



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

Date Amended:	<b>04/18/05</b>	Bill No:	<b>AB 9</b>
Tax:	<b>Sales and Use</b>	Author:	<b>Coto</b>
Related Bills:			

**BILL SUMMARY**

This bill would extend the state sales and use tax to specified services.

**ANALYSIS**

**Current Law**

Under existing Sales and Use Tax Law, a state, local, and district sales tax is generally imposed on the gross receipts of retail sales of tangible personal property, unless the property is specifically exempted or partially exempted from the tax. The basic state and local sales and use tax rate is made up of the following components:

5.00 %	State (General Fund)
0.25 %	State (Fiscal Recovery Fund / Bonds)
0.50 %	Local Revenue Fund
0.50 %	Local Public Safety Fund
1.00 %	Local (County/City) 0.25% County transportation funds 0.75% City and county operations
7.25 %	Total Combined State and Local Sales and Use Tax Rate

**Proposed Law**

This bill would amend various sections in the Sales and Use Tax Law to apply the state sales tax components of 5.25%, the .50% component for the Local Revenue Fund and the .50% component of the Local Public Safety Fund (a combined rate of 6.25%) to the following “specialized services”:

- The cost of membership to any private club.

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- The furnishing or provision of any prefixed telephone number used for information-access service, including, but not limited to, telephone numbers with the prefix 900 or 976.
- The furnishing or provision of marina services, including, but not limited to, boat slips and docking services, fuel for watercraft, and watercraft rentals.
- The furnishing or provision of any custom computer program as defined by Section 6010.9.
- The cost to charter an aircraft or limousine to transport passengers in this state.
- The furnishing or provision of accounting or bookkeeping services.
- The furnishing or provision of legal services.
- The furnishing or provision of security and detective services.
- The furnishing or provision of telephone services other than residential telephone service.
- The furnishing or provision of engineering, architectural, or surveying services.
- The furnishing or provision of management, scientific, or technical consulting services.
- With respect to the services described, the bill would provide that no portion of the charge for the service may be deemed a sale or rental of tangible personal property if the property transferred by the retailer is incidental to the furnishing or provision of the service.

The bill would add an uncodified section to provide that the revenues derived from the proposed tax be deposited in the Education Finance Account, created by this bill.

The bill would become effective January 1, 2006.

#### **In General**

A 1996 survey conducted by the Federation of Tax Administrators demonstrated that most states tax a wide range of services, including intangible items such as utility services, admissions, repair services, and lodging services. Beyond these general categories, however, the survey demonstrated that the states exhibit great diversity in the extent to which they tax the full range of the 164 services covered in the survey. Hawaii, New Mexico, and South Dakota have general sales tax systems with broadly defined bases that tax the bulk of the services. Delaware, which imposes no general sales tax, assesses a gross receipts tax on most businesses. Several other states tax a large number of selected services. These include Arkansas, Connecticut, Iowa, Kansas, Mississippi, New York, Tennessee, Texas, and Wisconsin. Conversely, there are some states, such as California, Illinois, Nevada, New Hampshire, and Virginia that include comparatively few services in their sales tax base. Professional services, such as lawyers, accountants, dentists, engineers, and physicians have been left largely untaxed.

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**COMMENTS**

1. **Sponsor and purpose.** This bill is sponsored by the author in an effort to provide more funding for education.
2. **Rationale for taxing services.** Proponents of a sales tax on services have argued that there is no basis for an economic or social policy that makes a tax distinction between purchases of services and the purchase of tangible personal property. Playing golf at a golf course, contracting for custom software, or hiring an bookkeeper fulfill the same personal desires and needs as buying golf clubs, canned computer programs, or calculators, except that under the current tax structure, the latter examples are subject to the sales tax.

Further, proponents would argue that California's continuing budget pressures require the establishment of new sources of revenue to support existing programs and implement new ones. They would look to a sales tax on services to produce some of the needed revenue. The uniform taxation of services would result in an elastic tax effect of revenue growing with the rate of economic growth.

Proponents see a tax on services as being a progressive tax. The assumption is that mainly people in higher income brackets would be impacted by a tax on services which is part of their discretionary income budget. People who can afford personal and professional services, such as those described in this measure, can better afford to bear a larger share of the tax burden.

