
Is a Sales Tax on Services the Future Revenue Generator for State and Local Governments?

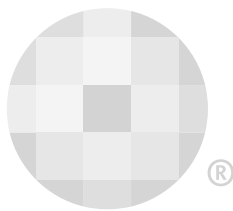
By Jonathan Oppenheimer

Jonathan Oppenheimer looks at the history of the taxation of services under the various sales and use tax regimes used by the states and examines whether it is prudent for states to include services in their sales and use tax base.

Introduction

In the past several decades there has been increasing pressure on state governments to provide more services. While many states have worked hard to find ways to pay for these services without raising taxes, many others have found that the demand for services has created a tremendous strain on their budgets due to a lack of tax revenue. Those states that are not generating enough tax revenue to cover the cost of these programs must find ways to raise tax revenue. One of the ideas that many states have considered in their attempts to increase tax revenue is to expand the sales tax base to include more services.

Currently, in most states tangible personal property is subject to sales and use tax, while services are generally provided tax free. Changes in the economy have resulted in the percentage of personal consumption that is attributable to purchases of tangible personal property to decline since the first imposition of sales taxes by the states and thus the amount of sales tax collected has diminished relative to the current level of personal consumption. To illustrate this point, in 1979 services accounted for 47.4 percent of all personal consumption, while just 17 years later in 1996 services accounted for 57.7 percent of personal consumption expenditures.¹ That is a 10.3-percent difference in the spending habits of Americans and represents a significant erosion of the sales and use tax base. It is statistics like these that have made expanding the sales and use tax base



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to include services so attractive to lawmakers as a means of generating the revenue that they need to pay for the obligations of the state.

The taxation of services is a highly controversial issue. Services that may be taxed by states include not only legal and accounting fees, but may also include services provided by small companies such as lawn care providers, home repair workers and other small independent contractors. Though lawyers and accountants may be the most vocal (and probably the most powerful) detractors of the inclusion of services in the sales and use tax base, the actual number of people impacted would be tremendous.

States have attempted to tap into this tax base in several ways. There have been states like Florida and Massachusetts that have attempted to include all services (with few exceptions) in their sales and use tax base. There have also been several states that have increased the tax base by including only a few enumerated services in their sales and use tax bases. Other states have decided against taxing services and found that it is easier to simply increase the sales and use tax rate already charged on tangible personal property. Several other states have adopted a hybrid approach, by both increasing the number of services that are taxed and the sales and use tax rates that they charge. Though the approaches have been different, it seems clear that the overall trend has been for states to include more and more services in their sales and use tax base.

The next four sections of this paper will generally look at a history of the taxation of services under the various sales and use tax regimes used by the states and examine whether it is prudent for states to include services in their sales and use tax base. The first section will look at the benefits of broad inclusion of services in the sales and use tax base. The second section will look at the negative consequences of the inclusion of services in the sales and use tax base. The third section will look at Florida's brief experience with a broad inclusion of services in their sales and use tax base. And finally, the current state of service taxation under the various state sales and use tax regimes will be examined.

The Benefits of Expanding the Sales and Use Base to Include Services

The obvious benefit that all lawmakers are trying to achieve by expanding the sales and use tax base to include services is that it will increase tax revenue. Experts estimate that the broad inclusion of services nationwide would result in an increase in sales and use tax revenue by approximately \$57

billion.² States such as California, Illinois, Michigan and Virginia would see a 25-percent to 30-percent increase in their tax collection alone if they broadened their application of sales and use taxes to include services.³ This type of increase in revenue would significantly increase the tax revenue and may help those states alleviate revenue shortfalls. Thus, this approach is surely difficult amounts for lawmakers to ignore.

Though increasing tax revenue is a powerful incentive on its own for states to include services in their sales and use tax bases, there are other advantages to their inclusion that may not be as obvious. For example, it may make the application of the sales and use tax fairer in certain industries. It may also simplify the application of the sales and use tax in some instances, as will be seen throughout this section.

