June 2017

HOT TOPIC ALERT

Sales Tax on Professional Services

States generally levy three primary types of taxes—income taxes, property taxes, and sales taxes. State sales and gross receipts taxes are a significant revenue source for state governments. Recent reports indicate that 32.7 percent of the nation's state tax revenue in the fourth quarter of 2016 came from sales and gross receipts taxes. In fact, in the South, sales and gross receipts taxes constituted the largest state tax category at 39.9 percent. Accordingly, state sales taxes receive significant attention from state legislatures, especially when state budgets are tight.

Most states assess a sales tax on many goods and some services. Only Alaska, Delaware, Montana, New Hampshire and Oregon do not have a state sales tax. However, even in some of those states, broadly based gross receipts taxes or corporate taxes based on sales may apply.

Sales Taxes on Services in General

Although most consumers are aware of which goods are taxed in their state, they might be surprised to learn that 81 percent of state-level jurisdictions[1] impose a sales tax on at least some services, most commonly telecommunications, entertainment admissions or utilities. On average, states assess a sales tax on 55 of the 168 services the Federation of Tax Administrators has identified as being potentially taxable. Most of these taxes do not, however, apply to construction services, real estate commissions or other services related to the real estate industry.

There are two ways a jurisdiction could tax real estate services: (i) business or occupation tax and (ii) broad based sales tax on services. Generally, this is the same tax but arguably, it could double. For example, with a (i or ii) tax, if a contractor performs "retail services" during the construction phase of a home and then a REALTOR® pays a sales tax on their services for the purchase of that home, the state would collect twice the tax on a home.

[1] AL, AZ, AK, CA, CO, CT, DC, FL, GA, ID, IL, IN, IA, KS, KY, LA, ME, MD, MA, MI, MN, MS, MO, NE, NV, NJ, NY, NC, ND, OH, OK, PA, PR, RI, SC, TN, TX, UT, VT, VA, WA, WV, WI, and WY.

Eight jurisdictions (Delaware, Guam, Hawaii, New Mexico, Oregon, South Dakota, Virgin Islands and Washington) have a business or occupation tax. Although technically not a sales tax, effectively this taxes the sale of services in the jurisdiction. Washington's fairly complicated tax scheme includes both a sales tax on some services and a business/occupation tax on many services. Oregon's excise tax is a tax for the privilege of doing business in the state, it is assessed on a company's net income, not sales.

Professional services are broadly taxed in only five states: Delaware, Hawaii, New Mexico, South Dakota and Washington. (Guam, Puerto Rico, and the Virgin Islands also tax some professional services.) The majority of these states apply their tax to most professions, although South Dakota exempts medical professionals. These are the same five states that tax real estate commissions. The definition of "professional services" in these states also includes many occupations that may be involved in a real estate transaction, such as lawyers, accountants, architects, engineers, landscape architects, real estate appraisers and real estate brokers.

When state budgets are tight, government officials frequently mention expanding state sales taxes on services. For example, in 2016, Oklahoma's Governor Mary Fallin acknowledged "almost a billion dollar budget hole" and proposed sales tax changes. This included an expansion of the sales tax to several specified services, in addition to the 32 services the state already taxed. Governor Fallin's fiscal year 2018 budget again included a plan to expand Oklahoma's sales tax to include a long list of services, explicitly including banking and real estate transactions. The Oklahoma Association of REALTORS® is closely monitoring proposals from the state that may include a sales tax on services.

Other states have recently considered expanding sales taxes on services:

- Louisiana's governor is proposing both a broad-based "gross receipts tax" on business transactions and expanding the state's sales tax to apply to more goods and services;

- Montana's legislature considered a bill that included a broad statewide sales tax, but that bill is "probably dead" from push back from several groups, REALTORS® included; and

- West Virginia's legislature considered changing its income tax to a general consumption tax, which is a tax on the money spent on goods and services, and eliminating some sales tax exemptions, including the exemptions that apply to several professional services. The WV legislative session has adjourned for 2017.

Sales Tax Trends

Sales taxes have generally increased over the past few years, which is a continuation of a long-term trend. Sales tax bases have eroded over time, and states have responded by raising sales tax rates. For example, of the 13 states that made changes to sales tax rates between 2007 and 2011, all raised their rates. The increases tended to be around one percent or below. More recently, research by the National Conference of State Legislatures indicates that between 2014 and 2016 the overall sales tax rates increased in only Louisiana (temporary increase), Maine (previously temporary increase made permanent), South Carolina (added a local education capital improvements sales tax), South Dakota and Utah (added a county-option tax). However, during the same time period, New Jersey decreased its overall rate, and 34 states[2] revised their exemptions or tax bases in a manner that was expected to decrease state revenues. Only 19[3] of those states made amendments that were expected to increase their revenues.

