Sales Tax on Services and Expanding the Base

Chicago Tax Club

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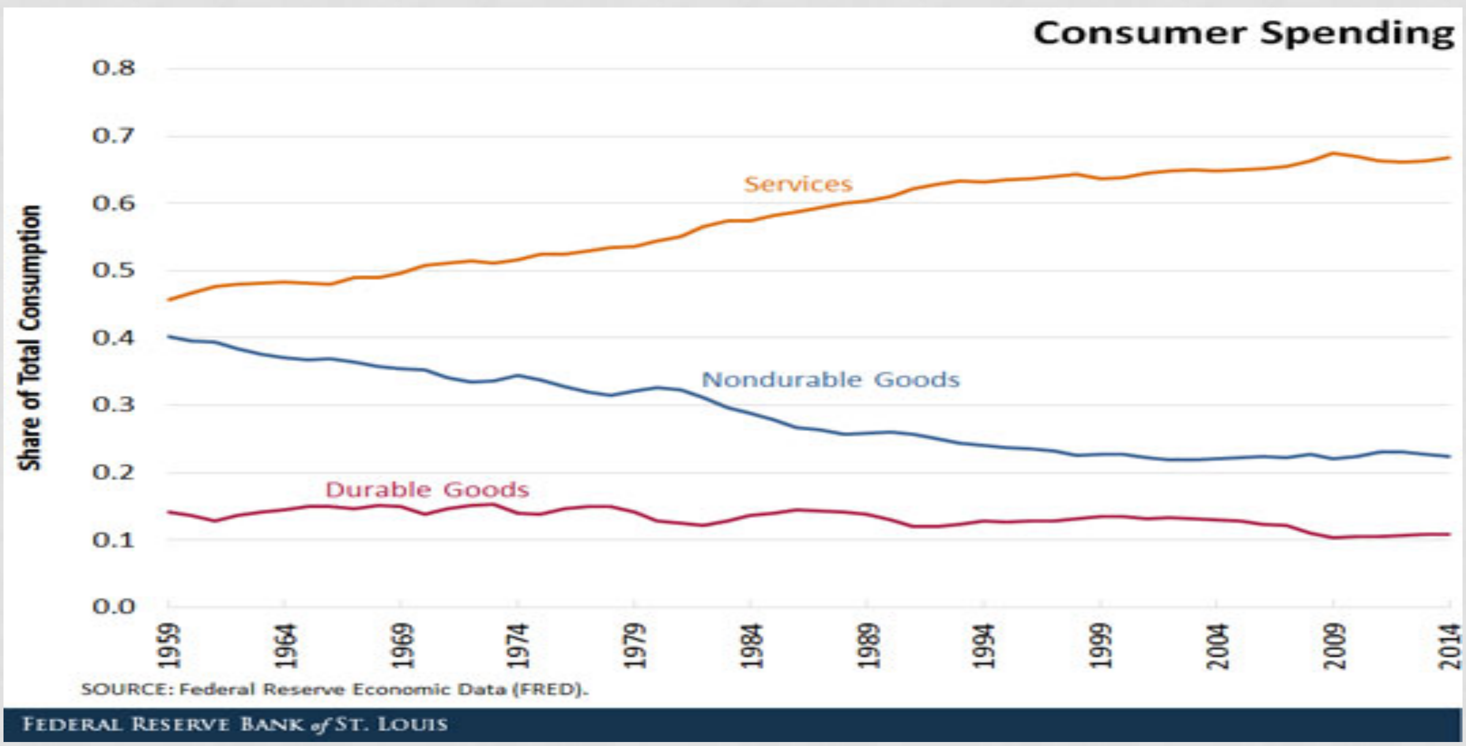
OVERVIEW

- Introduction
- Existing sales tax on services
- Trends in broadening imposition including Illinois
- Recent imposition of reporting requirements
- Questions