Since the general rule is that services are not taxable, many taxpayers have tried to get around paying sales and use tax by using bundled transactions. Bundled transactions are the sale of goods that are connected with the performance of services. When services and tangible personal property were bundled in the past, arguments could be made that the provision of tangible personal property was only incidental to the provision of the services and that the whole transaction should be free of sales or use tax, since it is primarily a service. In order to separate taxable and nontaxable bundles, the "True Object Test" was created. Under this test, a determination is made as to whether the "true object" of the transaction is a service or tangible personal property. If the service is the "true object," then the transaction *is not* taxable. If the tangible personal property is the "true object," then the transaction *is* taxable. These guidelines shed some light on how to solve the problem of bundled transactions, but determining the "true object" of a

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transaction can often be tricky. To combat this, there have been general guidelines (a 10-percent rule) set up by many states. Under the 10-percent rule, bundled goods and services may be provided tax free if the tangible personal property accounted for only 10 percent or less of the total value of the transaction.⁴ Though this has provided a clear and easy rule for many bundled transactions, there are other transactions that for one reason or another have been deemed nontaxable for some and unfairly taxable for others, mainly for political reasons. For example, the services provided by an ophthalmologist, in checking eyes and prescribing glasses, is considered to be tax free,

because it is the provision of a medical service, while the same services provided by an optometrist are considered in many states to be taxable, because the services provided are bundled with the sale of glasses, thus failing the True Object Test.⁵ This clearly results in a significant inequity between the taxability of the same basic service, based on an arbitrary law. If services were included in the sales and use tax base this inequity could be eliminated, thus leveling the playing field.

The imposition of sales and use tax on services may also help eliminate many of the confusing issues that are inherent in the application of sales and use commonly encountered under current regimes. For example, as discussed above, bundled transactions introduce a significant gray area in the application of sales and use taxes, since many bundled transactions are taxable, while many other are not. If services were included in the sales and use tax base, all bundled transactions would be taxable, thus clearing up any confusion.⁶

The Negative Consequences of Expanding the Sales and Use Tax Base to Include Services

Though there clearly are benefits to the expansion of the sales and use tax base to include services, there are also many vocal opponents fueled by the potentially very negative implications of such a tax. Among the many arguments against the taxation of services

are that it would be administratively impossible or at the least burdensome to enforce sales and use tax collection on all service providers, that it would be discriminatory and that it creates “pyramiding.”⁷

The administrative burden on both taxpayers and state sales and use tax audit departments, which would result from the broad inclusion of services, may be significant. Though there are some pundits

who do not believe that the administrative burden would be so significant, their arguments do not seem as plausible as their doom-saying counterparts.⁸ The administrative nightmare that this would cause essentially has two main components—first, the cost to taxpayers to

include services in their sales and use tax payments and, second, the cost that the state departments of revenue would have to undertake in order to police and enforce these new rules. The cost of compliance would, especially in the short term, become very burdensome for many tax payers. For example, big corporations may have to acquire and implement new computer accounting systems in order to properly tax the services that they provide. Additionally, small companies may have to start filing returns for the first time and learning to comply with these laws may be out of the skill set for many business owners who would have to hire costly professionals in order to comply with this law. David Doerr in his Los Angeles Times Op-Ed piece even claims that the inclusion of services in the sales and use tax base would usher in an era where “baby-sitters,... your neighbor’s kid who mows the lawn [and] student car washes” would have to not only properly charge taxes for their services but file sales and use tax returns with the state.⁹ The costs of compliance for these groups may be severe, and, to make things worse, those costs would likely be mirrored by state administrators who would actually have to review and audit many of the sales and use tax returns on a monthly basis. At best it would likely take some time before state revenue departments would be streamlined enough to make this profitable, at worst it could be an administrative nightmare that ends up costing taxpayers money and providing little to no new tax revenue to the state.¹⁰ There is clearly no guarantee that this will be administratively or fiscally a good idea.

