

General Concerns with a Tax on Professional Services

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Overview

The concept of taxing services is not new, but has gained favor in state legislatures over the years because of states' eroding tax bases and increased demand for spending. Some policy development groups and state lawmakers have begun to consider expanding the state's tax base to include a tax on professional services due to the downward shift in Utah's economy and the belief that Utah's tax structure is still based on archaic sales tax policies and the current economy has transitioned into one more service-based. As explained in the following talking points, taxing professional services, including legal services, may not be a wise alternative for raising state revenues.

Lawyers, in particular, perform necessary functions in the transaction of Utah's family, business and financial matters, as well as in the exercise and defense of their basic rights. Lawyers also provide expertise in specialty areas to Utah businesses to help them conduct and protect their business matters. A tax on the sale of legal services would impose a serious detrimental impact on the ability of Utah's people and businesses to retain help in carrying out these matters.

Keep in mind, the client would pay the tax, not the lawyer.

Utah's Citizens

- ✓ A sales tax on legal services would tax people at times of misery, misfortune and vulnerability. Clients dealing with criminal charges, personal injury, death, divorce, domestic abuse, housing, credit and bankruptcy seek legal services not from choice but from necessity. This "misery tax" would place yet another burden on those already suffering financial or personal crisis.
- ✓ A sales tax on legal services would tax people for taking responsible steps in managing their affairs. Examples include persons who wish to protect their families by drawing a will and appointing guardians; individuals buying and selling their homes or businesses; and those who are trying to incorporate a new business. Increasing the cost of legal services would deter individuals and small businesses from retaining lawyers at the outset, resulting in more costly legal problems and greater burdens on our state's judicial system down the road.
- ✓ Many transactions already taxed would be subject to additional taxes on legal fees. Examples include estate administration and real estate transfers.
- ✓ A sales tax is considered regressive - that is, the poor and middle class pay a larger percentage of their income in total sales taxes than the wealthy. Again, most legal services are purchased out of necessity, not choice.

- ✓ It would be impossible to distinguish taxes on other professional services, including medical, accounting, engineering, architects, real estate agents and many others. A sad consequence of this tax would then be that consumers will forgo needed services like preventative medical care because the prices will be higher.

Utah's Businesses

- ✓ Small businesses bear a disproportionately larger share of the expense of administration of tax collection. Small and emerging businesses may not have the resources to gear up to collect the sales tax to be remitted to the state. The administration of a tax on services typically requires software and consulting fees to implement it fully, which may be financially out of the reach of some businesses. Large corporations could avoid the tax by employing in-house lawyers whose salaries would not be subject to the tax. The majority of businesses in Utah are small businesses without in-house counsel.
- ✓ The small business entity that might be struggling to remain solvent will find its costs increased significantly when it must pay a sales tax on the professional services it receives. Small business contract for numerous services that they are unable to provide for themselves. These include not only legal and accounting services, but computer, custodial and security services. For most small businesses, a sales tax on professional (and related) services will tend to increase significantly the cost of doing business without corresponding offsetting benefits.
- ✓ Further, the large businesses that do employ in-house counsel frequently retain outside counsel for technical expertise in various specialty areas. The tax would discourage these businesses from hiring outside counsel, eliminating a source of business for the smaller specialty firms and decreasing the flow of dollars into Utah's economy. Service business will be forced to remit the taxes billed but not collected unlike point of sales transactions.

Economic Development/Competitiveness

- ✓ Sales taxes are designed to be based upon final retail sales or consumption. Taxing legal and other professional services provided to businesses requires businesses to build the tax into the price of the goods or services sold, which will *again* be taxed upon final sale. Imposing a sales tax on the services used in the distribution chain results in **pyramiding** and in a substantially increased sales tax burden. This would place Utah's businesses at a competitive disadvantage to states that do not tax professional services.
- ✓ This tax would discourage businesses and professionals from locating in Utah, resulting in lost job, wage and tax opportunities.
- ✓ The tax would encourage Utah citizens to seek professional services from out-of-state providers. This is especially true of border communities and sophisticated clients, or clients of law firms that have out of state affiliates.

