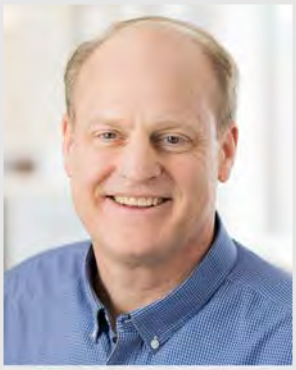
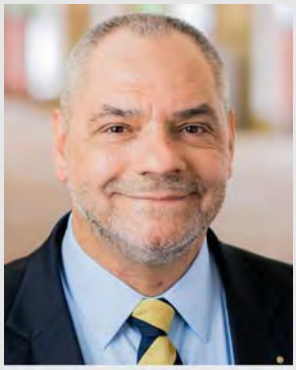
Rethinking the State Taxation of Services After COVID-19

by Michael J. Bernard and George L. Salis



Michael J. Bernard



George L. Salis

Michael J. Bernard is the chief tax officer of transaction tax and George L. Salis is the principal economist and tax policy adviser of Vertex Inc.

In this article, the authors argue that when policymakers reconsider indirect taxation overhauls prompted by the COVID-19 pandemic, tax leaders will have an influential advocacy mandate.

Please remember that this article provides information for educational purposes, not specific tax or legal advice. Always consult a qualified tax or legal adviser before taking any action based on this information. The views and opinions expressed in this article are those of the authors and do not necessarily reflect the official policy, position, or opinion of Vertex Inc.

Global crises tend to accelerate trends. For example, COVID-19 may have fast-tracked many organizations' transitions to remote-work models and will also hasten and compel three preexisting, but tentative, tax trends:

1. an overhaul of indirect taxation at the state and local levels;
2. public finance and reform regarding the acceleration of payments and tax revenue collection; and
3. the reacquisition and expansion of corporate tax leaders' new core skills set.

Once federal, state, and local governments tally the economic fallout from the coronavirus pandemic, they will consider a wider range of sales and use tax increases, tax base expansions, exemption eliminations, and the creation of new types of tax. Before this tax replenishment, some states may move toward periodic tax "holidays" to promote small to medium-size business activity. "States are hemorrhaging money responding to the public-health crisis at the same time tax revenues are cratering because of widespread stay-at-home orders and business closures," according to *The Wall Street Journal*.[1] As such, tax base restoration will be a priority.

Expanding sales taxes to traditional personal and professional services, an area in which they have been lagging behind, marks a major policy change that state legislatures appear likely to consider once they reconvene, according to both the National Conference of State Legislatures and the Federation of Tax Administrators.[2] Looming changes to indirect tax policies will also increase pressure on tax executives to strengthen their advocacy for balanced tax policies to multiple stakeholders.

Potential levies on services are far from the only major tax changes legislators will weigh. For example, some states may quickly pass gas tax increases given that the swoon in oil prices would offset the hit to consumers. Yet efforts to tax services are instructive because they illustrate how quickly long-standing views on taxation can

---

[1]Scott Calvert and David Harrison, "States See No Immediate Sign of Financial Help," *The Wall Street Journal*, Apr. 23, 2020.

[2]Savannah Gilmore, "Another Bill Bites the Dust: The State Struggle to Tax Services," NCSL (March 2020); Jackson Brainerd, "Services Targeted for Taxes," *State Legislatures*, Jan. 16, 2020; FTA 2017 Sales Taxation of Services Report (August 2017).

pivot in times of economic and budgetary distress.

For many tax functions, state tax policy changes on the horizon represent the next in a procession of waves saturating tax management activities with more complexity. Companies with e-commerce operations have been responding to a raft of new sales tax rules and requirements since the U.S. Supreme Court's 2018 *Wayfair* decision. The same holds true for marketplace facilitators. Global companies that sell in European Union markets have been adapting to new VAT compliance requirements. And large technology companies have been monitoring unilateral digital services taxes taking effect and then being temporarily suspended as they await approval of a "unified" multilateral DST (which also may be delayed as countries address their unique post-COVID-19 economic stresses). (See "The Uncertain State(s) of U.S. Digital Services Taxes" sidebar.)

Efforts to Tax Services: A Reversal in Fortune?

Numerous efforts to impose sales tax on traditional (that is, non-digital) services have failed to produce widespread tax policy changes in recent decades, even though approximately two-thirds of U.S. GDP is now driven by services industries.

That 50-year transition from a product-based to a services-based economy marks a prime argument for taxing both business-to-consumer and business-to-business services. Proponents of taxing services also contend that:

- proliferating exemptions have narrowed the sales tax base;
- sales taxes (on products) can have a greater impact on low-income taxpayers than on high earners (who tend to spend more on services); and
- broadening sales taxes to services is more effective during declining economic cycles than some other types of changes (for example, income tax increases).

