Attachment B

Legislative Oversight Committee Concerning Tax Policy

Sales and Use Taxation of Services

Colorado Department of Revenue
July 18, 2022

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Department of Revenue
Taxation Division

Agenda

- State Sales Tax on Services
  - Background
  - Current law in Colorado
  - Current administrative complications
- Expansion of the State's Sales Tax to Services
- Q&A

State Sales Tax on Services

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Background

- Colorado’s first general sales tax law was enacted as the “Emergency Retail Sales Tax Act of 1935,” which levied the first excise tax on general retail sales of tangible personal property (TPP).
- Although the act was scheduled to expire in 1937, the Old Age Pension Amendment, initiated in 1936, rendered the new temporary tax permanent.

Background

To prevent circumvention of the sales tax, a use tax was also added in 1937, imposing a levy on tangible personal property purchased outside Colorado and brought into the state for storage, use, or consumption.

The use tax rate in Colorado is the same as the sales tax rate.

Background

H.B. 379, known as the "Public Revenue Service Tax Act of 1937" levied a tax of 2 percent on almost every service performed by residents of the state.

The service tax was first enacted only for a period of two years but was extended until it was repealed in 1945.

Background

When state legislatures enacted the first sales tax laws in the 1930s, the United States' economy depended on the manufacture and sale of physical goods.

Since then, the United States has shifted from a manufacturing-based economy to a service-based economy.

Some even say that the sales tax base is currently only about 40 percent as large as the economy.

Background

John Due made the following economic argument for taxing services:

“The distinction between a service and a commodity is not a very significant one, since both satisfy personal wants. A haircut, an opera concert or a plane ride satisfy persons’ desires in the same manner as a loaf of bread, a piano, or an automobile. . . . Persons making relatively high expenditures for services are favored compared to those concentrating their purchases on tangible goods, resource allocation may be distorted, and in some cases administrative complications are created.”

Current Law in Colorado

- Colorado taxes retail sales of tangible personal property (TPP) and select services including telephone services, rooms and accommodations, and certain utility services.

- In the case of services tied to the purchase of tangible personal property, those services are not **taxed if they are separable and separately stated on the invoice**.

Current Law in Colorado

- **Separable** means that the service is performed after the taxable TPP is offered for sale and the purchaser has a meaningful option to acquire the good without the performance of the service.

- **Separately stated** requires the service to be set forth separately in a written sales contract, retailer's invoice, or other written document .

Administrative complications

Administrative complications arise when services are provided by businesses that also sell TPP - the line of distinction between service and TPP is not sharp and the two may be provided jointly. Drawing a line between sales of service and TPP can be difficult. Consider services related to TPP such as:

- Maintenance, servicing, or warranties
- Custom-ordered goods
- Delivery, transportation, or installation

Expansion of the State's Sales Tax To Services

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The case for taxing services

According to Walter Hellerstein, taxing services would lead to:

- Greater revenue for a given tax rate;
- Greater revenue elasticity;
- Ease of administration since goods and services need not be separable and separately stated if both are taxable;
- Enhanced neutrality; and
- Less regressivity.

Hellerstein's three concerns re taxing services:

1. Could lead to the taxation of business-to-business transactions, but not unlike what already occurs when taxing TPP;
2. The incentives for a business to vertically integrate arise for services, as with goods, but businesses are expected to be better able to bring services, such as legal and accounting, in-house, making vertical integration of services a bigger concern; and
3. Evasion associated with out-of-state purchases is a larger issue for services than for goods. Of course, a use tax is imposed on out-of-state service purchases, but it is difficult to enforce.

A few things to consider:

- What services to tax?
- Possible administrative issues?
- Possible practical issues?
- Possible legal issues?

What services to tax?

- Even though there are hundreds of different types of services that can possibly be identified, most services can be generally categorized in one of three service categories:
  - Tangible Personal Property Services
  - Real Property Services
  - Professional and Personal Services
- There may be other categories depending on the nature of the transaction.
- The decision on what services to tax require a balancing of equity, political, and other considerations.

Tangible Personal Property Services

Services that are performed directly on TPP in some form or another.

TPP services will usually involve the use of specialized knowledge, expertise, or ability but will usually involve direct contact with the TPP itself.

In performing TPP services there may or may not be a transfer of other TPP, and if so, the transfer of TPP may or may not be separately stated on an invoice or billing statement.

Examples of TPP services include carpentry, car repair, and other equipment repair and installation.

As explained, the state does not tax such services if the services are separable and separately stated. Taxing these services without consideration of separability and whether separately stated could potentially ease administration.

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Real Property Services

Services that are performed directly on real property such as land, buildings, or other structures.

In many cases, the service provider is deemed to be the consumer (rather than a retailer) of the TPP that they use in performing or carrying out their real property service.

Real property services include trades such as janitorial, electrical, air-conditioning and heating, drywall, roofing, masonry, painting, landscaping, and fertilizing.

Under current law, the application of sales tax to these types of transactions can be confusing, making voluntary compliance difficult. Taxing these services could potentially ease administration.

Personal and Professional Services

Services that involve the use or exchange of knowledge, expertise, or ability that is not usually associated with TPP (or maybe inconsequential TPP).

The primary or sole objective ("true-object") of these services is to acquire or benefit from the knowledge, expertise, or ability offered, not the transfer of TPP.

Common examples of personal services: lawn mowing, tanning salons, hair salons, nail salons, pet grooming, diaper service, health clubs, amusement park admission.

Common examples of professional services: legal, accounting, healthcare, architectural, consulting, engineering, private investigation, training, design, or employment services.

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What services to tax?

If there's interest in taxing professional services, it might be helpful to look at how many states currently tax professional services.

What services to tax?

According to a **2017** Federal Tax Administration survey of service taxation, professional services (doctors, lawyers) are taxed in only 7 states.

Only Hawaii and New Mexico have broad-based sales taxes that include most all the services that were tracked by the survey.

Delaware and Washington tax a large number of services, mainly through their low-rate business gross receipts taxes.

South Dakota and West Virginia are the only other states to tax more than 100 services. These states and Texas, which taxes land surveying, are also the only states to tax any of the professional services tracked by the survey.

What services to tax?

It is possible to choose to tax certain services, but not all.

In the FTA survey update, the FTA stated:

“The results of this survey illustrate that most states tax services to a certain degree. Despite the political rhetoric, there are many services that do not pose controversy and are widely taxed. As the table illustrates, utility services are taxed in most all states. Hotel or lodging services are taxed in all states (some at the local level). Also, admissions and repair services are taxed in many states.”

Possible Administrative Issues

- Both Florida (1986) and Massachusetts (1990) imposed a sales and use tax on most services, including professional services.
    - Both states subsequently repealed the measures shortly after enactment.
    - Their experiences can guide on some of the biggest administrative issues to consider, particularly related to taxing professional services.

Possible Administrative Issues

- How to source the sale
- Timing
- Defining the service
- Pyramiding
- Enforcement

Possible Practical Issues

- Sales and use tax is subject to the TABOR limit on state revenue and spending, expanding the base to include services will increase state revenue.

- State sales tax on services may create differences between the state administered jurisdictions and home rule cities, unless the cities all adopt the same expansions.

Possible Legal Issues

- Are TABOR voter-approval requirements triggered?
- Are there Due Process and Commerce Clause issues?
- If you tax advertising services, does that trigger First Amendment questions?
- If you tax legal services, does that trigger Right to Counsel and Equal Protection questions?

Q&A

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