
IX

The Florida Sales Tax on Services: What Really Went Wrong?

**By
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Taxation of service transactions by the states is widespread on a selective basis and inevitably will become more general.¹ As states and localities face mounting fiscal pressures, the inequity and economic distortion inherent in exempting the majority of service transactions while taxing most goods transactions will become increasingly unacceptable.²

Those interests that resist the taxation of service transactions have cited and likely will continue to cite Florida's experience in attempting to convince state legislatures to make minimal or naive approaches in expanding their sales tax bases. Only by mischaracterizing the events that shaped Florida's experience can such cases be made.

While reasonable people may differ as to the wisdom or efficacy of various technical provisions of Florida's legislation, the concept and execution of the tax were basically sound. Of the three key mistakes that led to the downfall of the tax, none had to do with the working of the tax itself. This chapter discusses the conceptual basis of the tax, refutes erroneous criticisms levied against it, and describes accurately the factors leading to its repeal.

Controversy #1: The Legislative Process

The initial enactment leading to the taxation of services was a prospective repeal of numerous sales tax exemptions, including the long-standing exemption for “professional, insurance, or personal service transactions.” Passed in 1986 to take effect in 1987, it was characterized as a sunset bill in the same fashion as a host of earlier bills providing for prospective deregulation of various professions.³ The legislation (Chapter 86-166, laws of Florida) admittedly was bare bones as it related to services. It lacked conforming amendments to existing sections of law, it provided no resale exemption (that is, no tax-free “wholesale” sales of services among businesses), and it contained no exceptions—all service transactions occurring in Florida would have become taxable July 1, 1987, absent further legislation.

This legislation encountered surprisingly little political resistance, considering its scope, primarily for three reasons. First, the notion of closing sales tax loopholes had been popularized by the senate leadership for the preceding two years.⁴ Second, evidence from a variety of sources indicated that the tremendous inflow of new residents was creating unprecedented levels of demand for governmental services and social infrastructure.⁵ Third, the sunset approach had the effect of disarming opponents of the legislation. No lobbyists’ client was affected, at least directly; prior sunset legislation rarely had resulted in consequential change;⁶ and all previously untaxed special interests were in the tank together. As a result, each legislator with a special interest constituency was able to resist its pressure for exclusion from the sunset bill. After all, how could he make their case for exclusion to his peers, when they too were accountable to certain groups whose exempt status was subject to sunset?

Although not generally recognized at the time, the sunset mechanism was a procedural coup. Not only did it facilitate initial passage in 1986, but it also prevented wholesale reduction of the forthcoming tax base in 1987. Once the sunset legislation was enacted, those interests seeking continued exemption needed the concurrence of the house, the senate, and the governor, since any one of the three could fail to pass or threaten to veto legislation reinstating their exemption. Normally, an exempt group maintains its status by stopping a tax bill with the concurrence of only one house or the governor.

Because interest groups long accustomed to success in Tallahassee found their political leverage suddenly reduced, charges of railroading and excessive haste were levied against the 1987 legislature. In fact, the final implementing legislation was preceded by more study and critical evaluation than any other tax bill in Florida’s history.⁷ Two independent examinations were commissioned by the legislature in 1986. The first was a study of the legal, administrative, and revenue implications of the tax, spearheaded by the Department of Revenue. This effort included the drafting of model legislation for which the department used the services of Professor Walter Hellerstein, a nationally recognized scholar in tax law.⁸ The second involved examination of the economic impact of service taxation by a special 21-personal study commission with membership from the public and private sectors.⁹ Of at least equal importance was the work of the House Finance and Taxation Committee chairman and his professional tax staff. Many hours were spent in meetings with the

revenue department and representatives of each affected service industry group in an attempt to tailor the implementing legislation to each of their special problems and situations.

Moreover, opponents of the legislation had a full year to make their views or suggestions known. The failure of some affected parties to actively consider the consequences or mechanics of the tax until the eleventh hour hardly can be considered a legislative failure.

A number of parties, including the Department of Revenue, suggested that the 1987 legislature push the effective date of the broadened tax back to allow for more education and response time for rank-and-file taxpayers not privy to the legislative process. For budgetary reasons, the legislature held to the July 1, 1987, start-up date adopted a year earlier. But in recognition of the need for early taxpayer notification, registration, and agency rule promulgation, the legislature passed its detailed implementing legislation (Chapter 87-6, Laws of FL0 on April 23, 1987, an unprecedented early date for major legislation in a session running from early April to early June.¹⁰ For the same reasons, the Department of Revenue began drafting its rules in December 1986.