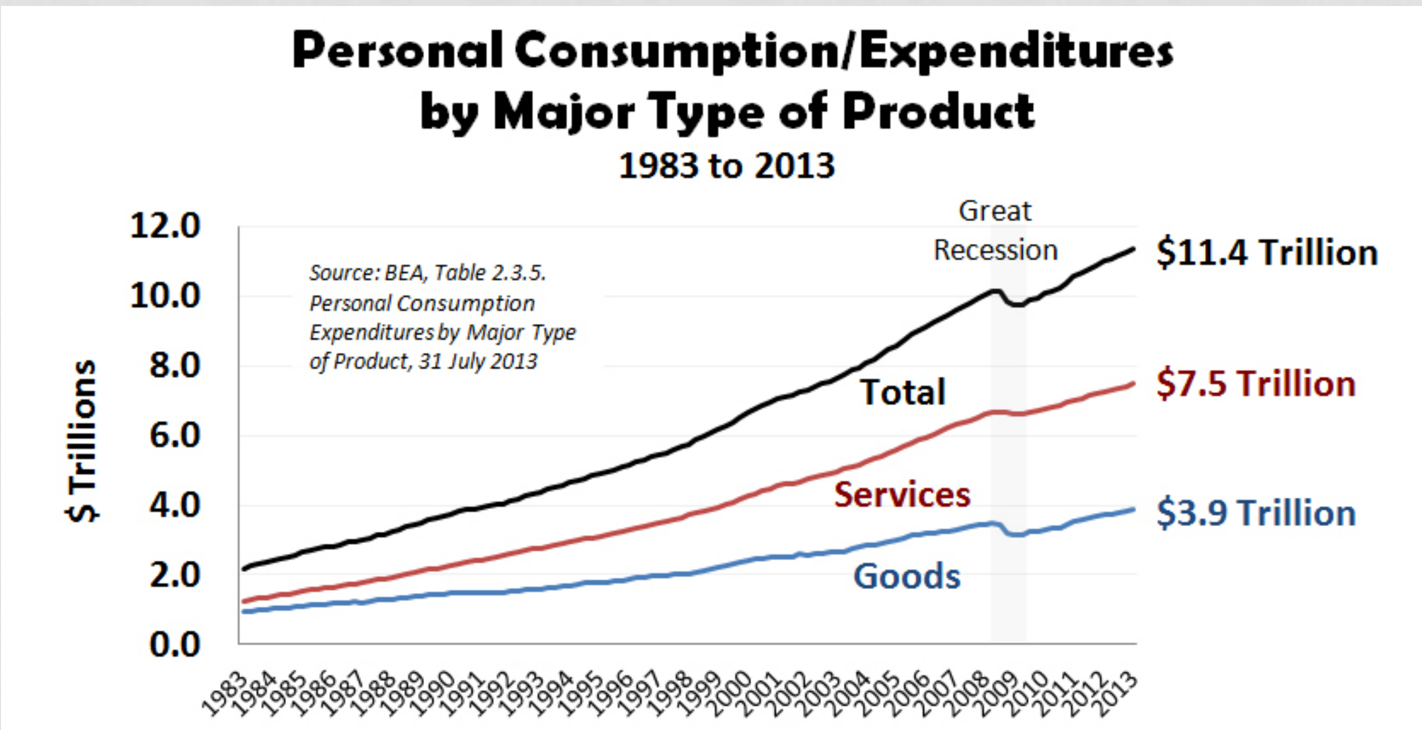
INTRODUCTION

- As originally imposed, sales tax was based on goods
- Changes in the US economy have resulted in a shift from goods to services and information based economy.
- Consumers spend twice as much on services as on goods.
- As state and local jurisdictions look to stabilize and increase tax revenues, extending the sales tax base to include more services could raise considerable revenue.
- The sales tax could also be structured to be revenue-neutral by broadening the base and reducing the rates.
- Items included in the sales tax base vary from jurisdiction to jurisdiction

INTRODUCTION



INTRODUCTION



U.S. Personal Consumption Expenditures
Source: U.S. Department of Commerce, Bureau of Economic Analysis

CURRENT TAXATION OF SERVICES

- All 45 sales/use tax states impose sales tax on sales of tangible personal property, unless specifically exempt by statute, but most of these states tax only a modest number of services specifically enumerated by statute.
- Almost all of the sales/use tax states impose sales tax on utilities.
- Over one-half of these states impose sales tax on digital goods – some under rules designed for TPP, some under rules focused on services.

