

# Sales Tax Challenges with Services



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On-Demand Webinar



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# Taxation of Services

- Sales tax is generally imposed on sales of tangible personal property
- Many states also impose sales tax on specified services as defined in their statute as a way to expand their sales tax base
- However, some states take a gross receipts approach where services are taxable unless specifically exempted.
  - Hawaii, New Mexico, South Dakota and West Virginia

# Taxation of Services (cont.)

- Categories that most services fall into and the order they are most likely taxed:
  - Repair and maintenance of tangible personal property
  - Repair and maintenance of real property
  - Business Services
  - Personal Services
  - Professional Services

# Taxation of Services (cont.)

- Common services that states include as specified services:
  - amusements,
  - cable television,
  - telecommunications,
  - parking fees,
  - information services,
  - data processing.
  - repair and maintenance of tangible personal property,
  - remodeling of real property

# Tangible Property Services

- A number of states tax services that are applied to tangible property.
- These services could include installation, repair, inspection, or maintenance.
- If there is an exemption for the service, it must be separately stated on the invoice to the customer. Absent the separate statement, the service is considered part of the sale of the property and will follow the taxability of the property.

# Tangible Personal Property Services

- If tangible personal property is conveyed with services, some states may construe the transaction as a sale of property thereby transforming a nontaxable service into a taxable tangible personal property. For example, the use of a disk as a medium for delivery of software may make the transaction taxable.
- In many states that tax services to tangible personal property, if the services are performed on exempt equipment, the otherwise taxable services are exempt. However, this is not always the case.
  - Connecticut taxes repair services on exempt machinery. (CT Reg. Sec. 12-407(2)(i)(DD)-1)

# Real Property Services

- Sales of real property are generally exempt
  - Construction contractors are generally considered the taxable consumer on the purchases incorporated into real property
- Nature of the contract (lump sum or time & material) could change the taxability (IN)
- Nature of the property (residential vs. commercial) could change the taxability (TX)
- Nature of the service (repair vs maintenance) could change the taxability (TX)



# Real Property Services (cont.)

- Many states distinguish between new construction and remodeling services. New construction is usually not taxable with the tax incidence on the contractor on the cost of materials. However, there are states that consider remodeling to be a taxable service.
  - For example, in Texas, new construction of all real property is exempt, but remodeling of nonresidential or commercial real property is a taxable service.

# Business Services

- Business services cover a range of areas including:
  - Computer services such as data processing, information services, SaaS and related service
  - Human Resource services such as temporary help, recruiting, background checks
  - Security Services
  - Advertising/Marketing Services

# Business Services (cont.)

- States that currently tax many business services include:
  - Connecticut
  - District of Columbia
  - Hawaii
  - Iowa
  - New Mexico
  - New York
  - Ohio
  - South Dakota
  - Texas
  - West Virginia

# Personal Services

- Personal services are primarily services to individuals, such as laundries and dry-cleaning, portrait photographic studios, beauty and barbershops, tanning, and body piercing & art.
- South Dakota, New Mexico, Connecticut, and Hawaii tax most professional and personal services. Texas taxes personal services.

# Professional Services

- Generally states exempt sales of professional services.
- Professional services including accounting, legal, medical, engineering, architecture, advertising and other services where the charge by the provider is for their expertise and there is really no tangible personal property involved in the rendering of the service.
- Materials used by the professional service provider are subject to tax when purchased. This generally includes materials that may be transferred to the service customer as an incidental part of the service.
- Most service providers should be registered for use tax in the states where they maintain offices.

# Professional Services (cont.)

- Some states do tax various professional services. The types of services taxed generally include professions where the service results in a tangible delivery like architectural services and engineering services.
- Other states tax business services such as human resources services and data processing services.
- Although most states do not tax professional services, this is an area that many states are considering taxing. In some cases it is part of a broader tax policy change.

