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COMMENTARY ON THE NEVADA SALES TAX ON SERVICES PROPOSALS

NSCPA

Prepared by the

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SALES TAX ON SERVICES - EXECUTIVE SUMMARY

To date, two plans have been put forth by Nevada lawmakers proposing a sales tax on services. The "Amodei-Care"[1] plan proposes a new 3% tax on services. On March 27, 2003, the Reno Gazette-Journal described a tax proposal unveiled by Assemblyman Lynn Hettrick that would reduce current sales taxes on tangible property by 2%, but introduce a new 4.5% tax on services.

If either proposal passes, select professionals will be taxed at an effective rate which is more than twice that of California's income tax. Furthermore, the tax may not always be easily passed on to clients or customers. Below is a comparison of the impact on a typical sole proprietor of the proposed Nevada sales tax and the current California income tax.[2]

	California (income tax)	Nevada (4.5% service)	Nevada (3% service)
Gross receipts	$ 405,000	$ 405,000	$ 405,000
Labor cost	(135,000)	(135,000)	(135,000)
All other costs	(135,000)	(135,000)	(135,000)
Net income	$ 135,000	$ 135,000	$ 135,000
Deductions/exemptions[3]	(35,000)	(35,000)	(35,000)
Taxable income (TI)	$ 100,000	$ 100,000	$ 100,000
Income tax	$ 4,900		
Service tax		$ 18,225	$ 12,150
Tax as a % of TI	4.90%	18.23%	12.15%

Roughly speaking, one third of billings are used to pay employees, one third is used for all other business costs, and one third represents the income of the business owner for their services. As you can see, a 3% tax on gross service income translates to a 12.15% income tax rate.

This high rate of tax would not hit all professionals equally. For example, professionals such as realtors and brokers, who receive a fee for services in the form of a commission, would be exempt under the Amodei-Care plan. Also exempted are medical services, new residential construction services, health care services, advertising services, utilities and garbage services. Clearly, the proposed tax on the gross receipts of service providers fails to meet the fairness test of being broad based.

The argument that the sales tax on services will simply be passed on to consumers, much like the current sales tax, fails to consider that, unlike the sales tax on products, only a handful of states provide any type of tax on services. Therefore, strong pressure will be on attorneys, accountants, engineers and other professionals to absorb the effect of the tax, particularly from clients who have relocated from outside the state or who do business in several states.

To avoid placing an unfair burden on select professionals, the sales tax on services proposals should be abandoned or applied to ***all*** service providers at a rate that would be competitive with other states' income tax rates.

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[1] S.B. 382, March 17, 2003.
[2] The example follows the "rule of threes" business model.
[3] Assumes self-employed taxpayer that is married with two children. Itemized deductions based on IRS Publication 1136, Statistics of Income Bulletin – Spring 2002. Health insurance premiums assumed to be $5,000.

Sales Tax on Services

Issue: Senate Bill No. 382, dated March 17, 2003, proposes a new tax on the amount charged for services at a rate of 3%. Service is defined as the result of useful effort that does not produce a tangible commodity. Exempted from the tax are new residential construction, childcare, health care, public utilities, entertainment, advertising and garbage.

NSCPA Taxation Group Position: The services tax should either not be implemented or if implemented, should be applied to all service providers at a rate that would be competitive with other states' income tax rates. A 3% tax would place an unfair burden on certain service providers as it equates to a 12% net income tax, as discussed in the executive summary. A host of administrative and technical considerations make the imposition of a "new" tax undesirable. Currently there are only four states that impose some form of tax on services. These states are Delaware, Hawaii, New Mexico and South Dakota.

Pros:

- Revenue Source – A tax on services would provide a source of revenue for Nevada.
- Reaches a new tax base – Service businesses have not been taxed in the past.
- Equity – Select service businesses would be put on the same footing with businesses that have to collect sales tax on tangible personal property.