Undoubtedly, more time between passage of the implementing bill and start up of the tax would have lessened apprehension among newly registered sales tax dealers, at least to a degree. As an element contributing to the demise of the tax, however, this shortcoming was only of marginal importance.

Controversy #2: Scope of the Tax

A second area of criticism related to the scope of the tax. By flatly closing a single exemption for services, the sunset bill could have reached some \$85 billion in previously untaxed transactions for a revenue yield of \$4.2 billion in fiscal year 1988-89.¹¹ Despite posturing threats to let the sunset bill take effect unaltered, the legislature displayed a strong and active interest in paring down the list of impacted services. The final legislation resulted in only 33.4 percent of previously exempt service transactions being taxed.¹² And even if one assumes that money lending, insurance underwriting, and licensing of patented materials or processes are not services, an arguable proposition at best, the legislature still taxed less than half of the potential new service tax base (45 percent).¹³ By comparison, taxed goods transactions represent 68.4 percent of the potential goods tax base, half again greater than the proportion of taxed services.

The real basis of complaint concerning the scope of the tax again rests on procedure. Antitax forces would have preferred an additive process requiring the legislature to vote to tax each activity on an individual basis. By casting a broad net and then discarding unwanted items, the legislature put itself in the advantageous role of primarily giving rather than taking away. As noted earlier, attaching each service industry separately via the build-up approach would have been far more difficult, particularly with respect to the professions.

Furthermore, broad imposition language followed by specific exemptions helps prevent unanticipated fiscal surprises from the judiciary, which, as a matter of interpretation, construes tax imposition narrowly. This approach also keeps the statute from becoming obsolete technologically or terminologically, as has been the case with many states' telecommunication taxes.

A necessary evil of this approach is that no matter how much research is done, certain transactions may be taxed that were never fully anticipated. In Florida, for example, private music teacher services were found to be taxable; the resulting political noise factor generally was considered to drown out the benefits from the revenue.

Nonetheless, music teachers and their brethren did not bring the tax down. Quick enactment of remedial exemptions is a certain cure for such problems. Far more difficulty would have been encountered if, for example, the law had specified that "data processing services" were taxable but the courts found "charges for time sharing of computers" to be beyond the scope of the tax. A court could reason that time sharing is different because it involves the payer renting property upon which he processes his own data. Remedial fixes to broaden the tax base generally are hard to enact and are particularly difficult after contentious initial enactments. And, most important, if a build-up approach is taken, what is the likelihood of a legislative body deciding separately to tax legal services, then to tax accounting services, and so forth? Failure to take a broad approach initially maximizes the difficulty a legislature will face in taxing professional services ultimately.

There is no legitimate economic reason for service transactions to be broadly excluded from a sales tax base.¹⁴ To effectively build support of the tax, legislators must capitalize on the inherent unfairness of a tax system that discourages the consumption of services. Similarly, the most favorable change that inclusion of services can create in the overall incidence or economic burden of a sales tax will occur only with the inclusion of professional services in the tax base. Neither of these arguments can be advanced if only a handful of services are added to the tax base. Apart from political timidity, there is little to justify the taxation of barber and pest control services today while paying only lip service to the possibility of taxing legal and accounting services in some future year.

Nonetheless, if a stepwise approach appears most prudent, the above consideration suggest that the initial legislation define the tax base to include all services and at the same time provide exemptions with self-contained repeal dates for each block of services to be taxed in future years. When budgets for those upcoming years are prepared, they should anticipate revenues from the services scheduled for taxation in that year. This will serve to clarify costs and benefits for future legislatures.

Controversy #3: Pyramiding

A third criticism asserts that the resale or antipyramiding provisions of the Florida law were too narrow. What distinguishes a sales tax from a transactional gross receipts tax is that the former is limited to final sales whereas the latter applies to all

sales. Exemptions for items purchased for resale effectuate the difference. Pyramiding occurs under the gross receipts approach to the extent that the object of taxation passes through various intermediate levels of commerce before final sale. Under a “pure” sales tax, the object of taxation is taxed only once at the final sale.