CURRENT TAXATION OF SERVICES

- One-third to one-half of the sales/use tax states include tax repair services, cleaning services, and landscaping services.
- Only three states include tax, legal and accounting services.
- Generally, educational, health care and financial services are exempt from sales tax.
- Ongoing efforts to expand sales tax base to services.

TAXATION OF SERVICES AND EXPANSION OF BASE

- Services generally targeted to expand the base…
  - Computer software and related installation and maintenance
  - Digital goods and services
  - Cleaning
  - Repair (labor component)
  - Credit
  - Processing and printing
  - Photographic
  - Information
  - Recreational
  - Entertainment
  - "Luxury" (e.g., private club memberships, pet grooming, limo services, tanning parlors, interior design services, charter jet use and elective plastic surgery)

TAXATION OF SERVICES AND EXPANSION OF BASE

- Over the years, other states have attempted to follow suit, but with very little success:
  - Florida – Enacted in 1987 – repealed after 6 months
  - Massachusetts: Passed in 1990 – repealed after 3 days
  - Michigan: Passed in 2007 – repealed after 17 hours

EXPANDING THE SALES TAX BASE: SALES/USE TAX IN ILLINOIS

- Background on sales/use tax in Illinois
  - The Illinois Department of Revenue defines the sales tax as a levy imposed on a seller's receipts from sales of tangible personal property for use or consumption. In Illinois, what are generally referred to as "sales" taxes are actually composed of two matching pairs of occupation and use taxes:
    - Retailers Occupation Tax (ROT) and the Use Tax (UT)
    - Service Occupation Tax (SOT) and the Service Use Tax (SUT)

EXPANDING THE SALES TAX BASE: SALES/USE TAX IN ILLINOIS

- Background on sales/use tax in Illinois
  - Illinois' general sales tax rate has remained at 6.25% for more than 20 years, although the number of local governments imposing additional sales taxes has grown:
    - 5% of the purchase price is kept by the State
    - 1.25% is paid to local governments
    - Additional local rates run 0 to 4% (Chicago total is 10.25%)