[2] AZ, AR, CA, CO, CT, FL, GA, ID, IN, IA, KS, KY, ME, MD, MI, MN, MS, NE, NV, NJ, NM, NY, NC, ND, OH, PA, RI, SC, TN, TX, VT, VA, WA, and WI.

[3] CO, CT, DC, FL, IN, LA, ME, MD, NJ, NM, NC, OH, PA, RI, TN, VT, VA, WA, and WV.

Several states made numerous changes in their sales tax bases and exemptions from 2014 to 2016, some of which were expected to increase the state's sales tax income, while others were expected to decrease it.

For example, Connecticut restored its sales tax exemption for non-prescription drugs, which was expected to cost the state $4.2 million in fiscal year 2015. But the state also made several changes that were expected to increase its income during fiscal year 2016, such as eliminating the sales tax exemption for clothing and footwear that costs less than $50. That change was projected to save the state $136.8 million in fiscal year 2016. (This wording is confusing) Most recent changes in the basic sales tax rate have been increases, making it more difficult to identify simple trends given that the dynamics between rates, exemptions and tax bases are complicated. Nevertheless, increasing the tax rate has generally been more successful politically than broadening the tax base (including adding sales taxes for services) and lowering rates.

Related to the trend of increasing sales tax rates is a broader trend of lowering income taxes, but raising sales taxes. Eighteen states and the District of Columbia adopted individual income tax cuts between 2008 and 2012, while a number of states, including several of those same states, raised sales tax rates over the same period. This appears to be a slow shift, primarily occurring in states that have targeted income tax cuts and then needed to increase sales taxes to offset part of that decreased revenue. Although no state has recently eliminated its income tax in favor of a higher sales tax, West Virginia's current proposal to change its income tax to a broad-based sales or consumption tax is illustrative of the possible trend.

Other recent predicted trends for sales taxes include a continuation of discussions the sales tax base to include more services and digital goods. Federal legislation, the Marketplace Fairness Act, which has been in limbo for several years, would enable state governments to collect sales and use taxes from remote retailers that do not have a physical presence in their state. The Act creates a destination-based collection system for sales taxes, so that the tax due is based on the buyer's location. It also allows certain states to require out-of-state sellers to collect and remit the tax due to the state in which goods are sent.

Another recent state trend involves click-through or affiliate nexus legislation. This legislation requires certain remote sellers to collect a sales tax on sales to residents who are in-state. The rationale behind the legislation is that online sellers should not have a competitive advantage over brick-and-mortar stores in a state that imposes a sales tax. Typically, customers are obligated to pay the appropriate use tax for online purchases, but many individuals are not aware of that obligation or neglect to pay. In most cases, it is not practical for state tax authorities to conduct individual audits. As a result, states are considering legislation to ensure that they are receiving the proper amount of tax due from online sales to their residents. Several states, including New York, California, Connecticut, Illinois and Pennsylvania, have enacted or implemented click-through nexus rules.

Arguments For and Against Sales Taxes on Services

Arguments for increasing sales tax revenues by taxing services are generally based on the premise that the expansion is necessary because consumers are spending more on services and less on tangible goods. As a result, sales tax revenues are growing slower than the economy as a whole, adding to budget deficits. Some assert that this spending change is, in part, because the cost of services has risen more quickly than the cost of goods. Other arguments generally state that taxing services would make the sales tax more fair by not burdening just goods and stabilize the overall tax system because the purchase of services does not rise and fall as sharply with the economy.

However, efforts to extend sales taxes to more services are frequently met with strong opposition for many reasons. For example, many argue that the impact on businesses is discriminatory. Small businesses and start-ups often must rely on outside services and may not be able to afford the extra cost added by the sales tax, while large, established companies with in-house expertise would not be taxed for the same services.

Opponents of a service sales tax also argue that the potential pyramiding of taxes on services and final goods could result in higher consumer costs. When Minnesota's Governor Dayton proposed a sales tax on services in 2013, analysts determined that about three-fourths of the $2 billion in expected new revenue from the sales tax expansion would be generated by the tax on business-to-business services. Economists and tax policy experts objected to taxing business-to-business services for numerous reasons, but the primary concern was that it would result in "tax pyramiding." Many products and services have multiple production stages. If the taxes are applied to several stages, then the state is applying a tax on top of a tax, effectively taxing the tax.

Because state sales taxes are not uniform, companies that are in states that have service taxes are at a competitive disadvantage over their neighbors. Thus, the taxing state may actually be creating a competitive disadvantage for themselves, ultimately lowering tax revenues. Companies are also discouraged from relocating to or expanding in the service-taxing states, which further impedes those states' economic growth and development.

