



Executive Director
Lisa Echeverri

November 2, 2007

Ms. Ann Gordon
Holland Building, Suite 245
600 S. Calhoun Street
Tallahassee, FL 32399-1300

Dear Ms. Gordon,

This is in response to questions received following the Department's recent presentation regarding taxation of services in Florida to the Finance and Taxation Committee of the Florida Taxation and Budget Reform Commission.

Commissioner McKay asked what percentage of Florida's total economy or economic activity was related to services. The Department agreed to work with the Legislative Office of Economic Growth and Demographic Research (EDR) to answer this question. The Department spoke with Amy Baker, the EDR Coordinator, regarding Commissioner McKay's question. Ms. Baker indicated that EDR had separately been asked by Commissioner McKay to provide some information and that she believed the type of information the Department was asking for would be contained in her separate response directly to Commissioner McKay. The Department indicated to Ms. Baker that it would relay that in this response, and that it may contact her office again if the Committee needed additional information or if the response given separately to Commissioner McKay did not in fact answer the question he had posed to the Department. She agreed that this would be fine.

The Committee also asked the Department to contact other states that have significant taxation of services to attempt to determine broadly the administrative difficulties these states experience with the taxation of services, specifically trying distinguish between those that are difficult to administer compared to those that are less problematic.

The Department spoke with officials and former officials of the Departments of Revenue (or their counterparts) in Texas, West Virginia, South Dakota, New Mexico and Massachusetts. The first four states were chosen due to there relatively high reliance on the taxation of services as compared to other states. West Virginia, South Dakota and New Mexico have taxed services for decades. For example, West Virginia's taxation of services dates back to 1937. Texas began taxing many services in 1987. Commissioner Miller specifically asked the Department to contact Massachusetts because it had previously had a broad based tax on services that was subsequently repealed.

Child Support Enforcement – Ann Coffin, Director • General Tax Administration - Jim Evers, Director
Property Tax Oversight - James McAdams, Director • Administrative Services - Nancy Kelley, Director
Information Services - Tony Powell, Director

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A few general observations can be made regarding the Department's discussions with these states:

There are challenging sales tax issues regarding tax situsing or sourcing whether the tax is on the sale of tangible personal property or it is on the sale of services. Services, however, can provide unique challenges when the service being taxed is not specifically related to tangible personal property or real property. This is due to the transitory nature of such services and the difficulty in establishing a particular place where a service is sold or provided. Examples include those professional, personal and insurance services as well as data processing services not related to tangible personal property or real property.

Issues regarding the definitions of which services are taxable and which are not prove to be challenging. Data processing services and information services were cited as examples where both sourcing and definitional issues prove challenging for Texas. West Virginia generally taxes services unless they are specifically exempt. They indicated that they encounter issues as new types of services emerge, with confusion regarding the taxability of the new services, or arguments being made that the taxation of such services amounts to "new taxes." It is noted that one might expect different arguments if a state specifically enumerated the types of services to be taxed, if the services were defined narrowly. Florida encountered this issue with the taxation of telecommunications services. Prior to 2001, telecommunications services were defined narrowly for sales tax purposes in Florida which led to some services being taxable, while other functionally similar services were not. Florida's adoption of the Communications Services Tax in 2001, alleviated this particular issue with a much broader definition of "communications services." Having heard this comment from West Virginia, we specifically asked South Dakota if they experienced similar issues. They indicated that while it did arise occasionally, it did not prove to be a significant issue for them. They offered that this was perhaps due in part to its taxation of broad categories of services. While no causal conclusion should be drawn from this observation, it is interesting to note that South Dakota relies on the 1987 Standard Industry Code (SIC) to define which services are taxable, while West Virginia uses neither the SIC Code nor the SIC Code's successor, the North American Industry Classification System (NAICS).

A common complaint heard by these states is that taxation of services puts businesses in these states at a competitive disadvantage with businesses in other states where the particular service in question is not taxed. This complaint appears to have been one of the primary reasons that the taxation of services in Massachusetts failed. In 1990, Massachusetts enacted a broad sales tax on services. However, the effective date was not until March 6, 1991, and the law was repealed on March 8, 1991, retroactive to the March 6 effective date. While the tax never materialized, significant time and effort was spent by Massachusetts in preparation of the need to administer the tax. Some expected administrative issues included:

- Problems with definitions- for example, what are "legal services" or "engineering services"
- The Massachusetts tax was only on services provided to businesses, so determining what is a "business" was expected to be difficult
- Timing Issues- when does the sale occur? This issue was also cited in our discussion with the other states

- Siting/Sourcing Issues- Again as described above, this is problematic with some services
- Problems with sales for resale/pyramiding- As described in our presentation to the Committee, this was also an issue that Florida experienced with its restrictive definition of what constituted a sale for resale

It is worth noting that New Mexico's taxation of services differs from the other states contacted in that it has a gross receipts tax. While New Mexico's gross receipts tax is similar to traditional sales taxes such as those imposed in Florida, a gross receipts tax is imposed on the total amount of gross receipts that a business receives for its transactions. Gross receipts taxes are sometimes criticized for causing "tax pyramiding" which can occur when one business purchases an already-taxed good or service from another business, causing taxes to build upon one another. In New Mexico, the gross receipts tax includes taxes on all receipts derived from performing services in New Mexico unless the services are specifically exempt or deductible. As a result, New Mexico's issues with the taxation of services differ in some respects from the other states contacted. An example cited was litigation involving payroll service companies and/or temporary employment agencies. The issue is trying to determine whether such companies or agencies were selling a management type service or if the service performed by its "employees" rendered all of the companies gross receipts taxable.

Other interesting comments received:

- Up to 50% of the West Virginia Department of Revenue's litigation involves issues regarding the taxation of services, which represents approximately 15-20% of their sales tax revenue
- Texas stated that the taxation of data processing services was particularly vexing- both for defining what is a data processing services and for sourcing that service. It was identified as their "number one problem"
- West Virginia noted that it believed that business-to-consumer taxation of services would be easier to administer than business-to-business taxation of services

We hope that this information is helpful for the Committee. Please let us know if additional information or more in depth research is needed, or if the Department can be of any further assistance.

Sincerely,



Vincent Aldridge
Deputy Director
Technical Assistance and Dispute Resolution