



## CPA- Information Paper

Tax Policy and Professional Services  
July, 2024

ILLINOIS CPA SOCIETY, FY.

# Chicago Professional Services Tax Proposal: Legally Invalid Tax Policy with Negative Economic and Administrative Consequences

With state and city revenues under significant pressures, leaders in both the city of Chicago and State of Illinois are facing difficult decisions in the months and years ahead as new fiscal-year spending plans are developed.

In Chicago, Mayor Brandon Johnson's Administration and the City Council are considering a number of new ways to battle budget headwinds. An online survey recently distributed to Chicago council members asked about their support for 16 different types of new or increased revenue sources, and the list included a possible new tax on professional services.

Asked about his views on taxing services at the state level, Gov. J.B. Pritzker simply declined to rule out any revenue option as the state looks to balance its budget and help fill a major revenue shortfall facing transit services that serve the Chicagoland area.

Even without the details which would be associated with a formal language for a new tax, we conclude that any sales tax on professional services represents legally invalid tax policy, poses substantial administrative problems, and, most importantly, will have a significant and negative impact on Chicago's economy in both the near and long term. In fact, Chicago already tried something like this once before, and it was found unconstitutional by the Illinois Supreme Court.<sup>1</sup>

## No Other Jurisdiction Singles Out Professional Services via a Targeted Tax

It's difficult to know exactly what Mayor Johnson has in mind without a full legislative proposal, but the bottom line is this: **no state or locality levies anything remotely resembling a targeted tax on professional services.** Three states (Hawaii, New Mexico, and South Dakota) have broad-based sales taxes that apply to services, but none of them target professional services, and the most recent of these was enacted almost six decades ago (South Dakota, 1965).

In recent years, many states have considered — *and all have rejected* — legislative proposals which would expand the sales tax base broadly to include professional services. **A targeted tax on professional services would make Chicago a sole outlier with a uniquely flawed policy.**

## Negative Consequences of a Tax on Professional Services

- **Taxes on professional services creates disincentives for both providers and consumers.**

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<sup>1</sup> *Commercial National Bank of Chicago v. City of Chicago*, 89 Ill. 2d 45 (1982), where the Illinois Supreme Court found Chicago's 1% tax on services, adopted in 1981, violated the Illinois Constitution.

A tax on professional services results in significant negative economic consequences. Assuming the tax falls on the firms themselves based on where the work is performed, it would create a disincentive for firms to perform work within Chicago and a disincentive for consumers to purchase services from Chicago professional services firms. If, on the other hand, the tax falls on purchasers of these services (a “use tax”), it creates a disincentive for corporate headquarters and other large purchasers of professional services to locate in Chicago or an incentive to ensure that these services are purchased by divisions located outside of Chicago and from service providers located outside of the city.

And that is just the beginning. Suppose the tax is initially limited to select professional services firms. Other professional services (perhaps engineering, architectural, and business consultants, for example) would assume they were next to be targeted. Rationally, firms which would otherwise find Chicago an ideal place to locate or expand would consider other cities. Moreover, the myriad of companies that support Chicago’s robust legal and accounting firms, from airlines to caterers to office supply companies would be negatively affected. Here’s why.

- **Services are highly fungible in modern society.**

In the modern economy, businesses and employees have the ability to serve customers and clients from anywhere in the world. Services are fungible and service businesses that aren’t physically tied to a location will be able to avoid the tax for significant tax savings. Legal and accounting services can easily be conducted remotely with no decrease in quality of service.

The proposition that Chicago businesses will pay more for professional services — business inputs — than competitors located outside the city limits is unfounded in today’s business environment where margins are often thin and competition is fierce. Work can easily be moved to satellite offices and likely will be if a tax such as this is implemented. While proposals to tax professional services are generally intended to hit large multi-location national and international firms, the reality is that the biggest losers will be those small- to medium-sized firms who have less ability to shift operations outside of Chicago.

