Service Taxes — Bad for the Economy

Service taxes can stifle growth and drive away investment — especially when professional and business-to-business services, such as accounting, are taxed.

Regressive. When middle and low-income consumers purchase professional services — such as legal and accounting services — it is usually out of necessity not choice, brought about by changes that they have little or no control over, such as the death of a family member, divorce, employment changes, accidents or lawsuits. Service providers price their services by cost, not by ability to pay. That means the wealthy and the poor often pay the same or similar costs for comparable services. In the case of many consumer services, middle and low-income taxpayers purchase repairs and other services when wealthy consumers can afford to replace or buy products that are less likely to need repairs. Elderly and disabled consumers purchase services that other consumers perform themselves. This could include paying a tax professional to file state and federal tax returns. Seeing a financial professional to manage finances. Using a laundry service or landscaping service to mow and care for their lawn.

Puts Illinois Firms at a Disadvantage. Professional service taxes place in-state firms at a competitive disadvantage by raising the cost of goods or services produced in the state. Without a clear exemption for professional services, Illinois firms will be unable to compete or be forced to workers in order to remain competitive.

Hurts Small Businesses Disproportionately. Service taxes squeeze small companies from both ends. As buyers, they must pay a tax for services that large companies can provide in-house. As sellers, they lose business when customers move services in-house, transfer the services to out-of-state firms or drop some services altogether.

Moves Services out of State. If professional services are taxed in Illinois, companies will move their consumption of those services out of state whenever possible. Many professionals, whether attorneys, consultants or accountants, work in regional or national practices and the services they provide are not linked to any specific location.

Difficult to Administer. Unlike traditional sales taxes, where there is a physical product to tax and consume, it is next to impossible to accurately source accounting, legal, advertising and other services offered to multi-state firms.

Layers Taxes on Taxes. Tax experts warn against “pyramiding” taxes. Taxes on professional services, without clear business-to-business exemptions, have a pyramiding effect in which the consumer ultimately pays not only any tax he or she may owe on the final purchase price, but they've also been charged numerous hidden taxes for the legal, accounting, advertising, warehousing, etc. costs that were incurred along the way.
Service Tax Proposals in Illinois

While running for Governor, Bruce Rauner endorsed a service tax and identified 32 services that could be taxed to raise an estimated $600 million. The Illinois-based Center for Tax and Budget Accountability has also proposed taxing 32 services. At least one measure (SB 1260) has been filed which lists 35 services. It is co-sponsored by Senate President John Cullerton. In early May, Voices for Illinois Children issued a report calling for as much as $4.6 billion in service taxes, including $1.4 billion from taxing professional services including accounting.

A 2011 study by the Legislature’s Commission on Government Forecasting and Accountability (CoGFA) estimated potential revenue from service taxes using both a broad-based estimate that encompassed virtually all services and a narrower estimate that excluded business-to-business services. They estimated revenues between $4 billion and $8.5 billion depending on how broadly the tax was applied.

Where the Money Is: Taxing Professional Services

Currently, only the Voices for Illinois Children proposal would tax accounting or most other professional services. Governor Rauner did propose taxing legal services.

But, as the Governor and lawmakers wrestle with the state’s massive budget problems, it is important to be aware that taxing professional services offers a temptingly large potential source of revenue. CoGFA’s 2011 estimates pegged professional services at 34-35% of total potential revenue. Similarly, the Voices for Illinois Children report also relies on taxing professional services for 35% of its service tax revenue.

In real dollars that translates into between $1.4 and $2.8 billion from a tax on professional services. As all sides search to close the budget gap, a category that accounts for more than one-third of the total potential revenue stream from a service tax should give pause to anyone providing professional services, especially in light of the recent agreement to raid numerous state funds, including the CPA regulatory fund and the formerly sacrosanct Road Fund.
Service Tax Myths and Facts

Myth: The wealthy will pay most service taxes.
Fact: Many services are more likely to be used by middle- and low-income persons. A middle-income homeowner must have their washing machine repaired. The upper-income homeowner can buy new. The owner of a 2005 Ford Fiesta is likely to spend more money on car repairs than the owner of a 2015 BMW.

