

Department of Legislative Services
 Maryland General Assembly
 2008 Session

FISCAL AND POLICY NOTE

Senate Bill 567 (Senator Garagiola, *et al.*)
 Budget and Taxation

Computer Services Tax Repeal and Transportation Funding Act

This bill repeals the sales and use tax on computer services imposed by Chapter 3 of the 2007 special session and provides for sales and use tax exemptions for computer services and software maintenance contracts that were in effect prior to the enactment of Chapter 3. The bill increases motor fuel tax rates and redistributes sales and use tax revenues from the Transportation Trust Fund to the general fund. The bill also establishes a Sales and Use Tax Study Task Force, staffed by the Department of Legislative Services, to study the feasibility and ramifications of applying the sales and use tax to services not currently taxed. The task force must report its findings and recommendations to the Governor and the General Assembly by December 1, 2008.

The bill takes effect July 1, 2008; except for Section 2, which takes effect July 1, 2009.

Fiscal Summary

State Effect: General fund revenues could decrease by \$342,300 in FY 2009 and Transportation Trust Fund revenues could decrease by \$81.1 million. The estimate assumes the current forecasts for sales and use tax revenues and motor fuel consumption.

(\$ in millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
GF Revenue	(\$.3)	\$45.2	\$50.6	\$55.8	\$61.5
SF Revenue	(81.1)	4.1	(3.2)	(10.4)	(18.3)
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	(\$81.5)	\$49.2	\$47.3	\$45.3	\$43.2

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: None.

Small Business Effect: Potential meaningful.

Analysis

Bill Summary: In addition to repealing the sales and use tax on computer services, the bill:

- increases the motor fuel tax on gasoline and special fuel as follows:

<u>Type of Fuel</u>	<u>Current Law</u>	<u>FY 2009</u>	<u>FY 2010 and later</u>
Gasoline	23.5 cents	27.5 cents	31.5 cents
Special Fuel	24.25 cents	28.25 cents	32.25 cents

- redistributes sales and use tax revenue as follows:

<u>Fund</u>	<u>Current Law</u>	<u>FY 2009</u>	<u>FY 2010 and later</u>
GF	93.5%	98.1%	99%
TTF	6.5%	1.9%	1%

Current Law: Chapter 3 of the 2007 special session expanded the definition of taxable service so that, beginning July 1, 2008, the State sales and use tax is imposed on specified computer services. This provision terminates on June 20, 2013. Computer services are defined as computer facilities management and operation; custom computer programming; computer system planning and design that integrate computer hardware, software, and communication; technologies; computer disaster recovery; data processing, storage, and recovery; and hardware or software installation, maintenance, and repair.

The definition of computer services excludes certain types of services that otherwise could be included in the definition, such as Internet access, typing or data entry, and computer training. The installation, maintenance, or repair of tangible personal property that includes computer hardware or software as a component part is also excluded. Also excluded are computer services provided in connection with other specified types of services, typically banking and financial related services, business management or other administrative services, various professional services, and telecommunications services.

Chapter 3 repealed the sales and use tax exemption for sales of custom computer software services and optional computer software maintenance contracts, but exempted computer services that are to be used by an individual in a home school program. In addition, Chapter 3 did not alter the sales and use tax exemption for the sale of a computer program that is intended to be reproduced for resale or incorporated into another computer program for sale.

Exhibit 1 lists the types of computer services that would be taxable under Chapter 3.

Chapter 6 of the 2007 special session increased the State sales and use tax rate from 5% to 6% beginning January 3, 2008 and redistributes 6.5% of total sales tax revenues (equating to approximately 40% of the increased revenues from the higher sales tax rate) to TTF beginning in fiscal 2009.

Background: The following services are subject to the State sales and use tax:

- fabrication, printing, or production of tangible personal property by special order;
- commercial cleaning or laundering of textiles for a buyer who is engaged in a business that requires the recurring service of commercial cleaning or laundering of the textiles;
- cleaning of a commercial or industrial building;
- cellular telephone or other mobile telecommunications services;
- “900,” “976,” “915,” and other “900”-type telecommunications services;
- custom calling services provided in connection with basic telephone service;
- telephone answering services;
- pay-per-view television services;
- credit reporting;
- security services, including detective, guard, or armored car services;
- security systems services;
- transportation services for transmission, distribution, or delivery of electricity or natural gas, if the sale or use of the electricity or natural gas is subject to the sales and use tax; and
- prepaid telephone calling arrangements.

Although they are not considered services under the State sales and use tax, the tax also applies generally to such items as rentals of tangible personal property, restaurant meals, hotel rooms, and utilities (although specific exemptions are allowed for residential purchases of electricity and gas).

Historically, the State sales and use tax has been imposed broadly on the sale or use of tangible personal property, but only narrowly on a few specifically enumerated taxable services. Over the past few decades, the growth in sales and use tax revenues has not kept pace with the growth in personal income, as the tax base has eroded due to several factors. One major contributing factor cited for the erosion of the sales tax base is a major shift that has occurred in the national economy from the consumption of goods, the traditional base of the tax, to the consumption of services.