# Health Care Services

- More recent trends have states taxing medical services in order to fund state Medicare
- In MN services provided by health care professionals are exempt from sales tax. However, they are subject to the MinnesotaCare tax which was imposed in 1997.
- This 2% tax is imposed on gross receipts received for patient services furnished by a health care provider or by an employer of health care providers.
  - A health care provider is a person whose health care occupation is regulated or required to be regulated through licensing, registration, or certification by the Minnesota Department of Health, and who furnishes health care goods or patient services directly to a patient or consumer.
  - Medicare payments are excluded



# Health Care Services (cont.)

- Michigan had taxed medical services provided by Medicaid managed care organizations under its use tax. Per the legislation, “medical services” means medical services provided only to Medicaid beneficiaries enrolled under Title XIX of the Social Security Act. (effective June 11, 2014, and retroactive April 1, 2014)
- These services are no longer subject to use tax after December 31, 2016. From April 1, 2014 through December 31, 2016, these medical services were taxed in the same manner as sales of tangible personal property.
  - Beginning on July 1, 2020 or on the effective date of the repeal of section 3 of the health insurance claims assessment act, or the effective date of the amendatory act that amended section 3 of the health insurance claims assessment act and reduced the assessment to 0.0%, whichever is sooner, use tax will be reinstated on these services notwithstanding any other provision or exemption under this act.(Act 390 (S.B. 1172), Laws 2016, effective December 28, 2016, applicable January 1, 2017)



# True Object Test

- When services are commingled with tangible personal property, the true object test is often used.
- The true object test looks at the intent of the transaction. Was the intent to receive tangible personal property or was the intent to receive a service and the transfer of tangible personal property was incidental to the delivery of the service?
- Examples: Photographer, Architect

# True Object Test (cont.)

- Other states may refer to the true object test as:
  - Essence of Transaction Test
    - Missouri (original or duplicates of video tapes)
    - Texas (copies of blue prints)
  - Incidental to Service Test
    - Michigan as defined in the Catalina Marketing Case
  - Real Object Test
    - Rhode Island (photographer fees part of photographs)

# Invoice Presentation and Contract Language

- If an item being sold has both a taxable and non-taxable component, generally the non-taxable component must be separately stated or the entire receipt becomes subject to tax.
- In some states, if the predominant cost of the items lumped into one amount are taxable, the entire amount is subject to tax.
- Some states allow the percentage of taxable items in the lumped amount be only subject to tax.
- The burden of proof of distinguishing taxable versus nontaxable items is normally on the taxpayer.

# Invoice Presentation and Contract Language (cont.)

- A service invoice which includes separately stated materials with a line item price could make the materials taxable. This also can occur with reimbursed travel expenses.
- For the travel expenses, the traveler must still pay all applicable taxes when the travel costs are incurred. States that tax these items consider the travel costs to be part of the cost of the taxable service and include these in the tax base.
- SST states are trending to include services that are required as part of the sale to be included in the tax base.

# Invoice Presentation and Contract Language (cont.)

- The language on a contract or invoice can have an impact on the service's taxability.
- Some states distinguish between repair and maintenance services and the taxability of these services.
  - In Texas, real property maintenance is exempt but real property repairs are taxable. (Texas Reg. 34 TAC Sec. 3.357)
- Installation and fabrication are often mis-represented and result in challenges for taxability.

# Design Services Classified as Taxable Retail Service in Washington

- A company providing architectural design and construction services was denied a refund of Washington sales tax on the design services because they were provided in respect to construction services also performed by the company.
- Taxpayers providing design services are usually not required to collect WA retail sales tax but must pay service and other activities B&O tax.
- When design services are rendered “in respect to” construction, the design service is considered a retail service and the service provider is required to collect WA retail sales tax and pay retailing B&O tax on those services.