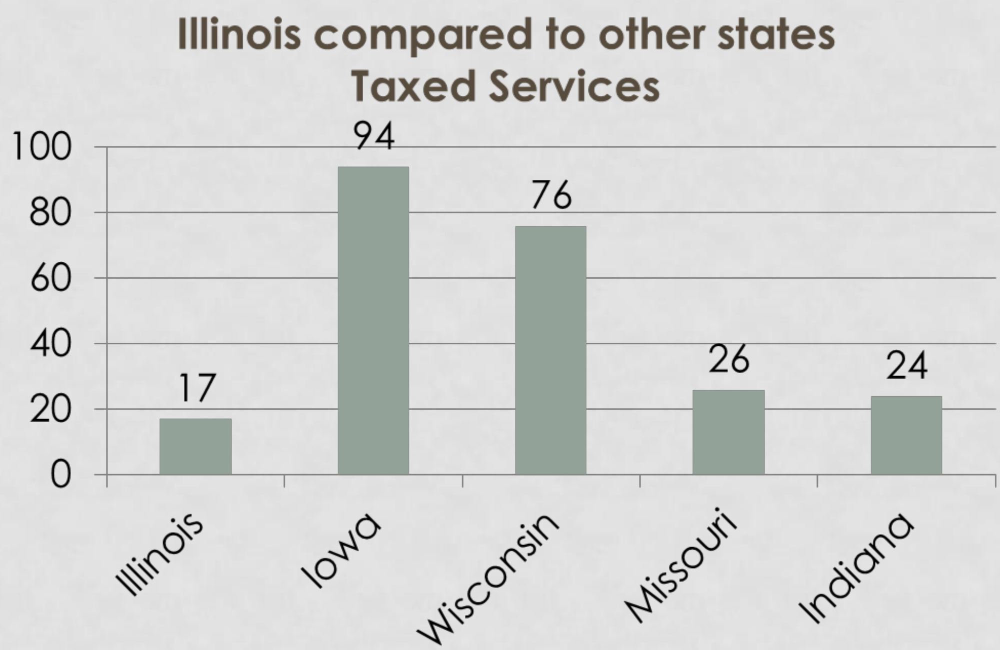
EXPANDING THE SALES TAX BASE: SALES/USE TAX IN ILLINOIS

- Like most other states, Illinois relies largely on sales of Tangible Personal Property (TPP) for sales tax revenues.
- However, Illinois also imposes taxes on 17 services. Most of the services taxes are related to public utilities including:
  - Electricity Excise Tax;
  - Telecommunications (Messages) Excise Tax; and
  - Natural Gas Revenue Tax.

EXPANDING THE SALES TAX BASE: SALES/USE TAX IN ILLINOIS

- Other activities taxed by Illinois that are considered to be services.
  - Hotel Operator's Occupation Tax Act
  - Automobile Renting Occupation and Use Tax Act.
- Service Occupation Tax and the Service Use Tax apply to TPP that is transferred in connection with sales of services.
  - The charge for the service itself is not taxed. For example, when a car is repaired, the tax applies to the price of replacement parts but not to the labor.
  - Service Occupation Tax Act, 35 ILCS 115/1-21; Service Use Tax Act, 35 ILCS 110/1-21.

EXPANDING THE SALES TAX BASE: COMPARISON OF MIDWEST STATES



- Average number of services taxed is 56
- Range of services taxed from 0 to 168

EXPANDING THE SALES TAX BASE: PREVIOUS ILLINOIS ATTEMPTS

- House Bill 174 (2009) proposed:
  - Revenue raising estimates ranging from $581M to $796M
  - Service categories including:
    - Cable and program distribution – $138M
    - Administrative / support services – $81M to $139M
    - Landscaping services – $48M to $112M
    - Warehousing – $50M
    - Transportation – $55M to $81M
    - Real estate / leasing & rental – $57M
    - Spectator sports – $35M to $39M

EXPANDING THE SALES TAX BASE: CURRENT ILLINOIS PROPOSAL

- Senate Bill 9(2017) proposed to expand the sales tax to tax a number of services including;
  - Storage
  - Repair and maintenance
  - Landscaping
  - Laundry and dry cleaning
  - Private detective
  - Alarm and security
  - Pest control
  - Cable television
  - Video and audio streaming
  - Direct satellite broadcast
  - Personal care services

EXPANDING THE SALES TAX BASE: WHY EXPAND BASE TO SERVICES

- The sales and use tax base is narrow, only approximately 25% of all goods and services purchased by households.
- Individual spending nationally is composed over 70% by the consumption of services.
- Services are the fastest-growing area of consumption.
- Consumption taxes in most countries are a higher percentage of total taxes than the United States (at all levels of government).
- Many in this country favor consumption taxes over income taxes – viewing them as a stable revenue base and/or less distortive of economic activity.
- "*As a matter of economic theory, there appears to be no distinction between goods and services that justifies a tax on goods but not on services.*" Hellerstein & Hellerstein

EXPANDING THE SALES TAX BASE: BASE EXPANSION PROBLEMS

- Many proposals to tax services have been introduced as part of broad tax reform – often a "tough sell," even as "replacement" taxes
- By attempting to tax many new categories at once, these proposals often create extreme opposition from diverse service industries
- Proposals to tax individual services also encounter opposition, e.g., Washington D. C.'s "yoga tax"

