Forbes

Robert W. Wood

THE TAX LAWYER

Sep. 16 2010 - 9:27 am

Taxing Gaga?

As consumers and taxpayers, we may well ask what taxes are next. And we're not the only ones worrying. At the federal, state and local level, taxes are big business. Faced with budget deficits, an eroding tax base, and the legal and political impediments to raising tax rates, what's to be done? Find new and untapped things to tax.

There's Botox, tanning, music downloads (many states now tax them), and more. Some taxes are labeled "sin taxes," targeting what some view as socially irresponsible behavior. They have the dual purpose of raising revenue and decreasing "bad" conduct. Usually they are excise taxes, such as on alcohol, cigarettes, soft drinks and candy. They are indirect and imposed on producers or sellers, but are usually passed on to buyers. They differ from sales taxes mostly by being more targeted.

Service With a Smile. Services may be targeted too. A 10% tanning tax went into effect in July 2010, and could raise $2.7 billion over 10 years from the nation's 20,000 indoor tanning salons. See Tan Tax Causes Confusion. The tanning tax has already produced more government regulations and line drawing how fees should be divvied up between tanning and other services. There's even talk of a challenge—some say it's discriminatory to tax tanning while leaving just about everything (and every body) unscorched.

Remember the proposed 5% federal excise tax on cosmetic surgery? Talk about Nip/Tuck! Also dubbed the Botox tax, this proposed excise tax was buried in the massive health care bill but became controversial and was not included in the law (tanning was taxed instead). Still, some say the Botox tax is not yet dead.

Putting aside efforts to tax one service or another, talk of taxing services—all services—is a perennial favorite among revenue raisers. After all, with decreased property tax, income tax, sales and use tax, what other major section of the economy is left? Services.

Sales tax applies to most sales of tangible personal property. Use tax is the mirror image, applying to tangible personal property purchased outside the taxing state, but brought into the state and used there. Use tax is notoriously under-collected.

Remember Tyco's Dennis Kozlowski and his art purchases shipped into New York? "Only little people pay taxes" mean queen Leona Helmsley had the same problem. A number of states (including California) are moving to collect more use tax, as by asking targeted questions about out-of-state purchases.

Sales taxes focus on sales of tangible personal property, but property is often produced when you hire someone to perform a service. How do you know if a transaction involves a sale of tangible personal property (sales tax applies) or the performance of services with a property transfer merely being incidental (no sales tax)? Huge dollars can turn on that distinction, and it's a notoriously litigious line in sales tax administration.

A key inquiry is the true object of the contract: was the real object the *service* or the *property produced* by the service? If the true object is the service, the transaction is not subject to sales tax. If sales tax applies, it can hit all gross receipts. Confused? A service tax can make that distinction a lot less important (good), but can also hurt your wallet (bad).

More than a few states are tempted to take the gloves off and tax services outright. Florida was the first state in decades to extend its sales and use taxes to services. But there was a veritable beachfront revolt, and the tax was repealed. In Iowa, a sales tax on consulting services lasted only a month.

But taxes on services have stuck elsewhere, including in Delaware, Hawaii, Nevada, New Mexico and South Dakota. Other states may try to tax services, either broadly or narrowly. So be on the lookout for new taxes.

Robert W. Wood practices law with Wood & Porter, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009, Tax Institute), he can be reached at wood@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.