Myth: The rich will pay more taxes because they pay more for services.
Fact: Service providers do not adjust their prices based on the customer, but rather charge based on the service they provide and the resulting cost of labor. The Governor estimated $46 million would be raised by taxing sewer and refuse services. Garbage pickup costs the same whether the home is $75,000 or $750,000.

Myth: Service taxes can be targeted to optional or luxury services to protect most consumers.
Fact: Some services are targeted as "luxury" items when for many consumers they are necessities. Lawn care services might be considered a discretionary expense, but the elderly and disabled must hire persons to mow, rake, clean gutters and clear debris. Single parents and those working multiple jobs must often rely on service providers.

Myth: Taxing legal fees will only hit high-income attorneys.
Fact: People hire attorneys because they have to, not because they want to; and the life circumstances that prompt most people to hire attorneys -- divorce, child custody, wills, accidents, etc. -- are not determined by disposable income. These taxes will be paid by the customer not the attorney.

Myth: Big business will pay most service taxes.
Fact: Large companies have the flexibility to move services in-house, thus avoiding taxes. Small employers don't have that option. Service taxes squeeze small companies from both ends. As buyers, they must pay a tax for services that large companies can provide in-house. As sellers, they lose business as customers migrate away from the services they provide. Taxing professional services is an incentive for consumers to purchase services from providers in states that do not impose a tax on services.

Myth: Taxing services is good public policy.
Fact: Tax policy professionals strongly discourage business-to-business service taxes, which have the effect of "pyramiding" costs to the consumers. Yet, it is much more politically popular to "hide" taxes by focusing on business rather than consumer services. Many of the taxes under consideration in Illinois target services that are either exclusively or primarily used by businesses.
Who Pays for Services: Indiana Study

The Indiana Fiscal Policy Institute recently released a study of sales and service taxes, which included a look at who purchases various services by income. It divided income levels into five segments and compared the percentage of income each quintile pays for services.

*In every category*, the lowest one-fifth paid a higher percentage of their pre-tax income for services than their wealthiest counterparts.

### Comparison of service expenditures as a share of before tax income

**Lowest one-fifth vs. highest one-fifth of income earners**

<table>
<thead>
<tr>
<th>Service Type</th>
<th>Percentage of Income for Lowest Earning One-Fifth of Population</th>
<th>Percentage of Income for Highest Earning One-Fifth of Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintenance, Repairs, Insurance</td>
<td>0.046%</td>
<td>0.015%</td>
</tr>
<tr>
<td>Personal Services</td>
<td>0.009%</td>
<td>0.007%</td>
</tr>
<tr>
<td>Other Household Services</td>
<td>0.032%</td>
<td>0.010%</td>
</tr>
<tr>
<td>Vehicle Finance Charges</td>
<td>0.005%</td>
<td>0.002%</td>
</tr>
<tr>
<td>Auto Maintenance and Repair Service</td>
<td>0.034%</td>
<td>0.009%</td>
</tr>
<tr>
<td>Vehicle Insurance</td>
<td>0.057%</td>
<td>0.009%</td>
</tr>
<tr>
<td>Health Insurance</td>
<td>0.113%</td>
<td>0.021%</td>
</tr>
<tr>
<td>Medical Services</td>
<td>0.036%</td>
<td>0.009%</td>
</tr>
<tr>
<td>Fees and Admissions</td>
<td>0.012%</td>
<td>0.010%</td>
</tr>
<tr>
<td>Personal Care Services</td>
<td>0.029%</td>
<td>0.007%</td>
</tr>
<tr>
<td>Educational Services</td>
<td>0.086%</td>
<td>0.018%</td>
</tr>
<tr>
<td>Legal Services</td>
<td>0.030%</td>
<td>0.008%</td>
</tr>
</tbody>
</table>