- ✓ Only three states - South Dakota, New Mexico and Hawaii - currently tax legal services. Florida and Massachusetts enacted sales tax on services, but promptly repealed the measures when they proved to be unpopular and difficult to administer. National advertising agencies refused to advertise in Florida. Several other states, including Maine, Maryland, Ohio and Vermont, as well as the District of Columbia, rejected similar proposals. There is almost universal recognition that it is not sound public policy to impose this tax.
- ✓ Taxpayers will not easily determine what is subject to the tax and how the calculation is determined. States enacting such laws invariably exempt some services making implementation difficult. This tax on services creates a disincentive to expand the service sector of the state's economy; the very sector responsible for the majority of highly desirable jobs. With expansion uncertain, Utah's revenue projections will be impacted.

Administration and Compliance/Impact on State Budget

- ✓ This tax may raise insufficient revenue to resolve the state's serious fiscal problems.
- ✓ Collection and enforcement of the sales tax on professional services would result in the hiring of more state employees. There would be serious administrative problems and costs incurred to collect the tax.
- ✓ The tax could place further strain on judicial resources as more serious problems evolve from the lack of legal counsel in early stages of transactions, processes or difficulties.

Impact on Lawyers

- ✓ This tax would have the potential of creating a tremendous financial impact on practicing attorneys - especially if the tax is due when the client is billed, not when the bill is paid.
- ✓ This tax would require all lawyers to set up the administration of applying, accounting, collecting and paying the tax, increasing overhead, even while creating a disincentive to being retained.
- ✓ All communications between a client and his or her lawyer are confidential to protect the client. An audit on a lawyer's client fund account in administering the tax could violate the client's attorney / client privilege, and create a greater burden on lawyers to continue to protect those communications.

Constitutionality

- ✓ It may be unconstitutional to selectively include certain professional services while excluding others. This tax could be invalidated by the courts, requiring reimbursements.

✓ There may be constitutional problems in taxing a person's ability to defend himself in a criminal defense case or in taking money from a worker's compensation award. There are numerous unresolved questions as to the constitutionality of the proposed tax on legal services, which the State of Utah might well have to litigate over the next several years, including but not limited to the following:

- **Access to courts.** Would the proposed tax on legal services impermissibly burden access to and use of the state or federal courts in violation of the Utah Constitution, Article III of the U.S. Constitution and the 5th, 6th and 14th Amendments to the U.S. Constitution?
- **Equal protection and due process.** Would unequal treatment of individuals and corporations, whereby a tax would be imposed on an individual's party's access to the courts but no tax would be imposed upon a corporate party in the same litigation, be a violation of equal protection and due process under the Utah Constitution and under and the 14th Amendment to the U.S. Constitution?
- **Separation of powers.** Would the proposed tax on legal services constitute an unauthorized regulation of the practice of law by the Legislature in violation of the constitutional guarantee of separation of powers under the Utah Constitution?
- **Tax on litigation in federal courts may violate U.S. Constitution Supremacy Clause.** Would the proposed tax on legal services, in connection with litigation before the federal courts, violate the Supremacy Clause contained in Article VI of the U.S. Constitution?
- **Breach of confidentiality burdening right to counsel.** Would the proposed tax on legal services breach the attorney-client privilege and confidentiality, and thus impermissibly burden the right to counsel under both the Utah Constitution and the 6th and 14th Amendments of the U.S. Constitution?
- **Taxing some professions while exempting others may violate equal protection of law.** Would imposing a tax on services performed by the legal, accounting, architectural and other professions, while exempting services rendered by the medical profession, be a violation of equal protection rights under the Utah Constitution and the 14th Amendment to the U.S. Constitution?
- **Burden on rights guaranteed in U.S. Constitution.** Would the proposed tax on legal services impermissibly burden the exercise of rights secured by the 5th, 6th, and 8th Amendments to the U.S. Constitution?