Conceptually, there are few disagreements on these points. Controversy arises, however, with respect to the desired level of purity in a sales tax and definition of “final sale.” The controversy is essentially no different whether goods or services are being taxed. From a strict economic perspective, a pure sales tax would never apply to a service or goods purchased by a business, since businesses are not final economic consumers. Only household purchases would be subject to tax.

Whatever the merits of such taxation, *no* state has chosen to levy a pure sales tax. All state sales taxes apply at least to some purchases by businesses. In testimony to the Sales Tax Exemption Study Commission, Professor Walter Hellerstein observed that conversion to pure sales taxation could so narrow tax bases as to result in intolerable rates.¹⁵ It also should be noted that to the degree of incidence of the tax on business purchases falls on owners of capital, the regressivity of the tax generally is reduced. In Florida, approximately 25 percent of the old (pre-services) sales tax resulted from business purchases.

Rather than taxing selected business transactions arbitrarily as is done in some states, Florida’s preservices resale policy was internally consistent and was based on a narrow definition of final sale. A business generally was considered to be a final consumer, so its purchase was taxable, if the item it purchased was not the object of consumption of some subsequent customer. Therefore, in contrast to a pure sales tax, the purchase of office furniture, computers and machines for business use, office supplies, productive machinery and equipment, electricity, business phone services, and office space rentals by businesses all were (and continue to be) subject to the sales tax in Florida.¹⁶

It is ironic that the considerable legislative attention devoted to the resale issue never centered on whether a “pure” sales tax would be applied to services or whether the prior-existing definition of final sale should be narrowed or broadened. Instead, the debate focused on which of two alternative sets of statutory criteria defining the resale of a service was most consistent with the *existing* resale policy for goods and which was most administrable.¹⁷

The narrower of the two ultimately was enacted into law.¹⁸ The broader of the two was hailed by revisionists within the legislature and by most lobbyists as the remedy for complaints of excessive pyramiding.¹⁹

Policymakers in other states should be keenly aware that the pyramiding controversy in Florida was not over whether business purchases should ever be taxable. Generally, it was accepted throughout the deliberations that the tax would apply when the purchase of a service by a business was not made on behalf of a specific customer. The real dispute involved the mechanistic problem of defining those facts that distinguished services purchased for internal consumption by a business from those purchases primary on behalf of the business’s customers.²⁰

Much of the appeal of extending sales taxes to service transactions lies in equalizing the burden of taxation between the goods and services sectors of the

economy. To accomplish this, a state must address three fundamental concerns regarding sales for resale.

First, the philosophical basis or principle underlying a state's resale exemption for goods must be enunciated clearly and applied uniformly. Second, this principle must be adapted to service transactions. Third, a set of statutory or regulatory criteria must be formulated to allow sales tax dealers clearly to apply the resale principle in practice.

In Florida, tangible personal property (goods) can be purchased tax free for resale only if they themselves are resold or if they are incorporated physically into another item of tangible personal property to be resold.²¹ Goods purchased by a business and necessary for its operation, irrespective of whether they are consumed in the process of producing other goods, are taxable, notwithstanding the "impurity" this adds to the economic notion of final consumption.

In attempting to draw as close a parallel to the goods criteria as possible, Florida's new tax legislation provided that services purchased on behalf of a business for a third party were exempt as purchases for resale, but those services consumed by a business, even though necessary in order to provide another service to its customers, were taxable.

As a result, court reporter services to a law firm were taxable, even though purchased by the firm in connection with the rendering of legal services to a client, just as the purchase of a published report or word processing equipment by the firm would be taxable. Conversely, a service station doing repair work on an automobile could farm out the recapping of a tire to a third party and purchase that service tax free for resale. This is because the garage did not consume the services of the recapper in the course of performing its own repairs; it parallels the tax-free purchase a repair shop could make of a new tire for resale to its customers.

What governed the applicability of the resale exemption was whether the item purportedly purchased for resale is the object of consumption by the final purchaser. In the garage example, this is clearly the case. However, a law firm client generally is seeking the best legal advice or representation the firm can render. He is unconcerned whether the firm needs court reporter transcripts, photocopies, law books, or dictating equipment in the course of its operations.²²

The third concern is perhaps the most important because it controls how effectively the chosen policy is carried out in practice. Unlike an income tax where there is direct interaction between the tax administration agency and the taxpayer, sales tax administration relies on intermediaries to deal with taxpayers. These middlemen—sales tax dealers—are not tax experts and have little interest in subtle nuances or philosophical bases of tax law. Therefore, to be applied effectively and unambiguously, sales tax rules must be structured as a series of black and white litmus tests.