# Design Services Classified as Taxable Retail Service in Washington (cont.)

- In this case, the contract language indicated that the parties contemplated that the service provider would handle both the construction and design services.
- Additionally, the manner in which the company marketed its ability to render both design services and construction services indicated that the parties contemplated that the company would perform both components of the work. (*Determination No. 15-0135*, Washington Department of Revenue, March 31, 2016)



# Resale of Services and Related Materials

- Generally, if the service is taxable, services and tangible personal property used to provide the service may be purchased tax free with a resale certificate if the item is passed on to the customer.
- Purchases from subcontractors that are a part of a taxable service may qualify for the resale exemption.



# Sourcing of Services

- States use two general rules when determining the situs (sourcing) for taxability of services.
- “Benefit Received” Rule
  - The state taxes the service if the benefit of the service is received within the state of the customer rather than where the service was performed.
  - States that use this rule impose use tax on the customer if the service provider is not registered to collect tax.
  - Almost every state that taxes services follows this rule.

# Sourcing of Services (cont.)

- “Services Performed” Rule
  - The state taxes a service if it is performed in their jurisdiction, even if the benefit of the service is enjoyed outside their jurisdiction
  - States that follow this rule take the position that the service is conducted in their state and the first use of any property used in providing the service occurred in their state and therefore it should be taxed.
  - This is usually the rule for real property services and personal services
  - Louisiana is a services-performed state.
  - Personal services are generally sourced using the service performed rule.

# Sourcing of Services (cont.)

- Issues arise when an interstate transaction is performed in a services performed state for a customer located in a benefit received state.
- Different types of services may be sourced using different rules.

# New York Issues Guidance on Method to Determine Delivery Location for Credit Rating Services

- New York has issued guidance outlining the method to use when determining the delivery location of credit rating services for purposes of New York City's local sales tax.
- The best method to determine the delivery location is to use the address to which the invoice for the service is sent.
- A credit rating service that is invoiced to an address within New York City is subject to the City's 4.5% local sales tax. No sales tax is due to either the State or New York City if the credit rating service is invoiced to an address outside of New York City.
- The rule outlined in the memorandum applies to all taxable sales of credit rating services originally invoiced to an address within New York City on or after September 1, 2015.

# New York Issues Guidance on Method to Determine Delivery Location for Credit Rating Services (cont.)

- The rule supersedes the conclusion in TSB-A-13(27)S that delivery of a credit rating service occurs at the location of the representative of a client who signs an engagement letter, but that advisory opinion remains valid in all other respects.
- Credit rating agencies that have not previously been put on notice by the New York Department of Taxation and Finance to begin collecting tax on these services will not be penalized for under collecting tax or using a different method of sourcing prior to September 1, 2015. However, any sales tax that has been collected must be remitted to the department. (TSB-M-15(4)S, New York Department of Taxation and Finance, July 24, 2015, effective September 1, 2015)

# New York Issues Guidance on Sourcing of Online Services

- New York has issued guidance on whether online services constitute “service” receipts and how they should be sourced for corporate franchise tax purposes.
- On January 5, 2017, a New York State Division of Tax Appeals administrative law judge determined that a taxpayer’s electronic bill payment and presentation receipts constitute “service” receipts and not “other business receipts,” and should be sourced where the service is performed, which is the taxpayer’s location, not the customer’s location. (*In the Matter of the Petitions of Checkfree Services Corp.*)



# State Updates



# Digital Advertising Services Exempt in Ohio

- Ohio enacted legislation that specifically exempts digital advertising services from Ohio sales and use tax. For purposes of the exemption, “digital advertising services” means providing access, via telecommunications equipment, to computer equipment that is used to enter, upload, download, review, manipulate, store, add, or delete data for the purpose of electronically displaying promotional advertisements to potential customers.
- The legislation also exempts certain business-related automatic data processing, computer services, and electronic information services if they are provided in conjunction with digital advertising services but are merely incidental or supplemental to the advertising service. (H.B. 466, Laws 2016, effective October 12, 2016)