By their nature, sales taxes are a regressive tax. As such, they have a disproportionate impact on the poor, who spend a greater portion of their total income on purchases of goods and services than the wealthy.

Furthermore, sales taxes on services are very difficult to administer. The American Institute of Certified Public Accountants have referred to taxing services as an "administrative nightmare," noting that states that face costs that are higher than expected, difficulty implementing the tax, or revenues that are lower than expected may seek additional tax changes that negatively affect the professional and business community.

Arguments For and Against Sales Tax on Services

Proponent Arguments	Opposition Arguments
• **Consumers are spending more on services rather than goods**	• **Unnecessary burden on small businesses**
• **Solution to budget deficits**	• **Pyramiding of taxes, result in higher consumer costs**
• **Cost of services rise more quickly than goods**	• **Competitive disadvantage for in-state businesses**
• **Taxing services is more fair, avoiding onus on goods**	• **Regressive tax, disproportionate impact on poor**
• **Stabilize overall state tax system**	• **Difficulty (and cost) of administering tax on services**
	• **Disruption of real estate market, impact to local economy**

Taxes and Real Estate Commissions

As described above, most states do not tax real estate commissions. However, other related taxes may apply in some cases. For example, Florida appears to stand alone in assessing a sales and use tax on commercial real property rentals. The total rent paid for the right to use or occupy commercial real property in Florida is subject to a sales tax equal to six percent of the total rent and a discretionary sales surtax, unless the rent is specifically exempt. If the tenant makes certain payments on the landlord's behalf, such as mortgage, property taxes or insurance payments, those amounts are also subject to the tax. Several exceptions apply, including but not limited to, agricultural property, rentals to certain nonprofit organizations or governmental agencies and dwelling units.

Most of the arguments against assessing a sales tax on professional services apply equally to sales taxes on real estate commissions. However, given the nature of real estate transactions, some additional arguments can be made against taxing real estate commissions and other real estate services. Various state REALTOR® Associations have frequently been successful in their battles against expanding state sales taxes to real estate services using some of the arguments described below.

Most obviously, a new tax of five or 10 percent on residential real estate transactions would have a major, disruptive impact on the real estate market. If the purchase of a $200,000 home were taxed at 10 percent, the home would cost the buyer an additional $20,000. The buyer would need to pay this amount at closing unless the lender was willing to roll it into the mortgage, which would mean the buyer would also need to pay interest on the tax amount. As a result, fewer families would be able to afford a house, which would depress home sales and real estate values, resulting in yet further reduced property tax collections.

Another concern is that many parts of a real estate transaction could be subject to a sales tax on professional services. For example, Norman Morris, Louisiana REALTORS®' 2013 Senior Vice President of Governmental Affairs, has pointed out that with a tax on real estate services, ten to twelve professionals in a real estate transaction could be subject to the tax.

Combining both of the above arguments in response to a 2012 proposal in North Carolina to expand the sales tax to services, the North Carolina Association of REALTORS®, with the assistance of the National Association of REALTORS®, presented the public and state legislators with detailed reasons why the sales tax extensions were bad policy. The Raleigh Regional Association of REALTORS® argued that licensed professionals would need to pass the sales tax on to the consumer in the form of increased costs for the services provided. Furthermore, if all, or even some, of the professional services involved in the home building and home buying process were taxed, the costs of the transaction would increase significantly, pricing some buyers out of the market.

Ohio, using a similar approach, focused on the effect on first-time buyers. Opposing a proposed five-percent sales tax on real estate services in 2013, the Ohio Association of REALTORS® emphasized that the tax would unduly increase the cost of housing and business throughout the state, threatening a fragile, but critical, sector of the economy. It also placed an unnecessary financial burden on Ohio property owners. The Association's Chief Executive Officer, testifying before the Ohio House Ways & Means Committee, argued that taxing essentially every service involved in purchasing real estate would make housing less affordable for first-time homebuyers, who represent almost 40 percent of Ohio buyers.

HISTORY OF SALES TAX IN THE U.S.

Sales or transaction taxes dates back to ancient times. Economic historians have noted tomb paintings depicting tax collectors in Egypt as early as 2000 B.C., and sales taxes on some commodities, such as cooking oil, have also been traced back to that time. More general sales taxes also existed in ancient Egypt, Athens, and Rome, and Romans are credited as being responsible for spreading sales taxes to the rest of Europe.

While many countries use a national sales tax, the United States has never applied a general sales tax. Economic historians believe that the use of sales taxes by the states dates back to the Pennsylvania mercantile license tax, which was initially introduced in 1821. Like numerous other early taxes, the Pennsylvania tax was not broad-based. Twenty-four of the states with a current sales tax first levied their tax during the 1930s. Others joined over the next several decades, with six adopting a sales tax in the 1940s, five in the 1950s, and eleven in the 1960s. Vermont was the last state to impose a general sales tax in 1969.