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There is also a common belief that imposing sales and use taxes on services would have a discriminatory effect. The most commonly cited discriminatory impact would be on small businesses, because large businesses can perform many services for themselves in-house, while the same services have to be performed by outside service providers for smaller businesses. Since services performed for yourself would not be taxable and services that you hire someone else to perform would be taxable, small businesses would be disproportionately taxed. For example, many big companies have an in-house legal staff that takes care of many of the company's day-to-day legal needs, whereas small businesses would have to hire an outside attorney to take care of these same issues. Not only would the small company incur attorneys' fees, but it would also then have to pay sales tax on the attorneys' fees. Clearly, this would create one more disadvantage for small businesses and make it even more difficult to challenge bigger competitors.¹¹

A sales tax on services may also have a discriminatory effect against the poor.¹² Since poor people may be more likely to have older homes and cars, the repair services necessary to keep their older cars and homes in functional condition would be subject to this tax. More affluent people are more likely to be able to purchase newer homes and cars that require less repair work and thus are less burdened with this tax.¹³ Taxing these services may have a dire impact on the budgets of the poor.

Pyramiding is another common complaint with the inclusion of services in the sales and use tax base. Pyramiding is when the same items get taxed over and over again before they ultimately get purchased by an end user. For tangible personal property resellers or manufacturers, pyramiding is often resolved by a sale-for-resale exemption. Services such as legal fees, accounting fees and consulting fees all would be taxable in a pure services tax system and are often critical components to the completion of a product or service for resale; however, the state may find the company acquiring these services to be the end user and assess a sales tax on the services.¹⁴ The determination of which services are services for resale, possibly qualifying for an exemption, and which services are purchased by companies as end users would create a significant gray area that would take time (if it could ever be done) for legislators and the legal system to clear up and provide the proper guidance to taxpayers.

The Floridian Experiment with Including Services in Their Sales and Use Tax Base:

In 1987, Florida allowed provisions exempting services from their sales and use tax base to sunset making all services taxable in the state of Florida.¹⁵ By allowing the services exemption to sunset, the Florida legislature essentially allowed laws to be enacted by their inaction. This inaction led to a nearly pure inclusion of sales and use tax on services, which in the end lead to widespread discontent and the eventual re-establishment of the services exemption in Florida.

Sunsetting the exemptions of services not only impacted the sales tax, but it also and perhaps more importantly impacted the use tax. The State of Florida could not allow in-state services to be taxed when out-of-state service providers could provide Florida companies and individuals with the same services tax free, because that would eventually result in everyone looking to out-of-state service providers to provide required services. Thus, big businesses would no longer look to Florida-based law firms or accountants to do work for them. They would instead look to similarly qualified individuals in other states who could do the same work and not be subject to the sales tax. In order to prevent this from happening, the use tax was applied to services, which would make out-of-state-provided services subject to tax for the services performed in the state of Florida. This alone would probably not create many issues among many taxpayers, but the application of formulary apportionment for multistate businesses created a great deal of controversy. That is, because the provision of legal services to a multistate corporation may only be partially attributable to Florida, the whole amount of the service is not for the benefit of the Florida office, only a portion of that benefit, so extending this line of thinking farther, all services acquired in any branch of a multistate business must have some impact on their Florida operations and therefore a part of that service must be apportioned to Florida. This created circumstances where the Los Angeles branch of the big corporation would hire a New York attorney and would then have to apportion some of those fees to be included in the Florida use tax base.¹⁶ Understandably, many taxpayers were unhappy with this result.