Because over 70 percent of the gross sales of services taxed in Florida were purchased by businesses, there was keen fiscal interest in proper application of the resale principle. Florida's solution was five straightforward statutory criteria that a service transaction must have met to qualify for the resale exemption.²³ The criteria keyed primarily upon specific facts of the transaction and provided a paper trail for audit purposes.

Due to the temporal nature of services, the lack of a parallel to the physical trail from manufacturer to final consumer that exists with goods, and the substantial revenue differences associated with various applications of the resale provisions, states should exercise considerable caution in this area with emphasis on the practical application of whatever resale philosophy is adopted.

Controversy #4: The Use Tax on Services

Beyond Florida's border, the most heavily criticized and most misrepresented provisions of the law involved its jurisdictional reach. Often repeated was the example of the Chicago office of a multistate business contracting for legal services from a New York law firm, with Florida having the audacity to tax the transaction. What often went unstated was the fact that a Florida tax would have applied *only if and to the degree* that the service was used or consumed in Florida. The underlying principle derives directly from the use tax on goods imposed by virtually all sales tax states.

If that same Chicago office of the same multistate business contracted for the purchase of a computer from a New York supplier, there would be a Florida cut on the transaction if the computer was delivered and used in Florida, and only the most ardent of antitax protestors would complain.

Use taxes, and exemptions or credits for out-of-state sales,²⁴ are long-standing features of most states' sales tax codes and are essential to the "level playing field" so often emphasized by economic development advocates. A level playing field exists only if the tax obligation faced by the purchaser in a given transactions is the same, irrespective of the location of the seller.

If a state imposes its sales tax only on those purchases its citizens make from in-state suppliers (that is, if it levies only a sales tax), those citizens have a financial incentive to buy from out-of-state supplies or out-of-state offices of multistate suppliers. To avoid a tax-induced competitive disadvantage for local businesses and to close a tax avoidance opportunity involving multistate sellers, states impose use taxes to complement their sales taxes. A use tax applies when a sale occurs of the levying state's jurisdiction, but use or consumption occurs within the state.²⁵

Similar economic distortions occur if a state insists on taxing sales that occur within its jurisdiction when the purchase is out of state (that is, when the item is used or consumed in another jurisdiction). A business located wholly within the taxing state will lose out-of-state sales since its foreign customers can avoid the tax by switching to a supplier in another state.²⁶ To the extent its out-of-state clientele is substantial, a business in this situation has an incentive to relocate. Multistate business serving out-of-state clients simply will begin serving those clients from one of their own out-of-state offices.

These economic realities are likely to be more prominent with respect to services than to goods. Service providers typically are more footloose than purveyors of goods since the former require less investment in physical plant space and inventory. Interstate services transactions are cost-effective because product delivery incurs

minimal or no transportation costs. A telephone wire or an envelope can easily accommodate the tangible output of an accountant, stockbroker, lawyer, engineer, data processor, consultant, and so on. Many service businesses could migrate out of state yet continue effectively to service the same clientele.

As a result, one of the most durable tenets held by Florida policymakers was the necessity of effective provisions to tax all in-state consumption, irrespective of point of sale or performance, and exempt all out-of-state consumption, even if the service was performed and sold in Florida. Any other approach inevitably would harm the competitive position of in-state businesses.

The goods tax already worked in this fashion. The question was how to structure the service tax for the same result.

The situs rule that most states have for establishing the location of use or consumption with respect to interstate goods transactions is simple and long-standing: the point to which the seller or his agent delivers the product. While a purchaser could manipulate his tax obligation by taking delivery in one state by then actually using his product in another, at least three factors mitigate against this: increased handling and transportation costs that would offset the tax advantage; the existence of special tax rules relating to the duration of presence of the goods; and the likelihood of simply trading one state's tax for another's.