Exhibit 1
Examples of Taxation of Computer Services

Taxable

- **Computer Facilities Management and Operation:**

Management and control of a purchaser's computer facility by a management company when the computers and peripheral equipment are not owned by the management company (if owned by the management company, would presumably be rental of tangible personal property)

Support services for computer systems or data processing facilities

- **Custom Computer Programming:**

Computer systems design and system analysis services

Writing, modifying, testing, and supporting software to meet the needs of a particular customer

- **Computer Systems Integrators:**

Designing computerized integrated systems for a specific application, including computer network systems; local area network (LAN) systems; office automation systems; computer-aided design, engineering; or manufacturing systems services

- **Computer Systems Consultants:**

Consulting services regarding computer systems design, systems analysis, program testing, debugging, or computer project advice

- **Other Computer Related Services:**

Computer disaster recovery services

Hardware or software installation, maintenance, and repair

Not Taxable

- Internet access service
 - Computer training
 - Repair of property that includes a computer as a component part
 - Any of the following that include a computer service provided as part of the service:
 - Banking or trust services, including electronic fund transfers, financial transactions, automated teller machine transactions
 - Business management, personnel, payroll, employee benefit, and other administrative services
 - Educational, legal, accounting, architectural, actuarial, medical, medical diagnostic, or other professional services
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About half the states that impose sales taxes limit taxation of services to utilities, rentals of property, restaurant meals, hotel rooms, and admissions and amusements. Only six states have taxes that generally apply to all services (including two that impose gross receipts taxes on businesses that are not technically sales taxes). About 10 states impose the sales tax broadly on services related to tangible personal property, such as fabrication, installation, and repair services. Several states also tax at least a few other personal services, and a few states also tax some business services.

Among surrounding jurisdictions, New Jersey, Pennsylvania, West Virginia, and the District of Columbia tax a broad range of repair services, including automotive repairs. Pennsylvania and West Virginia tax some business services, and West Virginia also taxes some personal services. Delaware, which does not have a retail sales tax, is considered to have a broad taxation of services under its gross receipts tax, which applies to most businesses.

Other States and Computer Services

Many states currently tax some form of computer services, as shown in **Exhibit 2**. This includes eight states – Connecticut, Delaware, Hawaii, New Mexico, Ohio, South
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Dakota, Texas, and Washington – and the District of Columbia that tax a majority of possible computer services. Pennsylvania previously taxed all computer services.

Exhibit 2
Taxation of Various Computer Services – Other States

<u>Service</u>	<u>States Taxing Service</u>	<u>Number of States</u>
Software – package or canned program	AL, AR, AZ, CA, CO, CT, DE, DC, FL, GA, HI, IA, ID, IL, IN, KS, KY, LA, ME, MA, MI, MN, MS, MO, NE, NV, NJ, NM, NY, NC, ND, OH, OK, PA, RI, SC, SD, TN, TX, UT, VT, VA, WA, WV, WI, WY	46
Software – modifications to canned program	AL, AZ, CA, CO, CT, DE, DC, GA, HI, IL, IN, KS, LA, MN, MS, MO, NE, NM, OK, RI, SC, SD, TN, TX, VT, WA, WV, WI, WY	29
Software – custom programs – material	AL, AR, CA, CT, DE, DC, GA, HI, IN, LA, MI, MN, MS, NE, NM, OK, RI, SC, SD, TN, TX, VT, WA, WV, WY	25
Software – custom programs – professional services	CT, DE, DC, HI, LA, MS, NE, NM, SC, SD, TN, TX, WA, WV	14
Internet Service Providers – Dial up	DC, HI, KY, NH, NM, ND, OH, SD, TX, WA, WI	11
Internet Service Providers – DSL/Broadband	AL, DC, HI, IA, KY, MO, NH, NM, ND, OH, SD, TX, WA, WI, WY	15
Information Services	CT, DE, DC, HI, NM, NY, OH, SC, SD, TX, WA, WV	12
Data Processing Services	CT, DE, DC, HI, NM, OH, SD, TX, WA	9
Mainframe Computer Access and Processing Services	CT, DE, DC, HI, NM, OH, PA, RI, SD, TX, WA	11

Source: Federation of Tax Administrators

Connecticut and Pennsylvania each imposed similar taxes on computer services. Both states did so as part of a larger effort to broaden the sales and use tax base to include various services. The issue of whether the service being provided is a computer service or another type of consulting service has arisen in both states. Connecticut imposes a sales and use tax on certain business related services at varying rates. The issues that often arise relate to the appropriate tax rate to be imposed or whether an exemption may be applicable. In Pennsylvania, the tax on computer services was repealed in 1997. An issue that arose there was the proper tax treatment of professional services that also met the definition of a computer service. Prior to repealing the tax, regulations were issued

that attempted to clarify how the tax applied when the computer service being provided was incidental to the otherwise nontaxable service. Maryland has addressed this issue by excluding various professional services from the definition of computer services.