# Debris Removal Services Taxable as Cleaning or Washing in Utah

- Utah upheld an auditor's determination that a crude oil refiner was liable for sales and use tax on purchases of services performed on outdoor equipment and areas and storage tanks.
- The services included removal of items such as debris and hard water, bird dung, and solids from gasoline, arsenic, or hydrogen fluoride.
- The services were taxable as assisted cleaning and washing of tangible personal property. The refiner unsuccessfully argued that the services were not cleaning services, but rather restoration services that protected equipment from corrosion and removed solids and hazardous materials. (*Commission Decision, Appeal No. 14-1518*, Utah State Tax Commission, July 20, 2016)

# Bill Pay Services Provided to Banks Exempt in Texas

- Electronic bill pay services provided by a taxpayer to banks for use by the bank's customers were determined to be nontaxable professional services rather than taxable data processing services for purposes of Texas sales tax.
- Through use of the taxpayer's portal, bank customers could make payments, view pending payments, add payment recipients and perform other tasks related to bill payment.
- The taxpayer's services to banks included conducting a credit check on users, executing payments as instructed by users, determining the method of payment, using ACH processing to execute the payment debits and credits, and providing paper checks to payees.

# Bill Pay Services Provided to Banks Exempt in Texas (cont.)

- The taxpayer provided banks with a dedicated connection, monitored and supported network hardware, software, and mainframe operations, employed professionals to monitor transactions to prevent fraud and ensure compliance with banking regulations, provided professional support directly to users in cases where payments were not made as instructed, and prepared reports for the banks regarding users and payments.
- None of the taxpayer's services to banks fall within the activities listed in the state's definition of taxable data processing services. The taxpayer came under a specific exclusion in the definition for providers of professional services who use a computer to facilitate the performance of their service. (*Hegar v. CheckFree Services Corporation*, Court of Appeals of Texas, Fourteenth District, Houston, No. 14-15-00027-CV, April 19, 2016)

# Unitary Transaction on Advertising in Indiana

- An advertising company's sale of advertising materials to customers was subject to sales tax in Indiana since the sale constituted a "unitary transaction."
- The company prepared and distributed direct mailers to recipients on behalf of its customers and billed one amount for the combined cost of the materials and any services performed in preparing the materials.
- The company argued that it did not owe sales tax on the sales since the "true object" of the transaction is the provision of exempt advertising services.
- It was determined that the sale constituted a "unitary transaction." which is one in which one price is charged for the sale of property and services together and is taxable. As a result, the company was liable for Indiana sales tax on the sales. (Letter of Findings No. 04-20150410, Indiana Department of Revenue, May 25, 2016)

# Reception Services not Security Services in New York

- The company was primarily involved in providing security services to clients, including security guards, but also provided reception services, such as greeting, screening, and processing people requesting access to a site, checking identification, preparing and issuing visitor passes, and refusing entry as needed.
- The security guard services were clearly subject to tax, but the issue was whether the reception services constituted protective or detective services under the applicable statute.
- The tax law doesn't provide a definition of protective or detective services. The Tax Appeals Tribunal held that the language of the applicable tax law was not intended to reach the type of hybrid reception services at issue.
- The Tax Appeals Tribunal held that the reception services are exempt. (*Alliedbarton Security Services LLC*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA Nos. 825169, 825690, 825691, 825692, and 825693, February 16, 2016)