Opponents' responses include the following contentions:

- **Extending sales tax to professional services would have a discriminatory effect on small B2B firms.** Larger companies can afford to employ a wide range of in-house expertise that small companies tend to outsource. Small businesses may find it challenging to bear the extra cost of a tax on their externally sourced professional services. On the consumer side, it is well known that taxes on services are regressive because they have an outsized impact on lower-income taxpayers.
- **Lack of uniformity in taxing services could lead to distortion by way of asymmetric information, uncertainty, and deadweight loss.** Normally, services are taxed where they are consumed or used, not where they are produced. If there is not a uniform movement among states to tax services, companies will look to consume services in states where they are not taxed, making some states more attractive to businesses. States may also take significantly different approaches to exempting some types of services from tax.
- **Administrative headaches.** *Stateline*'s Elaine S. Povich notes that snow removal is not taxable in Pennsylvania (one of a handful of states that taxes services), but that the removal of snow from gutters and downspouts is taxable since it qualifies as building cleaning and building maintenance services.[3] "Taxing drain repair services or landscaping services is one matter," *Tax Notes State* contributing editor Roxanne Bland writes, "but for multistate customers and service providers, it is not easy to pinpoint where the taxable service took place — that is, when, where, and how the services were used."[4]

Bland adds that opponents of taxing services note that the portion of private-industry GDP generated from services barely budged from 1997 (72 percent) to 2013 (75 percent). (Today, it is a bit lower at 68 percent.)

In recent years, service tax opponents have won out. In 2017, for example, Povich reports

[3]Elaine S. Povich, "Why States Are Struggling to Tax Services," Pew Charitable Trusts, June 27, 2017.

[4]Roxanne Bland, "Sales Taxes on Services: An Uphill Battle," *Tax Notes State*, Nov. 18, 2019, p. 567.

that 23 state legislatures "considered proposals to impose taxes on at least some services. But so far, none has made it into law intact — and most die outright."[5]

That trend may soon reverse.

What to Expect When States Foresee Revenue Shortfalls

Aside from specific federal relief funds included in fiscal and monetary policy responses, states typically have three levers to adjust when managing budgets during recessions. They can tap state emergency funds, cut spending, and increase taxes.

Tapping reserves is often the easiest and least painful move. However, COVID-19-related budget shortfalls may exceed the size of many states' rainy day funds. Research also indicates that there is less room for spending reductions in 2020 than there was in the previous recession.

Both factors make tax increases all but guaranteed, which is why tax leaders should keep the following in mind:

- **Public health, economic stabilization and stimulus, and unemployment-related costs will need to be covered.** The $2 trillion economic stabilization package the federal government approved this spring includes $150 billion to cover state and local COVID-19-related expenses. States are currently clamoring for more aid to cover unemployment insurance and other costs. In a letter to Congress, the president of the National Association of State Budget Officers asserts that "states are currently facing revenue impacts that could dwarf what was observed in the last recession." According to this official, state revenue declined by 11.6 percent during the 2007-2009 recession. Currently, the association is forecasting a decrease of up to 20 percent, primarily because of massive drops in sales and income taxes stemming from the current crisis.[6]
- **There were questions about state finances *before* the pandemic.** Although state reserve funds reached all-time highs just before the onset of the pandemic, closer scrutiny of states' financial health revealed several risks. Despite those robust rainy day funds, "states may not be as prepared for the next recession as they think," an October 2019 Pew Charitable Trusts research report concludes. The research points to states' high fixed costs (for example, Medicaid spending, which tends to increase in economic downturns), low spending levels because of cuts made in response to the 2008 financial crisis (that have largely sustained) and recent revenue volatility.[7] Separate Pew research indicates that strains from the 2007-2009 economic downturn remain in many states: States missed out on more than $280 billion of tax revenues in the five years following the 2008 global financial crisis. Although total state tax revenue eventually recovered, the Pew data show that many states in 2019 were "still dealing with fallout from the tough choices they had to make to fill budget holes during the recession."[8]
- **Tax policy changes will vary by state:** As state legislators and departments of revenue consider how to increase revenue, they will target tax types and categories that provide the greatest returns at the lowest political cost. States will attempt to revitalize the industries that are important to their individual economies and have been disproportionally affected. Preserving each state's competitive economic base will be as vital as sustaining and boosting the tax base, as one is dependent upon the other. For example, Hawaii would likely prefer to avoid hindering tourism-related businesses, while Texas, North Dakota, and New Mexico would want to avoid any change that would harm revenue from oil taxes and state leases.

---

[5] Povich, *supra* note 3.

[6] Calvert and Harrison, *supra* note 1.

[7] Mary Murphy, Steve Bailey, and Airlie Loiaconi, "Rainy Day Funds in 2019: Are States Ready for the Next Recession?" Pew Charitable Trusts, Oct. 1, 2019.

[8] Barb Rosewicz et al., "'Lost Decade' Casts a Post-Recession Shadow on State Finances," Pew Charitable Trusts, June 4, 2019.