For services, physical delivery is an unworkable standard for several reasons. There may be no physical item to deliver, except for electrons traveling on a telephone wire. Where there is a physical item, such as a document, letter, blueprint, tax return, or legal brief, its size and intrinsic value are likely to be negligible relative to the value of the service. Transportation costs would not hinder efforts to manipulate delivery to avoid taxes. Rules as to duration of presence would be similarly ineffective thanks to copy machines and the lack of inventory records or purchase ledgers for services. And any of 49 other states likely would provide a tax-free haven for initial delivery, at least in the short run.

The unique nature of service transactions required that new rules be developed. In the final legislation, situs for use or consumption of services was established via two general and three special sets of rebuttable presumptions.²⁷ All were formulated to balance the competing goals of simplicity in application with accuracy of result.

The general rules for business purchasers defined consumption to occur in the state in which realty, tangible personal property, or a local market of the purchaser was located, if the service directly related thereto. As a result, consumption of landscaping, janitorial, or construction services was attributed to the site of the affected realty; equipment maintenance services were attributed to the site of the machinery,²⁸ and a consulting report on how to penetrate a specific existing market area better was attributed to the state in which the market existed.

If the service did not relate directly to a specific location, but instead related to the purchaser's business in general, consumption was defined to occur in the state in which the purchaser was doing business. For single-state businesses, the result is obvious.

For multistate businesses, the law borrowed a well-established income tax principle: formulary apportionment. Because of the inherent ambiguity and

subjectiveness of dividing profits among the various individual activities of an integrated multistate business, taxpayers, tax administrators, and the courts all have come to accept the use of a relatively standardized, straightforward formula for the geographic assignment of profits. The formula is an average of three ratios: in-state sales to total sales, in-state property to total property, and in-state payroll to total payroll. These three factors have been found to reasonably represent the major business activities or sources that generate profits. Likewise, they reasonably represent business activity in general.

Thus the presumption provided that nongeographic-specific services purchased by a multistate business were consumed in a state to the degree that its profits were attributed to the state. The tax was calculated by reducing the purchase price by the apportionment fraction and applying the tax rate.

In practice, any service of an overhead nature, such as preparation of federal tax returns, legal advice on corporate takeovers, and data processing of company payrolls, was deemed to be consumed by the business in general and therefore was apportioned across all states in which the business was present. Note that this approach applied in determining out-of-state consumption for exemption purposes as well.

For those taxpayers accustomed to the all-or-nothing delivery rules governing taxes on goods, this was a startling change. Although many reacted negatively to apportionment principles being incorporated into a sales tax, few offered realistic alternatives. Agreement was widespread that more presumptions should be enacted relating consumption to specific geographic sites. When pressed, however, no one was able to provide specific suggestions, other than for certain types of legal services.

Some corporations with headquarters out of state suggested that the apportionment rule be dropped and consumption of all overhead (nonsite-specific) services be attributed to the corporation's state of domicile. Needless to say, this suggestion was unpopular with businesses domiciled in Florida as well as with legislators interested in attracting corporate headquarters to the state. If a wider array of states taxed services, this suggestion may have been more popular. In the short run, however, it would have insured that all wholly Florida businesses paid tax on all of their service purchases, while most multistate businesses operating in Florida paid tax on very few of theirs, a politically unacceptable and economically questionable outcome.

For individual (nonbusiness) purchasers, the situs rules were different, recognizing the lessened likelihood of manipulation of point of delivery and the difficulty of use tax enforcement where no written records are kept. In this case, a service was presumed to be used or consumed in a state if it related directly to realty located there, or if it was represented by tangible personal property (e.g., accounting reports, legal documents, and so on) delivered into that state.

If no tangible personal property embodied the result of the service, then consumption was assigned to the location at which the greater proportion of the cost of providing the service was incurred. A haircut, for example, would be ascribed to the state in which it was rendered, whether or not the recipient was a transient who "used" it mostly in another state.

Three sets of specialized rules governed selected situations: services provided to estates of decedents were presumed to be consumed in the last state where their

residency was established; transportation services were presumed to be consumed 50 percent in the state of origin and 50 percent in the state of destination; and advertising services were presumed to be consumed in a state in proportion to the audience in that state, measured by various readily available proxies.²⁹

While some legitimate disputes occurred over the application of these provisions, most of the arguments surrounding them were really arguments against the tax itself. The reaction of the advertising industry, as discussed shortly, is a case in point.