# Education Services in Wisconsin

- Charges for live in-person educational services and live digital online educational services, including charges for mandatory educational materials, are exempt from sales and use tax. Educational service providers must pay tax on purchases of mandatory educational materials provided incidentally with nontaxable educational services.
- Tangible books and videos are taxable unless a specific exemption applies, and there is no exemption for sales of educational products.
- Certain digital goods - including digital audio works, digital audiovisual works, and digital books - are taxable unless a specific exemption applies. Prerecorded webinars are generally taxable as digital goods, regardless of whether the webinar is downloaded or viewable streaming online.
- Digital goods are exempt if they would be exempt when sold in tangible form. Since sales of tangible videos are taxable, the sale of a prerecorded webinar is also taxable.
- Sales of a digital good such as a prerecorded webinar may be exempt if the purchaser is receiving an educational service, and the digital good is transferred incidentally to the service. There are specific requirements that must be met for this to qualify including interactivity with the instructor.
- In a bundled transaction - when taxable and nontaxable products, goods or services are sold for one non-itemized price - and the value of the taxable products or services is 10% or more, the entire sales price is generally taxable in Wisconsin. However, sellers can report and remit tax on the taxable portion of the sales price if they can show in their books and records the portions of the sales price that are attributable to the taxable and nontaxable products or services. The bundled transaction rules do not apply when a product such as a digital good is transferred incidentally in connection with a service. (News for Tax Professionals—Sales Tax Treatment of Educational Products, Goods, and Services, Wisconsin Department of Revenue, April 7, 2016)



# State Attempts to Expand Tax Base

# Missouri Voters Pass Amendment to Prohibit Expanding Sales Tax on Services

- On November 8, 2016, Missouri voters passed Amendment 4, which amends the state's constitution to prohibit the state from expanding the sales tax base to services or transactions that were not subject to sales tax as of January 1, 2015.
- This will limit Missouri's ability to broaden its sales tax base significantly. (Article X, Section 26 Missouri Constitution).



# North Carolina Taxes Repair, Maintenance & Installation Services

- Effective March 1, 2016, North Carolina's general 4.75% sales and use tax rate applies to the sales price of or gross receipts from repair, maintenance, and installation services sold at retail and sourced to North Carolina. The applicable local and transit sales and use tax rates also apply.
- Also effective March 1, 2016, “retailer,” is amended and defined in part, as “[a] person engaged in business of delivering, erecting, installing, or applying tangible personal property for use in this State ... unless the person is one or more of the following:
  - A person that solely operates as a real property contractor, or
  - A person whose only business activity is providing repair, maintenance, and installation services where the person's activities do not otherwise meet the definition of a retail trade.”
- There are exemptions such as for repair, maintenance and installation services purchased for resale and for services provided on machinery and equipment which otherwise qualifies for exemptions. (Directive No. SD-16-2, North Carolina Department of Revenue, February 5, 2016; N.C. Gen. Stat. §105-164.3(35))

# North Carolina Proposed Bill in 2016 to Expand Tax Base to More Services

- On May 10, 2016, the North Carolina Senate filed Senate Bill 870
- The proposed bill would expand the tax base to include house cleaning and janitorial services, landscaping services, gutter cleaning, window washing, furnace cleaning, pest control, and floor and carpet cleaning services, among other services.
- The bill was referred to the Committee on Finance on May 11, 2016
- This did not pass

# Maine's Proposed 2018-2019 Budget Includes Expansion of Tax Base to Include More Services

- The proposed 2018-2019 Budget from Maine Gov. Paul LePage includes an expansion of the tax base to tax more services
- The categories of services that will fall under the proposed expansion include amusement and recreation services; household services; installation, repair and maintenance services; personal services; and personal property services.
- (State of Maine 2017 Supplemental & 2018-2019 Biennial Budget Briefing, January 6, 2017)

# Pennsylvania 2015-2016 Budget

- In 2015, Pennsylvania Gov. Tom Wolf proposed an expanded tax base for the 2015-2016 Budget. The proposal would have expanded the tax base to include dozens of items and services
- The enacted budget did not expand the tax base to include additional services.

# Illinois 2017 Proposed Revenue Bill

- A proposed Senate bill released January 24, 2017 in an attempt to resolve the budget crisis includes new separate excise taxes on select types of services including:
  - Storage Services
  - Amusement Services
  - Landscaping Services
  - Laundry/Dry Cleaning Services
  - Repair/Maintenance Services

# Questions / Comments

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