- **States are not alone.** At last count, at least 2,100 cities were projecting budget shortfalls, according to the National League of Cities and the U.S. Conference of Mayors. Los Angeles forecasts a $231 million revenue decline this year — along with a $600 million drop in in 2021 revenue.[9] These budget shortfalls will spur some city councils to consider their own tax increases and adjustments.
- **The timing of states' fiscal retrenchment is pivotal.** Initiating fiscal retrenchment too early during a recession can prolong the downturn. Federal grants that financed state and local spending increased in the wake of the 2007-2009 recession. However, most of those grants were discontinued by 2011, "and overall spending by the sector dragged on growth for several years," according to Brookings Institution research. "This turn to fiscal austerity undoubtedly impeded the economic recovery. Hopefully, policymakers learned that lesson and will ensure that fiscal support is provided quickly and is not withdrawn prematurely."[10]

Tax leaders should keep these factors in mind while monitoring upcoming legislative sessions, including special sessions. Deeply held attitudes and policy positions before the pandemic may do an about-face after lawmakers and rule-makers come to terms with the economic damage COVID-19 has inflicted.

A Playbook for Influencing Tax Policy

Tax executives can and should do more than monitor state and local tax policy changes. Influencing that thinking and shaping tax changes increasingly qualify as parts of a tax executive's fundamental responsibilities, regardless of the size of their company. While most of the largest global companies have developed mature government relations capabilities, there are ways for small and medium-size companies — as well as large organizations without mature government relationship functions — to exert influence.

State lawmakers frequently consult with DORs when drafting tax laws and responding to ballot initiatives concerning tax matters. When new tax legislation emerges, legislators want to know if the DOR can enforce the requirements if it becomes law.

There are several different ways to exert influence, regardless of a company's size. A tax executive may meet directly with state tax officials or work through various intermediaries to indirectly share insights and perspectives. Chambers of commerce often take positions on tax matters, and tax executives can get involved with these efforts. Nonprofit research-based organizations in many states represent corporate taxpayer interests while sharing insights on tax policy with state and local rule-makers. In addition to working with groups like these, tax executives can join relationships — building efforts spearheaded by tax functions in larger companies.

For their part, small businesses can exert a unique influence. When illustrating the impact of a potential tax policy change on businesses, anecdotes featuring small, Main Street businesses often hold the most sway. As such, tax leaders in larger companies should solicit involvement from their counterparts in smaller companies, and small-company tax leaders should ensure that their powerful narratives are conveyed — directly or indirectly — to state tax officials.

Sidebar: The Uncertain State(s) of U.S. DST

There are compelling legal and constitutional reasons why the type of DST that France, the United Kingdom, Italy, Spain, Hungary, and Turkey have finalized will not pass muster in the United States. A few state legislatures — including Maryland and New York — have not gotten the memo, however.

In March Maryland lawmakers approved a digital advertising gross revenues tax; however, Gov. Larry Hogan (R) vetoed the bill in May. The legislature is now expected to override the veto. A similar, though broader, bill is also pending in New York.

[9] Calvert, "Governors Scale Back on Spending," *The Wall Street Journal*, Apr. 17, 2020.

[10] Sage Belz and Louise Sheiner, "How Will the Coronavirus Affect State and Local Government Budgets?" Brookings Institution, Mar. 23, 2020.

While DST laws have been enacted in Europe, similar taxes would face constitutional challenges if implemented by a U.S. state.

"The U.S. Constitution prohibits states from imposing taxes which discriminate against interstate commerce and requires that taxes on multistate businesses be reasonably related to their in-state activity," said Jared Walczak of the Tax Foundation.[11] Other tax and legal experts have pointed out that Maryland's threshold of global annual gross revenues ultimately targets larger global advertising service providers at a higher tax rate than their smaller domestic competitors, in violation of the commerce clause of the U.S. Constitution.

Further, McDermott Will & Emery's state and local tax experts, among other constitutional scholars, argue that the Maryland DST would be a "discriminatory tax" because it taxes digital advertising (but not nondigital advertising) and would therefore be prohibited under the Permanent Internet Tax Freedom Act.[12] There are also concerns of First Amendment unlawful regulation of commercial speech.

The fact that some state legislatures have approved controversial DSTs will not only spark fierce legal battles, but should give tax executives a hint of what may be on the horizon when states consider far broader tax proposals to address COVID-19-related budget shortfalls later this year. ■

[11] Jared Walczak, "Worse Than Advertised: The Legal and Economic Pitfalls of Maryland's Digital Advertising Tax," Tax Foundation (Mar. 16, 2020).

[12] Eric Carstens and Stephen P. Kranz, "Maryland General Assembly Sends Digital Advertising Tax to Governor; Nearly Identical Bill Pending in New York," Inside SALT (McDermott Will & Emery), Mar. 18, 2020.