executive branch officials who will be developing the proposals. These could either be criteria for what a fair and equitable tax system would look like, or aspects of a tax or system that are undesirable from an equity or business development perspective. For example, such a set of principles could include:

  - If a tax on services is to be applied, it should be applied equally to all services offered in the state

  - All business to business inputs should be excluded from service taxation

  - Any services tax that is adopted should be implemented in a manner that is equitable, does not disadvantage the service providers in the state and be easy to use and enforce

- Another reason that a state CPA society may adopt a 'neutral' analyst approach or advance broad-based tax principles is that there is rarely unanimity among the society's members on tax and revenue proposals. States society members who are in industry and not subject to a services tax may opt to support a proposal that would benefit their employers. Small CPA practitioners with largely tax practices, who typically would be hurt the most with a services tax since tax advisory and compliance services are mobile, typically oppose services taxes. Large and national firms also typically oppose services taxes due to the possibility of differing states adopting differing approaches to how a tax might be applied (i.e., where provided vs. where prepared).

- Yet another reason for a state CPA society to stay 'neutral' and/or play an 'analyst' role during the development and consideration of a tax proposal is that very often the final draft of a tax proposal contains many problematic provisions. This is especially true when service taxes are intended to offset other taxes, such as income or business taxes. In many instances, the expected revenues from a service tax simply cannot meet the necessary revenues needed, and the tax rates must then be increased significantly. Or, as happened in numerous states, political pressures result in some services exempted (despite authors' saying this would not occur), such as health care and legal. Thus, a CPA society which endorsed a services tax at the outset would then be in the uncomfortable position of having to retract or modify its position later on.

- States CPA societies have been inventive in seeking alternative means to offset possible state revenue losses. For example, some states like Ohio have provided additional revenue by adding a professional 'fee' on top of the professional's license to practice.