The Michigan Association of MACPA Certified Public Accountants

Technical Observations on the Possible Imposition of a Sales Tax on Services

In an effort to assist in the current legislative deliberations in Michigan regarding the potential imposition of an expanded sales tax on services, what follows are observations under three categories. 1) Positive factors relative to a sales tax on services; 2) Negative factors relative to a sales tax on services; and 3) Characteristics of an effective sales tax on services. This white paper is not directed at and should not be construed as a critique of any current proposal, or a statement of either support or opposition to the concept of the imposition of a sales tax on services.

Positive Factors Relative to a Sales Tax on Services

Revenue Growth – As our economy becomes more service-oriented, the extension of the sales tax to services is one way to achieve a tax base that grows with the economy. This argument is most relevant to the taxation of services at the business-to-consumer level, given the current broad business-to-business exemptions for inputs in the taxation of tangible personal property. Furthermore, the imposition of a sales tax on services has the potential to generate substantial new revenue. According to the Department of Treasury, a broad based sales tax on services at the 6% rate could raise an additional estimated $4.5 billion in revenue.

Revenue Stability and Flow – A consumption tax is not subject to the volatility of a profits based tax and less subject to planning and manipulation especially at the individual consumer level. Additionally, revenue from a transaction tax can be imposed based on monthly reporting and the institution of tax collection can therefore be accelerated over other alternatives.

Fairness – The existing sales tax on tangible personal property can be viewed as regressive in nature. That is, the burden of tax often decreases as income increases since higher income taxpayers generally purchase more services than other consumers. Imposing a tax on services at the business to consumer level would bring the sales tax burden more in line with income and the related tax principle of ability to pay.

Symmetry and Neutralized Impact on the Economy – The taxation of goods, while excluding services, can create distortions throughout the economy including in economic decisions to the extent that there is sufficient demand flexibility and service/good substitutions exist. Put another way, excluding services from the tax may create an incentive to purchase services. For instance, purchasing a DVD is taxable but tickets to a movie theater are not, and the purchase of home gym equipment is taxable but a gym membership is not.

Ease of Administration – A broad based single rate sales tax on both goods and services can be administrable with relatively low compliance costs, but this factor is undermined to the extent that exemptions are provided or that multiple rates of tax are imposed. Administrative complexities and costs increase to the extent that a taxpayer must determine which rate applies or if the service fit into an exempt category.

Addresses Lines Blurred by Technology – The evolution of digital media is obscuring some lines between tangible property and services. While the current sales tax addresses these issues by deeming digital delivery of software taxable, a broader base of tax could help ensure that, as the lines between goods and services blur further in the digital context, the sales tax keeps pace. However, it should be noted that a differential tax rate undermines this fact, and could distort decision making in favor of the digital or service substitute for a tangible good.

Negative Factors Relative to a Sales Tax on Services

Pyramiding – If business-to-business transactions were taxed, it would create "pyramiding" by taxing consumed services as well as the final product or service. Pyramiding penalizes businesses that outsource services and acts as a hidden tax on consumption of items intended to be tax free, such as food and rent. Every sales and use tax imposed in the country provides for some degree of exemption for items consumed in the production of goods for ultimate sale at retail, which mitigates this pyramiding effect to some degree but does not eliminate it since other items consumed by businesses remain taxable. Any tax on business-to-business services creates additional pyramiding, even with an analogous input exemption for items consumed in rendering a taxable service. The lack of such an input exemption would exacerbate this effect and result in a higher tax burden being imposed on the service sector than on producers of goods.

Incidence – As with the current sales tax system, the economic incidence (burden) of a sales tax on services which imposes tax where the benefit is received is on Michigan consumption only, that is, it is paid only by individuals and businesses consuming services in Michigan. This may have a negative impact on economic development in the state as it burdens only those businesses that choose to locate their operations here. In addition, in the absence of a compensating use tax it would encourage consumers to procure services in states not taxing those services.

Not Deductible for Federal Purposes – For most individuals, lack of federal deductibility of a sales tax amplifies the tax cost to Michigan residents. The federal law allows individuals who itemize a deduction for the greater of the state income tax or state sales tax paid, but not both. Even when imposed on service consumption as well as goods, the total sales tax paid by an individual would rarely exceed the income tax paid by that individual. And even in those rare instances where the sales tax paid does exceed the income tax, only the incremental tax becomes deductible. As a result, the expansion of the sales tax to services has a higher net cost to individuals who itemize than an increase in other deductible taxes such as income tax or property tax.

Administrative Burden – Substantial new analysis, collection and reporting burdens for service providers and service consumers would result from the imposition of a sales tax on services. Most service providers are unlikely to currently be subject to sales and use tax reporting. In addition there are significant interpretive issues in determining the services which are taxable, and new implementation burdens in computing and collecting the tax. These burdens are particularly high during the initial implementation of a new tax (a "one time hit") but there are also ongoing compliance challenges. This is especially true as technology evolves and its impact on the mode of delivery of various services needs to be addressed.

Furthermore, taxing “all” services at one time puts a critical hardship on the agency responsible for administrating this tax. It is likely that the taxing authority would need significant time to implement a new service tax; it is also likely that it will need significant time to develop an efficient system for compliance, banking, and enforcement.