The proper tax treatment of computer software is an issue that numerous states are currently considering. Many states, including Maryland, treat computer software as taxable personal property when the software is sold in a tangible medium form. However, states vary on the treatment of software when the software is transferred in electronic form. Businesses have begun to require more specialized software; this often involves using custom computer programming services to create either specialized software packages or to manipulate prepackaged canned software. An issue may arise regarding taxability when a sale is classified as a sale of software in electronic form and not as providing custom computer programming services.

State Fiscal Effect: State revenues are affected by • repealing the sales tax on computer services; • altering the distribution of sales tax revenues by requiring a higher percentage be distributed to the general fund; and • increasing the motor fuel tax. Total State revenues would decrease by \$81.5 million in fiscal 2009, but increase by \$49.2 million beginning in fiscal 2010. **Exhibit 3** shows the overall effect of the bill on general fund and TTF revenues over a five-year period due to the tax changes and fund redistributions.

Exhibit 3
Overall Effect on State Revenues
(\$ in Millions)

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
GF Revenues	(\$0.3)	\$45.2	\$50.6	\$55.8	\$61.5
TTF Revenues	(\$81.1)	\$4.1	(\$3.2)	(\$10.4)	(\$18.3)
Total Revenues	(\$81.5)	\$49.2	\$47.3	\$45.3	\$43.2

Sales Tax on Computer Services

Repealing the sales tax on computer services could decrease total sales and use tax revenues by \$214.0 million in fiscal 2009, as estimated in the fiscal and policy note for Chapter 3 and the current revenue forecast. **Exhibit 4** shows the estimated revenue decrease over a five-year period. Of the total revenues attributable to the tax on computer services, 6.5% are to be distributed to TTF, per Chapter 6 of the 2007 special session. The revenue estimate is based on data from the two most recent (1997 and 2002)

Economic Census reports from the U.S. Census Bureau. The estimate reflects an estimated 6.0% decline in the taxable base resulting from the imposition of the sales tax on these services.

Exhibit 4
Repealing Sales Tax on Computer Services
(\$ in Millions)

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
GF Revenues	(\$200.1)	(\$206.1)	(\$212.3)	(\$218.6)	(\$225.2)
TTF Revenues	(13.9)	(14.3)	(14.8)	(15.2)	(15.7)
Total Revenues	(\$214.0)	(\$220.4)	(\$227.0)	(\$233.8)	(\$240.9)

Impact of Fund Redistributions

The bill also alters the distribution of sales tax revenues by requiring that 1.9% be distributed to TTF in fiscal 2009; and 1.0% be distributed to TTF beginning in fiscal 2010. Under current law, 6.5% of sales tax revenues are distributed to TTF. Due to this adjustment, the revenue loss from repealing the computer services tax will reduce funding for TTF, whereas the general fund will receive a net increase in funding as shown in **Exhibit 5**.

Exhibit 5
Effect of Repealing Sales Tax on Computer Services and Fund Redistribution
Fiscal 2009-2013
(\$ in Millions)

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
GF Revenues	(\$0.3)	\$45.2	\$50.6	\$55.8	\$61.5
TTF Revenues	(213.7)	(265.6)	(277.6)	(289.6)	(302.4)
Total Revenues	(\$214.0)	(\$220.4)	(\$227.0)	(\$233.8)	(\$240.9)

Motor Fuel Tax Increase

Increasing the motor fuel tax by \$0.04 in fiscal 2009 and by \$0.08 beginning in fiscal 2010 could increase TTF revenues by \$132.5 million in fiscal 2009 and by \$269.7 million in fiscal 2010. The estimate is based on the current motor fuel consumption forecast. **Exhibit 6** shows the estimated revenue increase over a five-year period.

Exhibit 6
Estimated Motor Fuel Tax Revenue Increase
Fiscal 2009-2013
(\$ in Millions)

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
Gallons of Fuel	3,312.9	3,370.8	3,429.5	3,489.9	3,550.9
Tax @ Current Rates	\$778.5	\$792.1	\$805.9	\$820.1	\$834.5
Rate Increase	0.04	0.08	0.08	0.08	0.08
Tax @ New Rates	911.0	1,061.8	1,080.3	1,099.3	1,118.5
TTF Revenues	\$132.5	\$269.7	\$274.4	\$279.2	\$284.1

Small Business Effect: To the extent that small businesses providing computer services would be adversely affected due to lost sales resulting from the tax imposed on these services, repealing the tax would mitigate any negative effects. As noted, the fiscal and policy note for Chapter 3 assumed a 6% reduction in sales due to the imposition of the tax. As a point of reference, this would result in approximately \$60,000 in recouped sales for a business with \$1.0 million in gross sales. However, the actual effect could vary from business to business, depending on sales and proximity to other jurisdictions.

Small businesses for which motor fuel constitutes a significant portion of their costs (transportation firms, delivery companies, taxicabs, etc.) could be meaningfully and negatively affected by an 8 cent per gallon increase. There are approximately 2,200 service stations in Maryland, most of which are small businesses.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office, Maryland Department of Transportation,
Department of Legislative Services

Fiscal Note History: First Reader - March 10, 2008
mll/hlb

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