EXPANDING THE SALES TAX BASE: BASE EXPANSION PROBLEMS

- Some political groups oppose sales tax expansion as "regressive"; others are concerned consumption taxes will raise too much money
- Many local factors are also at work in individual states
- Certain types of services present difficult sourcing, administration and compliance issues
- Most frequent explanation is the disproportionate impact of these proposals on business

EXPANDING THE SALES TAX BASE: IMPLICATIONS TO BUSINESS

- 2013 COST/EY Study (soon to be updated) concludes:
  - Often 70%-80% of the increased revenue derived from sales taxes on business input purchases.
  - Legislative debate on these proposals is a debate primarily about business taxes, not taxes on households.
  - In Minnesota, for example, $1.9 billion of the $2.6 billion in increased sales tax revenue (80%) would be attributable to the business purchase of services.

EXPANDING THE SALES TAX BASE: IMPLICATIONS TO BUSINESS

- Case against taxing B2B Sales of Services
  - Inconsistent with overall purpose of sales tax which is to be on consumption
  - Harmful tax pyramiding – taxing inputs to taxable products
  - Adverse effects on state "competitiveness" and potentially impedes the development of the state economy
  - Administrative complexities
    - Multiple points of use
    - More interstate transactions
    - Sales for resale/other exemptions

EXPANDING THE SALES TAX BASE
TAXABLE SERVICES

- Which Services To Tax?
  - Professional Services
  - Non Professional Services
  - Services on Property - TPP or Real
  - Services using digital, cloud, …

EXPANDING THE SALES TAX BASE
EXEMPT SERVICES

- Which Services Should Be Exempt?

EXPANDING THE SALES TAX BASE ECONOMIC NEXUS TREND/INDICATOR

- Proposed 2017 sales tax economic nexus legislation: WA,UT, NM, TX, NE, KS, HI, AR, IN, MS, FL, GA, NC, MD, DE, MA & RI
- Sales tax economic nexus legislation enacted: WY, ND & SD
- Sales tax economic nexus regulations promulgated: TN & AL

EXPANDING THE SALES TAX BASE NOTICE & REPORTING TREND

- Notice & reporting legislation introduced in 2017: WA, UT, HI, NE, KS, IA, AR, AL, GA, PA & RI
- Notice & reporting legislation enacted: CO, LA & VT

RECENT REPORTING REQUIREMENTS: COLORADO

- Applies to out of state retailers with greater than $100,00 in sales that don't collect Colorado sales tax effective July 1, 2017.
- These retailers must:
  - At the time of sale, must notify Colorado customers of their obligations to self-report and pay use tax to the Colorado Department of Revenue ("DOR").
  - Must provide each Colorado customer who spends more than $500 with the retailer during the year with an annual report detailing the customers' purchases during the preceding calendar year and a notice regarding the customers' reporting and payment obligations.
  - Provide the Colorado DOR with an annual report that includes the names and amount of total purchases of Colorado customers.

RECENT REPORTING REQUIREMENTS: COLORADO

- Definition of Sale – any transaction whereby a person in exchange for any consideration (such as money or its equivalent, property, the rendering of a service or promise of any of these things) transfers or agrees to transfer tangible personal property or performs a taxable service.

- Most services are not subject to sales tax. Exceptions to this guideline include: rooms and accommodations, catering, commercial gas and electric service, steam and intrastate telephone and telegraph services. The transportation of tangible personal property between a retailer and purchaser is a service presumed to be not subject to sales or use tax. Transportation charges are not taxable if they are both (1) separable from the sale transaction and (2) stated separately on a written invoice or contract.

RECENT REPORTING REQUIREMENTS: COLORADO

- If a service is provided after the sale of tangible property, the service charge must be itemized separately on the invoice/bill to become a nontaxable service. For example, if you order cabinets with an agreement to install, then the installation charges must be separately stated on the invoice.