Cons:

- Discrimination against small and emerging businesses – Small businesses generally must purchase many services, such as accounting, data processing, computer consulting and legal, which larger businesses provide internally. The compliance costs associated with such a tax make up a higher percentage of their total sales. Siphoning monies into additional taxes and the related compliance costs limits the growth of small companies. A tax on services creates a disincentive for larger businesses to outsource services to small businesses or independent contractors because of the additional cost burden of the tax. Businesses providing "optional" services (such as salons, landscapers, housekeepers and massage therapists) will be negatively impacted as consumers, particularly retirees, try to stretch their shrinking dollar.
- Not broad-based – Much emphasis has been put on expanding the tax base. As proposed, the service tax would affect select service businesses. If the law exempts realtors, brokers, medical services, new residential construction services, healthcare services, advertising services, utilities and garbage services, it certainly could not be considered broad based.
- Discrimination against intrastate business versus interstate business – Clients from another state that does not impose a service tax will be unwilling to pay a higher price for services. Therefore, strong pressure will be on service businesses to absorb the effect of the tax, resulting in an extremely burdensome effective net income tax rate (as discussed in the executive summary).
- Pyramiding – Under this kind of system, the potential for goods and services being taxed several times exists. For example, if an independent contractor is used to machine a particular piece of equipment, the sales tax on the piece of equipment will include an additional cost component generated by the service tax on the contractor's service. Rules similar to the re-sale exemption for tangible personal property would have to be implemented so that only the ultimate consumer would be taxed.

- Competitive disadvantage – Unlike the sales tax on tangible personal property, only a handful of States provide any type of tax on services. Therefore, strong pressure will be on service businesses to absorb the effect of the tax, resulting in an extremely burdensome effective net income tax rate (discussed below). In addition, this "unfamiliar" tax will discourage service companies seeking to relocate or expand. Businesses often choose to locate or expand in states that impose fewer taxes and lessen the compliance burden. This is particularly true for technology and service companies as they are generally very mobile.
- Regressivity – A sales tax on services increases the front-end costs of doing business. Of particular concern in a down economy is that even businesses that are losing money (reporting no income or a loss) would still have to pay the services tax.
- Employment opportunities reduced – If fewer businesses locate or expand in the state, employment opportunities will be reduced. Moreover, the increase in the overall cost of services will decrease demand for the newly taxed services and may result in the loss of existing jobs.
- Double taxation – Certain specialized industries may have separate issues with the service tax. For example, insurance companies pay a tax on their gross premiums collected within the state.

Counter to Good Tax Policy: The start of the twenty-first century has been for many state and local governments a period of serious economic difficulty. They are faced with the need to maintain an adequate revenue flow and, at the same time, preserve and improve services. This has resulted in many legislatures considering tax measures in a piecemeal fashion, without a comprehensive review of the entire tax system. The result is a tax system that violates many of the principles of "good tax policy".

- Tax Law Transparency – Taxpayers should know that a tax exists and how and when it is imposed on them and others. Sales taxes that are levied on purchases made by the final consumer generally meet this criterion. However, when business inputs are taxed (services consumed by businesses), the principle of transparency is violated. The additional tax is included in the price of the final product and is effectively hidden from the ultimate consumer.

- Equity and Fairness – Equity simply means that similarly situated taxpayers should be taxed similarly. While a sales tax on services is consistent with the ability to pay standard (those who spend more, pay more), sales taxes are generally regressive (the average tax rate decreases as the tax base increases). A sales tax on services ultimately falls most heavily on the consumers of those services who are least able to pay, since services that are likely to be subject to the tax include everyday expenditures.

- Simplicity – The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and cost efficiently. In general, the sales tax system with its many exemptions, multiple definitions, and different rates is not simple. It is hard to imagine a sales tax on services that would not require many exemptions from the tax and detailed rules defining what is or is not a service. For example, should health related services be exempt? What about legal services? If exemptions exist, how will the system insure that different types of service providers offering similar services are treated in a similar manner? How is the value of a co-mingled service and product separated? In addition, this bill is complicated by the presence of exemptions allowed to certain types of service industries and not to others. In order to be simple, the tax should be applied to all service industries or to none.