The real bone of contention for multistate businesses was not the theory of the use tax but the cost of compliance.

To comply with the use tax requirements, a multistate business was required to identify those of its service purchases that were subject to apportionment and those subject to allocation (site specific to Florida). Use tax was self-accrued by the purchaser on those amounts. All argued that their accounting systems were not coded to extract total service purchases, much less categorize them as apportionable or allocable. Accounting system software would have to be changed and clerks trained to classify service purchase invoices properly.³⁰

By rule, the Department of Revenue provided multistate businesses with the option of treating all service purchases as apportionable, substantially reducing the training needed for clerks. This option was met with general disdain since the businesses then complained they would not be in a position to exclude service transactions eligible for various exemptions.

The cost of proper accounting, it was argued, would be substantial compared with the revenue generated, particularly if multistate purchasers were allowed to pay the tax directly to Florida vendors and self-accrue taxes only on purchases from out-of-state vendors. Their solution—at first implied and later expressed—was to require payment to Florida service vendors and essentially ignore purchases from out-of-state vendors.

If ignoring a problem constitutes a solution, this approach by all means qualifies. It begs the question of how to maintain a level playing field, because it presupposes that multistate purchasers will not shift to out-of-state suppliers of services, even though such a move would cut costs by 5 percent (or by whatever tax rate was in effect).

While it is reasonable to expect that businesses initially would maintain their existing sources of supply, observed behavior of multistate businesses would respect to other taxes strongly suggests that when cost-effective tax avoidance opportunities exist, they eventually will be taken.

The compliance cost argument has a short-term bias as well. As more states move to tax services, the ratio of costs to revenue will shift. In discussing of a sales tax on services in California, Gary Jugum, assistance chief counsel for the California State Board of Equalization, recently stated, “If you are interested in the technical aspects and applications of the ‘new’ California tax on service transactions, you should pay close attention to the events now occurring in Florida.”³¹

Whether or not Florida’s approach becomes the model for taxing services, someday, probably in the not-too-distant future, some state will tax services comprehensively. And sooner or later that state will come to grips with the use tax

issue. The cost argument will be raised, but as other states follow the lead, such concerns will fade into history. How many legislators today are persuaded by arguments that the extra costs faced by multistate corporations in complying with state corporate income tax codes are prohibitive?

The use tax issue figured prominently in the national debate on Florida's service tax. In Florida, however, it was primarily the domain of technicians. Political leaders held firm to the level playing field notion and directed the technicians to minimize difficulties with the use tax without sacrificing its fundamental purpose.³²

How, then, did this affect the mortality of the tax? Certainly, some multistate corporations took strong exception to what Florida did. Some went so far as to threaten to finance a citizen initiative drive to prohibit constitutionally the taxation of service transactions.³³ Others with large advertising budgets exerted pressure on the media to arouse public opinion against the tax. Many, however, expressed a willingness to work on various legislative or regulatory changes to overcome the difficulties they were experiencing with compliance.

In the final analysis, it appears unlikely that opposition to the tax by multistate corporations per se was a critical element in the downfall of the tax. The debate on the tax was not focused in the halls of the state house, where such firms are typically so effective. Instead, it raged in the popular consciousness and received inordinate media coverage. In such a form, politicians normally can overcome the resistance of outside special interests by appealing to the populist instincts of the electorate. When an issue is framed as pitting large out-of-state corporations against the interests of the average citizen and home state firms, it is not difficult to predict which way rank-and-file legislators will lean.

Unfortunately for proponents of the tax, events played out differently in Florida.

Controversy #5: Who Shot the Service Tax?

The tax on services, praised barely six months earlier by politicians of both parties as the key to Florida's future, was repealed in December 1987, in the third of three special tax sessions. The repeal bill, which only in the eleventh hour was amended to replace a portion of the revenues via a higher general sales tax rate, represented the culmination of a bizarre roller coaster of events (see chronology in the appendix following this chapter).