It was estimated that the sunseting of the Florida services sales and use tax exemption would increase the sales and use tax base by \$85 billion, leading

to an increase in tax revenue of \$4.2 billion by the 1998–1999 tax years.¹⁷ Part of this increase in tax base and revenue was the result of increased scope, but a significant portion of that scope increase was the result of pyramiding. Many critics of the Florida services tax found that the anti-pyramiding rules were too narrow and allowed for too much pyramiding to still take place.¹⁸ As mentioned above, a business that paid for a necessary service could be viewed as the final purchaser subject to tax, rather than an intermediary not subject to tax. Since the costs of these fees were included in the cost charged by the business to their customer (who was also taxed on that transaction), there would have been multiple levels of tax being paid, thus increasing the tax base. For obvious reasons, many businesses found this to be unpalatable.

The scope of the tax included 33.4 percent of the services previously exempt, and it included many industries that did not take kindly to the imposition of this new tax, namely the legal industry, the accounting industry and perhaps most importantly the media (mainly in the form of taxes on advertising agencies). The application of the use tax on these services likely proved to be the breaking point for many of these service providers, especially the New York based advertising agencies that were doing business in the State of Florida. At first, when the complaints were from wealthy lawyers, accountants and doctors, not much attention was paid to the issue, but the force of the media pushed the tax to be repealed.

When it first became apparent that this tax was going to impact New York advertising agencies, an ad campaign was created to alert people to the impact of including services in the sales and use tax base. This may have been effective, but it did not have the impact that pulling advertisements from local Florida television and radio stations did to stir up discontent. Once the ad agencies started pulling advertisements to avoid tax and the local media started to feel the impact of this on their bottom lines, local news broadcasts suddenly were much more interested in the impact of the tax and in creating public awareness of its negative impact.¹⁹ Not only did the debate against this tax dominate the local media, it became a topic across the country, with several front page articles in the New York Times.²⁰ This media campaign ended with the Florida legislature succumbing to the pressure and restoring the services exemption after only a couple of months. Then, in order to make up for the lost revenue, the sales tax rate was increased from five to six percent.²¹

The Inclusion of Services in State Sales and Use Tax Regimes

Although at this point, no state has pushed the inclusion of services in their sales and use tax bases the way that Florida did, there has been a push to make more services taxable. As is the case with most types of state and local taxes, every state taxes services a little bit differently ranging from 160 different services being taxed in Hawaii to no services being taxed in Oregon.²² Many states, however, have started looking at taxing more services. For example, between 1996 and 2004, Nebraska removed exemptions from 27 different types of services, and Michigan enacted legislation that took effect on December 1, 2007 to remove the service exemption from at least 15 more services.²³ The dilemma that many states face is that it is politically difficult to tax the “big ticket” services, such as legal, medical, accounting and educational fees and it is not financially worthwhile to tax smaller revenue services. Thus, a middle ground ripe for taxation is still being developed.²⁴ Because of this conflict, many states have simply copied what has worked in other states, the most popular of which include telecommunications, amusement services (sporting events, amusement parks, *etc.*), motor vehicle parking, and certain personal property remodeling and repair.²⁵

The trend now is for states to not only keep up with what their neighboring states are doing regarding taxable services, but also to keep pushing new services onto the list to help expand their tax base and increase tax revenue. Pundits and legislatures are actively pushing for this as a means of relieving the burden of increasing income taxes, property taxes or general increases in the sales tax rate.²⁶ Beneficial or not for the overall economy, it seems that the political climate is becoming more accepting of increasing the application of sales and use tax on services and it seems unlikely that this trend will stop anytime soon.

Conclusion

Though there are certainly benefits to the inclusion of more services in the sales and use tax base, there are many negative consequences that may make taxing services an undesirable result. On its face, increasing the number of services to which sales and use tax can be applied may seem appealing, since it would ease the economic woes of many states, but without well-crafted and well-thought-out laws, the result of

such regimes could be disastrous. Because it seems that an increase in the number of services that are taxable is inevitable, serious thought must be put into how to limit the expansion of services to only those industries that can best adapt to the imposition of this tax at the lowest cost possible, while still generating tax revenue for the state, and care must be taken to make sure that adequate anti-pyramiding provisions are put into place to eliminate intermediate levels of taxation.