Early sales taxes, which tended to be selectively applied to a specific item or group of items, were not popular. Taxes were at the heart of the Boston Tea Party. Somewhat lesser known is the Whiskey Rebellion, which was a small-scale revolution staged by American citizens almost 20 years after the Revolutionary War began. In July 1794, several whiskey rebels attacked and destroyed a tax inspector's home. This insurrection represented the largest organized resistance against federal authority between the Revolutionary War and the Civil War. Although the opposed tax, which ranged from 7 and 18 cents per gallon, does not seem oppressive in today's economy, even a small annual tax of $5 would have cost farmers a large percentage of their disposable income at the time.

Failed Attempts to Tax Services

Although taxing services appears to some to be an easy fix for budget deficits, some states' experiences have proven otherwise. Florida, Massachusetts, Michigan and Maryland have passed sales taxes on services and then swiftly repealed the laws, at least in part because of the complexity of administering the taxes. In some cases, the acts were even repealed retroactively to their effective dates.

Massachusetts

Massachusetts has a long and storied history involving sales taxes on services. In July 1990, the Massachusetts legislature extended the state's sales tax to several services. The tax was originally scheduled to become effective on December 1, 1990. That effective date was first postponed until March 6, 1991. After a loud public outcry, the legislature repealed the tax as to most of the services on March 8, 1991, retroactive to March 6, 1991. Thus, the tax never actually applied to the new services. Several reasons are cited for that repeal. The services to be taxed generally included services provided to businesses, and many feared the tax would result in economic harm and potential job loss. A gubernatorial administrative change may also have contributed to the policy change. The Dukakis administration passed the original state sales tax on business and professional services in late 1990, but the new Weld administration repealed it.

The Massachusetts legislature later attempted a more narrow sales tax on certain computer services in 2013. The passed legislation expanded the definition of services to include computer software and design services, including cloud services. Technology is an increasingly large part of a state's economy, and legislative analysts projected that the new "tech tax" would bring in $160 million per year. However, opponents feared that the law would have had a significant negative impact on the growth of Massachusetts' technology sector, so the new tax faced an immediate backlash from the technology and services community. Businesses claimed that the tax was putting them out of business, and opposition from the state's businesses "rained down pressure on lawmakers." As a result, Massachusetts repealed the tax two months later.

Currently, most personal and professional services are not taxed in Massachusetts. However, the saga continues. Citing insufficient tax revenues, Senate President Stanley Rosenberg recently stated that Massachusetts should consider imposing a tax on services.

Michigan

Michigan does not currently have a broad-reaching sales tax on services. However, like Massachusetts, the Michigan legislature has a history of proposing, considering and even enacting sales taxes on services. In 2007, the legislature passed Public Act 93, which expanded Michigan's six percent use tax to several specific services, including many personal services and consulting.

Opponents worried that the tax would negatively affect jobs. A taxpayer coalition was quickly formed to repeal the law. After considerable public outcry, Michigan's governor signed Public Act 145, which repealed the tax on numerous services only 17 hours after it became effective. The repeal was effective retroactively to the time the law took effect on December 1, 2007, so the tax was never assessed. (Although Public Act 145 repealed the tax on services, it also imposed a surcharge on the Michigan Business Tax to replace revenue lost from the service-tax repeal.) Other bills proposed in 2007, such as S.B. 307 and H.B. 4368, which would have levied a two-percent tax on every person performing a service in a transaction, did not pass into law.

Sales taxes on services last discussed in March 2010, Governor Granholm proposed expanding the state's sales tax to many service categories and reducing the sales and use tax rate, but that proposal did not become law.

Florida

Florida's sales tax on services had a slightly longer life, but ultimately faced the same demise as the taxes in Michigan and Massachusetts. In July 1987, Florida passed a sales tax on several services. The state repealed the bill just six months later, primarily because the tax put the state's businesses at a competitive disadvantage to out-of-state businesses.

Maryland

Another notable failed sales tax reform occurred in Maryland in 2007. State officials proposed expanding the state's sales tax to several services, but deliberately did not include some of the more politically powerful ones, such as legal, accounting, medical and real estate services. Representatives of other service industries argued that their services were just as vital as the excluded ones. In the final legislation, the broad sales tax expansion became just a new tax on computer services, which was ultimately repealed after pressure from the computer industry.

The Future

The consideration of a sales tax on professional services is likely to continue, as state governments must get creative in generating revenues to meet budget demands. No jurisdiction added a tax on real estate commissions during the four years preceding April 2017, nor was any broad-based tax on professional services added during that time frame. Although sales tax is generally a fertile area for legislative reform, adding a tax on professional services has proven to be politically unpalatable.

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