Certainly the controversies discussed in this chapter did nothing to enhance the tax's changes. But these problems could have been redressed or ridden out, and all were of the nature one could have easily anticipated with an enactment of this type. Revision bills prepared in all three special sessions were aimed directly at solving or ameliorating these problems.³⁴

Instead, the tax fell because of three logistical failures:

1. The governor's campaign rhetoric gave opponents an antitax message that was sellable to the electorate;

2. The media, aggravated by inclusion of advertising services within the tax base, were only too happy to bombard Florida's households with that message; and
3. Ill-conceived responses by leaders within both parties dissolved the coalition supporting the tax before an effective counterattack could be mounting

During the course of the gubernatorial campaign in 1986, the mayor of the city of Tampa, now Florida's governor, characterized his opponent, a 12-year member of the Florida House, as "a man who never met a tax he didn't like."³⁵ The mayor's campaign then was clearly against excessive government spending. He repeatedly vowed to "sweat \$800 million of waste out of state government." Although he actually indicated support for the taxation of at least some services, it is clear that to the man of the street he was the antispense, antitax candidate. His postelection support of the service tax came as a surprise to many voters as well as to members of his own party.³⁶

As with most service providers, the advertising media were not elated at the prospect of their sales becoming taxable. The industry commissioned an economic consulting firm to produce a report, heavily criticized by governmental economists,³⁷ which estimated a job loss of at least 46,000 and a drop in personal income of \$2 billion two years after imposition of a tax on advertising. (To reach this conclusion, one must assume that government will not spend the new revenue it collects.)

Whether it was a genuine fear of economic disaster, concern over governmental infringement on free speech,³⁸ pressure from big budget advertisers,³⁹ or fear of a domino effect across the states, the media were dead set against the "advertising tax." Repeated attempts by the Department of Revenue and legislature to accommodate the technical problems faced by broadcasters and publishers did little to placate them. Unlike other service providers, the media were in a position to voice their objection easily and effectively.

In the same fashion that television viewers are convinced to want products they do not need and cannot afford, the advertisers effectively convinced Florida voters to oppose a tax they did need and could afford. The "public service" messages wasted little time upon the substance of the tax. Instead, they centered on the governor's support ("Billion-dollar Bob") of the "largest tax increase" in the state's history—"one which threatens to flatten Florida's economy."⁴⁰ Nowhere was there a discussion of public needs or tax alternatives. Nonetheless, the campaign was effective because it played directly upon the public's frustration with broken political promises. The governor unfairly was painted with a broad brush as one who immediately and completely broke faith with the voters. At one point, his approval rating fell below 30 percent.⁴¹

In the face of this pressure, either one or both of two courses of action would have been prudent: a public information campaign to counter that of the broadcasters, and/or exemption of advertising services, at least until the political situation stabilized. Neither was done because the coalition between the Republican governor and the Democratic legislative leadership disintegrated early on.

The service tax was a gift the 1986 legislature presented to the new governor (who was sworn in January 1987). He was in no way responsible for passage of the

tax (sunset) legislation; he could argue for exemptions for favored industries; and he could produce a budget that realistically dealt with Florida's growth needs. He could have distanced himself from the tax by blaming it on his predecessor, taken credit for the newly enacted exemptions, and proceeded with his budget. Instead, in his first state-of-the-state address, delivered April 17, 1987, he bravely supported the tax. With respect to special interests opposing it, he said:

For my part, every increase in pressure from those who would shirk their duty to Florida's future convinces me again that we are embarked on the right course. Under the leadership of Speaker Mills and Representative Patchett in the House and President Vogt and Senator Jennings in the Senate [majority and minority leaders in each chamber] and the cooperation and support of all of you, I am confident we will stay the course and put this critical issue [taxation of services] behind us early in the session.

On August 22, after consulting with only two senators, and on the advice of his campaign strategist who was then serving as a co-chief of staff, the governor proposed letting the voters decide whether to retain the tax.⁴² Proponents of the tax were somewhat surprised by this.

Because the hostile media campaign had led the voters to identify the tax as a symbol of political duplicity, few legislators were eager to pick up the torch. Whatever hopes the legislative leadership had of maintaining the coalition were dashed when the chairman of the state Democratic Party, with an apparent similar lack of consensus, publicly announced that Democrats would use the service tax issue against Republicans in the next election.⁴³

With this, the fate of the service tax was sealed. While there were minor glimmers of hope, such as when the governor announced he might not continue to press for repeal after the second special tax session ended in deadlock, efforts to save the tax were too fragmented and ill planned.