- If it is not separated, the entire invoice is taxable. In addition, fabrication labor used in preparing the tangible property is never exempt, such as the labor used to manufacture curtains, cabinets, tables, chairs, window coverings, etc.

RECENT REPORTING REQUIREMENTS: LOUISIANA

- Applies to out of state retailers with greater than $50,000 in sales that don't collect Louisiana sales tax
- These retailers must:
  - Notify the purchaser that the purchase is subject to use tax unless specifically exempt. The notification must state that there is no exemption for making the purchase over the Internet, through a catalog, or by other remote means. The statement must also indicate that Louisiana law requires use tax to be paid annually on the individual's income tax return or by other means.
  - Send an annual notice to a Louisiana purchaser containing the amount paid for purchases during the preceding calendar year by January 31 of each year. The remote retailer's notice must contain the name of the retailer, a list of dates and amounts of purchases, whether the purchase is exempt (if known), and a statement indicating that Louisiana law requires use tax to be paid annually on the individual's income tax return or by other means. Just like Colorado, the requirement is for retailers to report purchases starting July 1. However, they're encouraged to report all of 2017.
  - By March 1 of each year, file an annual statement with the Louisiana Department of Revenue that includes the total amount paid by the purchaser in the past calendar year. It may not contain any other details as to the specific property and services purchased.

RECENT REPORTING REQUIREMENTS: LOUISIANA

- The Louisiana general sales and use tax is levied on the following transactions:
  - The sale of tangible personal property at retail in Louisiana
  - The use, consumption, distribution, or storage for use or consumption in Louisiana of any tangible personal property;
  - The lease or rental within Louisiana of any item or article of tangible personal property; and,
  - The sale of services as defined in the statutes under R.S. 47:301(14), which include the following:
    - the furnishing of rooms by hotels;
    - the sales of admission or the furnishing of access to amusement, entertainment, recreational or athletic facilities or events;
    - the furnishing of storage or parking privileges by auto hotels and parking lots;
    - the furnishing of printing and overprinting;
    - the furnishing of laundry, cleaning, pressing, and dyeing services;
    - the furnishing of cold-storage space and the preparation of property for such storage;
    - the furnishing of repairs to tangible personal property; and
    - the furnishing of telecommunications services.

RECENT REPORTING REQUIREMENTS: VERMONT

- The new law requires non-collecting vendors to notify their Vermont purchasers that sales or use tax is due and is required to be paid on the purchasers' tax returns and that failure to report eligible purchases may result in a $5 penalty for each instance of non-compliance.
- A non-collecting vendor must also send an annual notification to each Vermont purchaser who has made $500 or more in purchases from the vendor during the previous calendar year including the total amount paid by the purchaser and a notice stating Vermont requires the reporting and payment of sales or use tax on nonexempt purchases. A $10 penalty may be imposed on the non-collecting vendor for each instance of non-compliance with the notification requirements.

RECENT REPORTING REQUIREMENTS: VERMONT

- The Following is a non-inclusive list of transactions subject to Vermont's sales tax:
  - Sales of tangible personal property—anything that can be seen, weighed, measured, felt, or touched
  - Sales of alcoholic beverages
  - Entertainment, recreation, and amusement admission
  - charges
  - Nonresidential retail sales of public utility services—
  - electricity, gas, water, steam, and fuel
  - Sales of telecommunications services
  - Internet purchases, digital downloads, and prewritten
  - software
  - Delivery charges, even if stated separately on an
  - invoice, of items subject to the tax
  - Fabrication charges
  - Rentals and leases of tangible personal property
  - Barter transactions
  - Sale of items for which a coupon is used, and the
  - seller is reimbursed for the full cost by a third party
  - Certain labor charges
  - Bundled transactions where retail sales of two or
  - more distinct and identifiable products sell for one price

QUESTIONS?