Similarly, businesses outside of Chicago have no incentive to pay a tax for the privilege of using legal or accounting professionals located in Chicago (as opposed to tens of thousands of capable professionals located in literally every other city in the country which has no such tax). Currently, the Chicago professional services market serves national and international clients — a tax policy such as this will damage this robust market, harming businesses, employees, and consumers alike as a result of the decreased economic activity.

By attempting to extract revenue from a small group of companies, Mayor Johnson’s idea would make the long-term cost of operating in the city higher than that of other cities. Presumably, there will be a tipping point when tax costs exceed the other benefits of being in Chicago, and the Chicago business market will adjust accordingly as all markets do — usually resulting in less robust businesses, fewer jobs, and lower tax revenue for the government’s treasury.

- **Illinois already tried targeted taxes on specified businesses but abandoned the idea!**

The Illinois General Assembly has recognized the disincentive that tax policy can create around jurisdictional investment. In 2017, the Legislature introduced SB 1719 and HB 3393, which imposed a privilege tax at a rate of 20 percent on partnerships and S corporations engaged in the business of conducting investment management services. Upon review, the Legislature acknowledged that such a tax policy would penalize businesses that invest in the state, and the proposals were abandoned. A Chicago tax on services can be similarly interpreted: as a tax that may generate short-term revenue but negatively impact the city’s long-term economy. The contemplated services tax would directly target firms that have greatly invested in Chicago and form a material piece of the city’s portfolio of taxpayers.

## Mayor Johnson's Tax on Services Violates Fundamental Principles of Tax Policy

All of these negative economic effects are to be expected, because a tax on professional services — whether imposed as a gross receipts tax or a sales tax — runs afoul of fundamental tax policy principles.

Sound tax policy requires that a tax system be neutral and promote economic growth. Neutrality is important in that the system should not impact how consumers make decisions or affect whether a consumer carries out a particular transaction. The tax system should not be used to micromanage the economy or create winners and losers within a group of similar situated professional competitors. It should be used to raise revenue, and, in the spirit of economic growth, should not unnecessarily impede or reduce the productive capacity of the economy.

- **Professional services are business inputs and taxing them leads to tax pyramiding.**

Attempts to impose a sales tax on professional services, like accounting services, are nonsensical: the data shows that accounting services are by definition business services, and thus do not fit in any rational sales tax base. Public finance economists and fiscal policy experts on both sides of the political spectrum agree that business inputs shouldn't be taxed under the sales and use tax because they lead to tax pyramiding, where a tax is embedded many times in a good or service's final purchase price (in other words, a "tax on tax").

Based on Bureau of Economic Analysis (BEA) data,<sup>2</sup> we estimate that 81 percent of "accounting, tax preparation, bookkeeping, and payroll services" (the most granular BEA category for these services) are purchased by other businesses as an intermediate input. Further, 10 percent of accounting services are purchased by governments and nonprofits (states shouldn't apply sales tax to these purchases either – and usually don't).

Therefore, if traditional economic principles are applied and business inputs, along with government and nonprofit consumption, are excluded from the sales tax base — and only final consumer purchases are taxed — only nine percent of accounting, tax preparation, bookkeeping, and payroll services would be taxable. And that nine percent is comprised mainly of individuals purchasing tax preparation services. Does the city really want to tax a service people purchase only because they are trying to determine how much of another tax they have to pay?

- **Taxing professional services violates principles of horizontal equity and amounts to picking winners and losers.**

Many of the services that are performed by accounting firms, and in some instances law firms, would be similarly performed by professional service firms that would not traditionally qualify as law and accounting firms. The expansion of services performed by firms traditionally viewed as law or accounting firms has resulted in nontraditional competitors of the targeted firms, and Chicago's potential tax would almost certainly result in similar economic actors being taxed differently.

In this instance, professional firms such as law and accounting firms would find their services artificially more expensive than those of their competitors. Thus, similarly-situated professional service firms by way of size and multinational reach would have pricing advantages over both law and accounting firms for no reason other than their professional designation as a lawyer or accountant. Artificially swaying the competitive landscape between professional service firms away from the legal and accounting community in Chicago is an inexplicable but unavoidable consequence to the contemplated tax.

