

Beware New Taxes

Consumers and professionals alike should hold onto their pocketbooks, for more taxes are surely on the horizon. At federal, state and even local levels, taxes are big business. Faced with budget deficits and an eroding tax base everywhere, what's to be done? Sure, the government can just raise the percentage tax rates, but that has legal, practical and political implications - so what's the alternative?

The answer, it seems, is to find new and untapped things to tax. There's Botox, cappuccinos, music downloads, and more. Some taxes are collectively labeled "sin taxes," targeting what some view as socially irresponsible behavior. Sin taxes, the theory goes, can have the dual purpose of raising revenue and decreasing supposedly bad conduct.

Taxes on alcohol, cigarettes, soft drinks and candy are labeled "excise" taxes, which is basically indirect taxes imposed on producers or sellers. Excise taxes are usually passed on to buyers. They differ from sales taxes mostly by being more targeted.

Then there is sales tax, which already applies to most sales of tangible personal property. Use tax is the mirror image of sales tax, applying to tangible personal property purchased outside California but brought into the state and used here. Use tax is one of the most notoriously under-collected taxes, but California has taken steps to collect more of it, ask-

ing probing questions about out-of-state purchases.

There's even movement to enact an "Amazon" tax to nab out-of-state retailers who sell into California but have no physical presence here. Eventually, California will probably be successful in getting its share of all such sales.

There are already many, many lines drawn in sales and use tax administration, but the most fundamental line is between sale and service. Putting aside rifle shot amendments to tax one particular service or another, one of the perennially favorite proposals among revenue raisers is a broad tax on services. After all, with decreased property, income, sales and use tax revenues, what major section of the economy is left? The answer is services, *all* services.

Although services are currently excluded from sales tax, there's no end to line drawing. For example, suppose you pay someone

to do your payroll, producing checks, taking and remitting tax withholding, and producing a binder of all your payroll records. Is that a service or are you buying the binder and therefore subject to sales tax? That seems a silly example, for clearly the binder and forms are incidental to the service you are buying. But many situations are not so clear.

In determining whether a transaction involves a sale of tangible personal property (subject to sales tax) or the transfer of tangible personal property incidental to the performance of a service (no tax),

the basic distinction is the *true object* of the contract. Is the real object of the contract the service or the property produced by the service?

If the true object is the service, the transaction is not subject to tax even though some tangible personal property is transferred too.

Some services morph into property, but that doesn't

always make them taxable. For example, an author's transfer of his original manuscript to a publisher for publication is not subject to sales tax. However, sales tax clearly applies to sales of copies of the author's works. Ditto for manuscripts that are of particular value as items of tangible personal property, where the purchaser's primary interest is in the physical

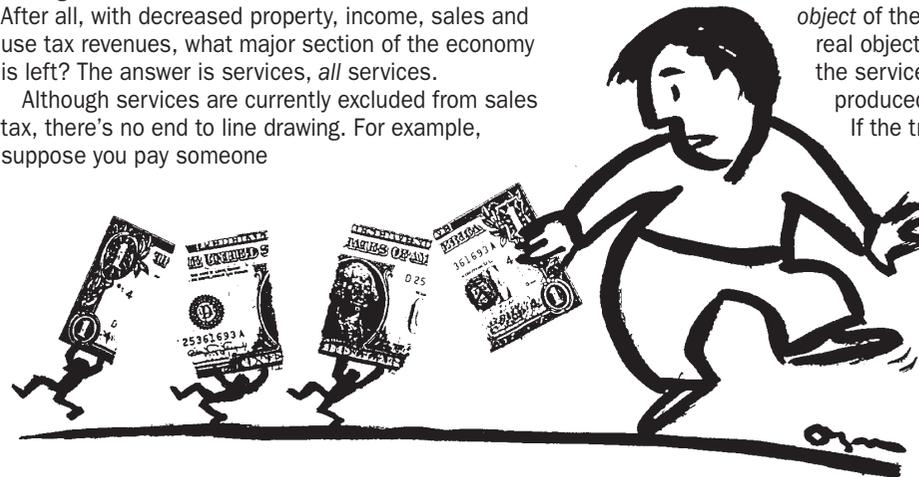
property.

Big dollars can turn on this wavy line. If a transaction is a sale of tangible personal property, sales tax applies. Plus, the tax is on all gross receipts, with no deduction for the work, labor, skill or other expense of producing the property.

Given the deeply ingrained symbiosis between sales and services, it should be no surprise that more than a few states have taken their gloves off to tax services outright. Florida was the first state to extend its sales and use tax to services. But there was a veritable beachfront revolt and the tax was repealed six months later. In Iowa, a sales tax on consulting services survived for only a month before being repealed.

But the tax has stuck elsewhere. There is a reasonably broad-based tax on services in Delaware, Hawaii, Nevada, New Mexico and South Dakota. It is inevitable that others will follow suit, either broadly or narrowly taxing services. For lawyers and other professionals, a new tax on services would add new strains, and add increased costs to clients. Get ready.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.



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