Constitutional Concerns – If the tax on services is imbedded in the *Sales Tax Act*, Section 8 of the Michigan Constitution may have to be amended by a vote of the public to include services. Section 8 also limits the rate to 4% plus 2% (6% total) with the proceeds from the 2% to be deposited in the School Aid Fund. Any expansion of the sales tax to services should address the constitutional earmarking of the proceeds. Any upward change in the rate or imposition of multiple rates can only be done by an amendment to the Constitution. Significant legal consultation should be sought in this regard.

Complexity of Sourcing Rules – Unlike tangible goods that have a single physical location, the "benefit" of a service is subjective, and subject to planning and manipulation. For instance, a seller of a consulting service might structure a contract so that a large fee is paid with respect to a service that has no connection to Michigan, and a minimal fee is paid with respect to a service connected to the state. The potential for abuse and manipulation is amplified in the context of a service tax given the inherent subjectivity of the concepts of value and place of benefit. The statute and subsequent rules implementing a sales tax on services must make it clear how the "benefit" rule will be implemented when the services are both performed out-of-state and purchased by someone in Michigan or the services performed in Michigan and purchased by someone out-of-state. Additionally, sourcing language in the statute must provide sufficient clarity with respect to services for which there are multiple "points of use" as is common with a multi-state business. For instance, an employee benefit consulting service rendered for a company headquartered in Michigan might benefit the headquarters where the HR function is based, but might also benefit multiple business locations in other states where the company has operations and employees.

Characteristics of an Effective Sales Tax on Services

Single Rate – The rate of tax applied to tangible personal property and all services should be the same. A single rate provides for ease in administration, compliance and audit and eliminates any potential conflict with membership in the Streamlines Sales Tax Agreement. The Agreement, of which Michigan is a member, contains a prohibition against the imposition of multiple rates of tax by members seeking to participate in the sales tax registration and collection program. The program is designed to require out of state sellers to collect sales tax on mail order and internet transactions, which is clearly a growing segment of our economy. Being barred from participation in the program would frustrate efforts to create a level playing field for Michigan based retailers relative to their out of state competitors.

Limited Exemptions – Exemptions for designated services (as opposed to categories of consumers like government, nonprofit) politicize the tax and create significant equity and competitive issues, as well as increase the administrative complexity. Some exempt service providers compete directly with other taxable service providers for the same consumers and these providers would be competitively disadvantaged. The administrative burden created by exemptions is particularly high given the relative lack of precedent for sales taxes on services in other states. The lack of guidance and experience in defining and interpreting exemptions in other states increases the complexity, uncertainty, and controversy around such exemptions.

Input Exemption – Any sales tax on services proposal should provide an input exemption for items of tangible personal property and/or purchased services consumed in rendering a taxable service. The input exemption would be similar to the resale and industrial processing exemptions currently in the Sales and Use Tax Acts In addition, an exemption comparable to the agricultural production exemption should be allowed. The theory of the sales tax is that the tax is imposed on the final buyer, user or consumer. As such, a sales tax on services should provide an exemption not only for services resold such as payments by a general contractor to a subcontractor, but also for items consumed in rendering a taxable service consistent with the current industrial processing exemption applicable to producers of tangible personal property.

Need for a Compensating Use Tax – In keeping with the efficiency and fairness principles of taxation (Adam Smith, The Wealth of Nations [1776]), a tax on services should be in the form of a sales tax with a compensating use tax, or in the form of a use tax. A sales tax eases the burden of enforcement by imposing the legal obligation for the tax on the service provider even though the economic burden is imposed on the purchaser of such services. Any such sales tax should contain a mechanism comparable to the current use tax which is imposed at the consumer level and also provide that sellers of taxable goods and services subject to Michigan taxing jurisdiction are required to collect the tax from the consumer and remit it to the taxing authority. (The distinction as to whether the seller is collecting a sales tax or use tax is typically based on where the transaction takes place - if the transaction takes place outside the state but the goods or services are taxable in Michigan then it is subject to use tax and not sales tax), Incorporating taxation of services into the current sales tax may require a constitutional change by the people of the State of Michigan, as noted above, or might be able to accomplished via a newly created tax.

Administration – A sales tax on services should be administered pursuant to the Revenue Act (Public Act 122 of 1941). In addition, it would be desirable for administrative simplicity that the new tax be administered in parallel with the existing sales and use tax so that registrations, returns, and payments are integrated and administrative burdens are minimized.

Statutory Clarity – There are two alternate approaches that a state can take to the imposition of a tax on services, and each has advantages and disadvantages to consider:

One approach is the "inclusive" approach of imposing the tax on every service sourced to Michigan unless specifically exempted. This creates a presumption of taxability for all services since exemptions as a matter of law are interpreted narrowly. One advantage of this approach is flexibility, since it will allow the taxation of new forms of service not contemplated when the tax was enacted. Another practical implication of this approach of deeming every service taxable unless specifically exempt is that there will likely be numerous transaction in the "grey" that the state will assert are taxable. This will likely lead to controversies and frequent efforts to modify and expand exemptions, creating more technical complexity and risk of inequitable results.

The alternate approach is the "enumerated service" or "exclusive" approach, which imposes tax only on those services which are enumerated specifically in the statute. This approach avoids the issues noted above regarding controversy over the taxation of services not contemplated when the tax was enacted. It also limits the need for exemptions. However, this approach may create instances where competing services are treated inconsistently, and has many of the same political and equity issues noted above with respect to exemptions. This approach is by far the prevailing approach taken by other states since most states tax only specific enumerated services, and broad taxes on services are relatively rare. The MACPA is not advocating a specific approach but merely is seeking to highlight the competing considerations underlying each approach.