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<sup>2</sup> U.S. Bureau of Economic Analysis, "Input-Output Accounts Data," Use Tables (2012), <https://www.bea.gov/industry/input-output-accounts-data>.

## Administrative Barriers To Professional Services Taxation

In addition to the economic and tax policy implications, there are numerous practical challenges to the administration and enforcement of a targeted tax on professional services.

- **Administrative Barrier #1: Establishing the Scope of the Tax**

Although there hasn't been proposed language in Chicago, a universal challenge in designing these taxes is defining the scope of the tax. Decisions include whether the tax will be designed as a gross receipts tax enforced against "large," "multinational" law and accounting firms or a transaction tax on the traditional legal and accounting services that is enforced only upon firms of a certain size and geographic presence. In either case it's important to understand what constitutes a "law or accounting firm" and a "legal and accounting service."

The application of the tax is further complicated when considering the thresholds that the city will select in order to distinguish "large" firms from "small" firms. Regardless of the method to determine a "large" firm, whether that be by revenue, headcount, or number of offices, there's likely to be very similarly situated firms that receive disparate tax treatment. This disparate tax treatment will create an incentive for firms to stay below the thresholds — and imposes significant "cliff" effects for firms which unintentionally cross the barrier. These thresholds also create timing issues: What happens if a firm crosses the threshold on the final day of the year? Does it owe tax on all its activity for that year?

- **Administrative Barrier #2: Defining Professional Services**

Secondly, taxes on professional services are inherently more difficult to apply and enforce than taxes on sales of goods because professional services are subject to interpretation (e.g., Which portion of the service qualifies as a taxable service? What's the true object of the transaction?). These questions will undoubtedly lead to difficult determinations that are ripe for disagreement and litigation.

There is no precedent for targeted taxes on professional services, which itself is a significant administrative problem: no city tax administrator nor any targeted taxpayer can rely on experience in any other jurisdiction for support in enforcing or complying with the tax.

- **Administrative Barrier #3: Determining How to Source Receipts Subject to Tax**

The third issue is the question of sourcing taxable services. There are two general options for sourcing transactions for indirect tax purposes, origin-based sourcing or destination-based sourcing. Both options come with challenges when applying these concepts to professional services because there may be multiple attributes to consider on a given transaction (e.g., location of firm home office, location of work performed, location of benefit received by client, location of client contracting office). The State of Illinois is, coincidentally, one of the few states that relies upon origin-based sourcing for local sales tax purposes. Origin-sourcing in Illinois evidences the difficulties and distortions associated with origin-based taxes, and it has been the subject of significant planning and litigation (see *Hartney Fuel Oil Co. v. Hamer (Ill. 2013)*).

If the tax sourcing is origin-based, there would be significant competitive disadvantages to firms located in Chicago, as discussed previously. While destination sourcing appears to be a more logical solution, challenges exist when the client and benefit of the service are in separate locations. Additionally, as previously noted, clients that are the consumers of impacted services would have another incentive to relocate to a convenient suburb, or, at a minimum, relocate the legal, finance, and accounting functions to offices outside of Chicago.

- **Administrative Barrier #4: Enforcement Will be Difficult**

Lastly, assuming the city passes the ordinance to impose a tax on specified professional services, the city will need to consider the costs and difficulties of enforcing a tax that would operate outside the general structure of the Illinois sales and use tax. The variety of scenarios that would require guidance via administrative regulation would take significant consideration by tax administrators, and even so, there would likely be many scenarios causing confusion as businesses arrange their relationships to reduce their tax burden or even eliminate the prospect of having to pay the tax. These efforts would likely have many valid claims given the relatively small geographic scope of the tax (*i.e.*, within the city limits).

**Governor Pritzker and Mayor Johnson should abandon ideas of imposing a tax that experience shows would be nearly impossible to implement and, were it to be implemented, would be economically damaging to the city.**