In addition, across all income levels, the highest earning one-fifth of consumers paid the lowest percentage of their income for services in *all but three categories*. Persons in the third quintile (40-60%) paid 0.004% of their income for personal services, compared to 0.007% for the highest income earners. Persons in the second, third and fourth quintiles (20-80%) paid .008% of their income for fees and admissions (compared to 0.010 for the highest income earners). Persons in the third and fourth quintiles (40-80%) paid 0.012% of their income for educational services, compared to 0.018% for the highest income earners. *In all other categories, the wealthiest 20% paid the smallest percentage of their income for services.*
The Experience in Other States

Just three states – Hawaii, New Mexico and South Dakota – broadly tax nearly all services, including accounting and other professional services. In fact, more states have repealed service taxes than have imposed professional service taxes.

Of the three that tax nearly all services, South Dakota is the only one that imposes a true sale tax. Hawaii and New Mexico impose a gross receipts tax constructed like a sales tax.

The service tax rates in all three states fall below Illinois’ 6.25% sales tax rate. South Dakota does not impose a state income tax.

Most comparisons of service taxes use a Federation of Tax Administrators (FTA) survey, which found that only three other states – Delaware, Washington and West Virginia – tax more than 100 services.

Illinois taxes 17 services according to that survey. While that is lower than other nearby states, it is not out of line. Indiana taxes 24 services, Missouri and Michigan tax 26 each and Kentucky taxes 28.

In 2012 three states considered taxing at least some services provided by accountants. Arizona considered a tax on most professional services. Kentucky considered a state sales tax on tax preparation services. Maryland considered an “e-filing” tax. None of these passed.

Also in 2012, South Dakota rejected a proposal to increase their service tax by .35 percent.

Several states have enacted broad-based service taxes, only to reverse themselves later.

Florida enacted a service tax in July 1987 and repealed it after six months because it put Florida businesses at a competitive disadvantage. Massachusetts passed a service tax in 1990 that was repealed two days after it took effect.

Maryland attempted to tax most computer services in 2007. The tax was viewed as so damaging to technology businesses that it was repealed before it went into effect.

And, while Michigan is listed as a nearby state that taxes more services than Illinois, not noted is the fact that in 2007 the legislature greatly expanded service taxes to include a wide range of services now under consideration in Illinois, including warehousing, landscaping, janitorial services and packaging. The public outcry was so great, that the tax was repealed just 17 hours after its effective date.
Illinois Services Taxes Rejected Before

Service taxes have been proposed in the past in Illinois, but each time lawmakers have rejected the proposal.

In 2009, the Senate approved HB 174, a service tax plan sponsored by Senate President John Cullerton that extended sales taxes to 39 services. The House never took up the plan.

A 2011 study by the Legislature’s Commission on Government Forecasting and Accountability (CoGFA) estimated potential revenue from service taxes using both a broad-based estimate that encompassed virtually all services and a narrower estimate that excluded business-to-business services. They estimated revenues between $4 billion and $8.5 billion depending on how broadly the tax was applied.

In the early 1990s, a Champaign state legislator proposed a broad tax on services that was rejected by lawmakers. In fact, many political observers believe the proposal was a significant factor in the legislator’s loss in the next election.

None of Illinois’ neighboring states tax professional services. Imposing a professional services tax in Illinois would make Illinois businesses less competitive as customers shift their services across borders.

Another fact for consideration. The Illinois Supreme Court has closely scrutinized the application of the uniformity clause of the Illinois Constitution and has overturned past attempts to distinguish classes and subclasses of professions subject to a service tax. (Fiorito v. Jones, 39 Ill. 2d 531 (Ill. 1968) and Commerical National Bank of Chicago v. City of Chicago 89 Ill 2d 45 (Ill. 1982).

While examining the potential revenue from a broad-based service tax, CoGFA warned in their 2011 study – Groups have argued that services such as medical care, legal services, and financial services, should not be taxed because the associated additional (cost) could cause lower income consumers to avoid these services, due to the increased cost, at their own detriment.”