- Economy of Collection – The costs to collect a tax should be kept to a minimum for both taxpayers (compliance costs) and the government (administrative costs). While compliance costs of a sales tax on services incurred by individual consumers of services are minimal, the compliance costs incurred by providers of those services (including individuals) are great and usually burdensome. Firms and individuals providing services to consumers are often large in number, small in size, and less sophisticated -- thus making both compliance and administration difficult. Where does the line get drawn? How easy will it be to draw the line? For example, every teenager mowing yards, every barber cutting hair, every contractor painting houses would be faced with a greater compliance burden. Further, every individual that consumes these services would pay more tax.

- Tax Upon a Tax – The potential exists for multiple-taxation through the pyramiding of tax and lack of tax reciprocity. In theory, a retail sales tax is a one-time levy on the final sale of the product to the ultimate consumer. If the product is taxed at interim steps before the final delivery, the result is multiple-taxation.

Administrative Complexities: A sales tax on services brings with it tremendous enforcement and compliance issues, significant costs of compliance, and numerous administrative burdens. In addition to imposing compliance costs on businesses, additional costs for state administrative personnel and the creation of a system to enforce and collect the tax will reduce the net revenue generated for the state.

- Ability to Enforce – A tax should be structured to minimize noncompliance. While compliance with the existing sales tax on tangible personal property is very high (possibly with the exception of the use tax), compliance with a new tax on services may not be. As noted earlier, service providers are primarily small, less sophisticated businesses. In addition, the enforcement of a tax on services at the consumer level would be nearly impossible.

- Administrative burden – A tax on services creates a different set of requirements for states that are accustomed to normal retail "point of sale" collection procedures. The taxation of services introduces the element of "sourcing" in determining whether the service occurred in Nevada or elsewhere. It entails added difficulties because of the dramatically increased number of new venders that must be registered and monitored and the complexities of collection of use tax by out-of-state vendors. There is also the added difficulty of defining what services are subject to the tax.

- Changes Needed to Other Laws – Changes in the sales and use tax statutes will create the need to change other laws and provisions. For example, if laws are changed regarding the imposition of sales tax on services, a corresponding change to the sale-for-resale provisions will be necessary. In addition, the consequences to the Streamlined Sales Tax Project must be considered.

- Difficulty in Determining the Taxable Location (or sourcing) of a Service – Imposition of a sales tax on services involves a number of difficult sourcing issues. For example, is the service taxable in the "performed location" or the "benefit location?" If different states chose different imposition choices, does the service get taxed in both places? If this is the case, how will tax offsets be applied? If the tax is imposed on the benefit location, how would allocation of service costs performed for a large business with divisions in multiple states be determined? What if the out-of-state service provider does not have nexus in the state and is, therefore, under no obligation to collect the tax? These are just some of the issues that will need to be addressed.

- Compliance – Compliance is made even more complicated when dealing with multiple taxing jurisdictions. For example, a professional service provider in one jurisdiction could very easily provide services in several nearby jurisdictions thus requiring the filing and remitting of sales taxes in each of those jurisdictions.

Other Considerations

- Effective Tax Burden of Different Taxes – The state income tax burden is effectively reduced when a taxpayer is allowed to deduct state income taxes in determining federal taxable income. Essentially, the federal government is picking up part of the cost of the state income tax. Since 1986, the federal government has not allowed individuals to deduct state sales taxes in determining federal taxable income. Thus the out of pocket cost of an additional dollar of state income tax is less than the out of pocket cost of an additional dollar of state sales tax.

- Unpopular Tax – A sales tax on services has been tried before. In 1987, Florida enacted a sales and use tax on services. The tax was repealed after only six months. Then in 2002, Florida attempted to amend the state constitution to include a sales tax on services. The courts determined that the ballot measure was unconstitutional. Likewise, in 1990, Massachusetts repealed its tax on services after only one day when it proved to be confusing to explain and difficult to administer. There is a long list of "sales tax suicides" throughout history.

- Discourages Use of Professional Service – A consumer in an uncertain situation could be discouraged from seeking professional guidance on important questions when they must also pay sales tax to get the correct answer. On the margin, the additional cost imposed by a sales tax on professional services might push individual consumers to bypass needed professional services, such as legal and accounting advice.

- Chilling Effects – A sales tax on services may levy a tax on consumers at a most sensitive or inopportune time, such as in conjunction with an IRS tax audit, bankruptcy, estate administration, or divorce actions when the services of professionals are essential.

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