The U.S. economy is largely a service-based economy at this point in history and a large part of the growth in service industries may be attributable to the effectiveness of the system as it is now.

Therefore, tax decisions must be made carefully on this critical segment of our economy. It is a sincere hope that politicians looking for short-term solutions do not hamper long-term economic growth by implementing haphazard taxing schemes without much thought. If the proper thought and care are put into creating appropriate taxes, the inevitable expansion of services in the sales and use tax base may turn out to provide the necessary extra funding that states need with little impact on the economy. However, based on the experiences of the past, like those in Florida, we may be in for a tumultuous road before state and local governments can properly apply these taxes.

ENDNOTES

- ¹ RICHARD D. POMP AND OLIVER OLDMAN, *STATE AND LOCAL TAXATION*, Vol. 1, at 6-25 (5th ed. 2005).
- ² Michael Mazerov, Center on Budget and Policy Priorities (CBPP), *Expanding Sales Taxation of Services: Options and Issues*, at 1 (2003); available at www.cbpp.org/3-24-03sfp.htm.
- ³ *Id.*, at 1
- ⁴ POMP AND OLDMAN, *supra* note 1, at 8-15 and 8-16.
- ⁵ POMP AND OLDMAN, *supra* note 1.
- ⁶ POMP AND OLDMAN, *supra* note 1, at 6-28
- ⁷ David R. Doerr, *Notion of Expanding the State Sales Tax Does a Disservice to Us All*, *Cal-Tax Commentary* (Jan. 2003); published Jan. 3, 2003, on the Op-Ed page of the *Los Angeles Times*; available at www.caltax.org/member/digest/jan2003/1.2003.Doerr-NotionExpandingSalesTax.03.htm.
- ⁸ See James Francis, *The Florida Sales Tax on Services: What Really Went Wrong?*

- THE UNFINISHED AGENDA FOR STATE TAX REFORM, at 129 (Steven D. Gold ed., 1988) for a view that the administrative costs and burdens would not significantly outweigh the benefits of taxing services under a sales and use tax regime.
- ⁹ Doerr, *supra* note 7.
 - ¹⁰ Francis, *supra* note 8 and Doerr, *supra* note 7.
 - ¹¹ Doerr, *supra* note 7
 - ¹² *Id.*
 - ¹³ *Id.*
 - ¹⁴ Francis, *supra* note 8.
 - ¹⁵ *Id.*
 - ¹⁶ *Id.*
 - ¹⁷ *Id.*
 - ¹⁸ *Id.*
 - ¹⁹ Robert A. Levine, *Sales Tax on Services? Not So Fast*, *ORANGE COUNTY REG.*, Jan. 30, 2003.
 - ²⁰ Francis, *supra* note 8.

- ²¹ *Higher Sales Tax To Replace Florida Services Tax*, *N.Y. TIMES*, Dec. 12, 1987; available at <http://query.nytimes.com/gst/fullpage.html?res=9B0DE0DF123FF931A25751C1A961948260#>.
- ²² *FTA Releases 2004 Survey on State Taxation of Services*, *Tax Administrators News*, May 2005; available at <http://www.taxadmin.org/FTA/pub/services/services04.html>.
- ²³ *Id.*, and *Michigan Expands Tax to Include Specific Services*, *Sales Tax Institute*, Oct. 2, 2007; available at <http://www.salestax-institute.com/>.
- ²⁴ POMP AND OLDMAN, *supra* note 1.
- ²⁵ *State of Texas, Taxable Services Bulletin*, May 2003.
- ²⁶ Iris J. Lav and Sarah Farkas, *Maine Could Tax More Services Under Its Sales Tax*, *Center of Budget and Policy Priorities* available at <http://www.cbpp.org/2-1-07sfp.htm>.

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