3. **Rationale against a sales tax on services.** Opponents would argue that the imposition of a new tax could result in lower consumer spending or dramatic changes in planned business expansions or expenditures which could put new pressures on California's budget. Also, opponents have expressed concerns with "pyramiding." Opponents point out that taxing the services businesses buy to use as inputs into the production of goods and other services often leads to "tax pyramiding." This term refers to the situation in which an input is taxed when purchased and then effectively taxed again when its cost is passed through into the price of a taxable good or service into which it has been incorporated.
4. **Clear definitions of each service should be made.** In order to effectively administer a proposed service tax, clear definitions of each service is essential. Perhaps the bill should reference the applicable industry codes using the North American Industry Classification System.
5. **Some administrative problems could arise in drawing the line between taxable and exempt services.** For example, the bill would provide that telephone services other than residential telephone services are subject to the proposed tax, as are any charges for prefixed telephone numbers used for information-access services, such as 900-numbers. How would the tax apply, for example, in cases where a service provider provides both exempt paging services and taxable telephone services for a bundled price? The service provider would be required to break down a separate charge for each service on the bill so that the telephone service could be taxed.

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This could add to the recordkeeping cost of the provider and could lead to disputes about whether the provider is overcharging for the exempt service and undercharging for the taxable one.

6. **Taxing business purchases of services can create some difficult administrative problems that are less likely to arise if sales taxes are confined to household services.** For example, services such as accounting services and legal services are often purchased for companywide use. When that use occurs in multiple states, it would be difficult to determine how and where such services should be taxed. The absence of clear rules could likely to lead to audit disputes and litigation. Moreover, if the rules for dealing with these kinds of purchases are not consistent among the states, the sale of the service could be taxed more than once or escape taxation entirely.

Businesses purchase services across state lines much more often than households do. For example, a corporation is more likely to have an out-of-state architect design its new headquarters than a homeowner is to design an addition to his or her house.

To avoid putting in-state service providers that must charge sales tax at a competitive disadvantage with out-of-state competitors who would not be required to collect the tax, perhaps the bill should be amended to impose an equivalent use tax on any services purchased from out-of-state companies (just as the law imposes a use tax on purchases of goods). However, use tax has proven to be more difficult to enforce, and it is currently the largest area of noncompliance by California taxpayers. The fewer business-to-business sales of services are taxed, the fewer use tax enforcement issues arise.

7. **Should out-of-state retailers of services that have a business presence in California be subject to the proposed tax?** Under the current sales and use tax structure, out-of-state retailers of goods that have a business presence in California are required to collect California sales or use tax on any sales made to California consumers. As currently drafted, this bill would not impose similar requirements on out-of-state retailers of services. It is recommended that such a provision be incorporated into the bill. Otherwise, retailers of services that have out-of-state offices, such as law firms and accounting firms, may be compelled to funnel all their service transactions with California clients through their out-of-state offices to the extent they could to avoid the tax.
8. **The language will need to be refined as the bill progresses.** This proposal provides the basic language necessary to administer a tax on services. However, in order to clarify specific areas of the law, some contradictory references will need to be amended. Board staff is willing to work with the author to refine the language as the bill progresses.
9. **The Board would need more lead time to implement the new tax.** Since the Board would be required to identify, notify, and register a vast number of new

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taxpayers, it is recommended that the Board, at a minimum, be given a lead time of six months.

**COST ESTIMATE**

Major costs would be incurred to identify and register thousands of new business entities and processing a vastly increased volume of tax returns. Proportional expenses for collections and audits would increase, and taxpayer education and seminar programs would also have to be developed. An estimate of these costs is pending.

**REVENUE ESTIMATE**

We compiled information on the specialized services as defined in the bill using data from the U.S. Census Bureau’s 1997 Economic Census for California. These 1997 figures were factored to 2005-06 based on the California Consumer Price Index.

The Census figures have also been adjusted to reflect any receipts that were due to the sale of tangible personal property or other non-service sources. These adjustments were made based on information from either Merchandise Line Sales or Sources of Revenues for each type of service. These reports are compiled by the U.S. Census Bureau on a nationwide basis and not by state.

Specialized Service	2005-06 Estimated Receipts (in millions)
1 Sale of memberships to private clubs	\$699
2 900 or 976 number services	139
3 Marina service	105
4 Custom computer programs	6,790
5 Aircraft / limousine charters	961
6 Accounting and bookkeeping services	15,225
7 Legal services	22,315
8 Security and detective services	4,027
9 Custom telephone services	2,241
10 Engineering, architectural & surveying services	20,202
11 Management, scientific & technical consulting services	10,120
Total	<u>\$75,091</u>

The estimate of receipts for the 11 selected services amounts to \$75.1 billion. Extending the sales and use tax to these services will generate \$4,693 million in additional sales and use tax revenue.

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**Revenue Summary**

Fund	Revenue (in millions)
State General Fund	\$3,755
Fiscal Recovery Fund	188
Local Revenue Fund	375
Public Safety Fund	375
	<u>\$4,693</u>

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