

Meaningful Resurgence of Discussions for a Broad-Based Sales Tax on Services

by Mark J. Richards

Numerous state tax issues can be expected in 2017. The state income tax list includes various aspects of combined reporting (states considering mandatory unitary combined reporting, lists of so-called tax havens, transfer pricing, and disputes over the existence or composition of a unitary group); watching to see if Washington will act to create a de minimis nexus safe harbor; worker classification; the effect of the section 385 regulations; the COP method; and the interpretation and application of *Wynne*,³⁹ just to name a few. Sales tax issues will include the continued watching of Washington for legislation on remote sales and the potential for the U.S. Supreme Court to revisit *Quill*,⁴⁰ and states continuing to wrestle with the application of sales tax to the digital era. Retroactive state tax legislation will certainly be discussed.

I considered choosing the income taxation of passthrough entities. With the proliferation in use of passthrough entities, the state corporate income tax base has suffered as a revenue source. State revenue needs, coupled with the view of some on tax equality, could lead to more states imposing entity-level taxes on passthrough entities. States may also be more aggressive with out-of-state investors in passthrough entities in allocating and apportioning income. However, I expect the legislative efforts will be tempered by concerns over the perception of taxing small businesses.

My 2017 dark horse is the meaningful resurgence of discussions by state lawmakers of a broad-based sales tax on services. Florida adopted a broad-based sales tax on services in 1986 that was to take effect in 1987 and was repealed six months after its effective date.⁴¹ Massachusetts adopted legislation in 1990 to impose sales tax on services provided to businesses, and that tax was repealed two days after its effective date.⁴² Michigan adopted a broad-based sales tax on services in 2007, and that law was repealed 17 hours after it went into effect.⁴³ Only a few smaller states have adopted

a broad-based sales tax.⁴⁴ Missouri recently approved a constitutional amendment prohibiting sales tax on services.⁴⁵

Two key drivers could lead to renewed focus on this topic. First, money is needed to run state government and provide essential government services. Many states have deficits, and some have enormous deficits. Even states operating in the black have high-dollar needs they have postponed, such as for infrastructure. To further exacerbate that problem, recent projections show state revenue declining.⁴⁶ States are weighing options and looking for the “least objectionable” one, and may be asking, “If not this, then what?” The revenue needs may require big steps, not small ones. Second, there is a recognition that our nation has been moving toward more of a service-based economy for some time, and that is not expected to change. Some argue that broadening the sales tax base to include services is more equitable, claiming that if you tax retail goods, you should also tax retail services.

As is usually the case, the devil is in the details, and theoretical justifications and economic and political practicalities may not coincide. The primary revenue streams appear to be business-to-business (in addition to retail), medical, and other professional services (legal, accounting, education, realtor, construction, transportation, insurance, and financial services, among others).⁴⁷ Taxing business-to-business services can lead to “tax pyramiding,” which sales tax regimes generally try to avoid, as it causes the cost of goods to increase to the ultimate consumers. Taxing medical services, at a time when medical costs are significantly increasing, is clearly a challenge. Finally, taxing various other professional services raises numerous issues and challenges, not only on the potential impact on the industries being taxed, but also on administrations and taxpayers in sourcing the services. Are services taxed where provided or where the recipient is located? Taxing retail services may be viewed as a “new tax” or “tax increase” on people who provide jobs or vote, and it may create competitive (and thus economic development) disadvantages given the lack of broad-based sales tax on services in competing states.

Is this a major funding solution or economic and political suicide? Look for a resurgence of this debate in 2017.

⁴⁴Phil Schlesinger, “The Taxability of Services,” 2009 CCH, *available at* <http://bit.ly/2fCCwxO>; and Elaine S. Povich, “As Nation Moves to a Service Economy, States Look to Tax It More,” *Stateline* (2016), *available at* <http://bit.ly/21PGPWM>.

⁴⁵Mo. Const. Amend. IV, Art. X, section 26.

⁴⁶Maria Koklanaris, “More States Reporting Weak Revenues and Budget Shortfalls,” *State Tax Notes*, Nov. 14, 2016, p. 486; and Jeanne Rauch-Zender, “Declining State Revenue,” *State Tax Notes*, Nov. 14, 2016, p. 475.

⁴⁷A study by the Indiana Fiscal Policy Institute in 2009 estimated that the annual revenue from taxing all services in Indiana at the current rates would be in excess of \$6.7 billion.

³⁹*Comptroller of Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015).

⁴⁰*Infra* note 50.

⁴¹Hellerstein, “Florida’s Sales Tax on Services,” 41 *Nat’l Tax J.* 1, 15 (1988).

⁴²Mass. Gen. Laws ch. 4, section 7 (1991).

⁴³2007 Mich. Legis. Serv. P.A. 145 (H.B. 5408).