The house speaker and senate president held public hearings around the state in an attempt to popularize the tax, but press coverage emphasized testimony of tax opponents. The chairman of the House Finance and Tax Committee worked hard on modified versions of the service tax, but his efforts seemed largely unilateral. When the legislature finally passed a referendum bill, the governor vetoed it, having moved on to demanding outright repeal. When it was proposed that advertising services be exempted, tax proponents seethed they would rather lose the tax than give in to media "blackmail." One special tax session ended after the House Finance and Tax Committee found it did not have a majority for any of three proposals: repeal, referendum, or revision.

Post Mortem

The Florida service tax was a classic case of snatching defeat from the jaws of victory.

Had the governor not campaigned so heartily against government spending, the media's antitax message would have been more obviously self-serving.

Had the governor not so boldly embraced the tax, proponents would have taken a more active role in selling it to the electorate and not been caught so off guard when he backed away.

Had advertising services been exempted, tax opponents would have been unable to saturate the airwaves.

Had initial political reaction to these problems been better thought out, the protax coalition might have mounted an effective salvage operation.

This chapter contains three fundamental messages for legislators in other states: 1) the piecemeal approach to service taxation is not the appropriate method because then the politically toughest but most important measure will likely never be taken; 2) a method must be found to make the self-serving, antitax posture of the media obvious for what it is. (One approach would be to tax advertising sales in a separate bill, after a general service tax has been implemented and accepted by the public;⁴⁴ another would be to tax advertising in a different—yet constitutional—manner, such as by denying the deductibility of advertising and promotional expenses for income tax purposes⁴⁵); and 3) it must be recognized from the outset that the protax coalition must proceed on a consensus basis both before and after enactment.

Florida's legislation did not mark the end of service taxation, nor was it a nonproductive exercise. Given the valuable lessons it provided, Florida's experience may be characterized best as the end of the beginning of service taxation.

Notes

1. For example, in 1984, it was reported that 16 states taxed car washing, 33 taxed tire recapping, 27 taxed linen and towel supply services, 14 taxed dry cleaning, 17 taxed cable TV services, 33 taxed room rentals, 28 taxed telephone services, and 10 taxed house painting services. Source: *Survey of Sales and Use Taxation in the United States* (Pierre, S.Dak.: Business Research Bureau, The University of South Dakota, 1984). See also John Mikesell, "General Sales Tax," in Steven D. Gold, ed., *Reforming State Tax Systems* (Denver: National Conference of State Legislatures, 1986), pp. 217-221.
2. For an interesting account of the nature of the service sector in the United States and its domination to today's economy, see "Understanding a New Economy," *The Wall Street Journal*, December
3. In 1976, the Florida Legislature created S.11.61, Florida Statutes, providing for periodic review via sunset of each "profession, occupation, business, industry, or other endeavor" subject to regulation. Since 1978, a once-every-10-year cycle has been in effect for such reviews.
4. These efforts occurred under the leadership of Senator Harry Johnston. Ironically, the house—generally known for creative work in this area—was at first reluctant to consider such legislation under the conservative leadership of Representative James Harold Thompson.

5. During this period, ongoing study by the State Comprehensive Plan Committee eventually concluded that the state had a \$52.9 billion backlog of infrastructure needs directly attributable to population growth.
6. Since 1976, only two sunset bills (truck transportation and psychology) actually had eliminated statutory regulation. The psychology profession was reregulated a year later.
7. Only two tax bills in modern Florida history were comparable in scope with the service legislation: creation of the sales tax in 1949 and creation of the corporate income tax in 1971. There is nothing in the historical record for either to indicate research or evaluation approaching that given the service tax, although considerable care went into the drafting of the corporate tax bill.

In a letter dated September 9, 1987, to a member of the Department of Revenue, Professor Oliver Oldman, Learned Hand professor of law at Harvard University stated, "I have now gone through all of that material [from the Department of Revenue] to realize what an enormous effort you and your associates made in getting ready for this important new law...I will be showing the Blue Book [the department's report to the legislature—see note 8] to my students as an example of what a state ought to do whenever it produces important new tax legislation."

8. Florida Department of Revenue, Report to the Legislature—Legal, Administrative and Revenue Implications of Chapter 86-166, Laws of Florida: Repeal of Sales Tax Exemptions for Services and Selected Transactions (Tallahassee, Fla.: March 1987).
9. Sales Tax Exemption Study Commission, *Report and Recommendations of the Sales Tax Exemption Study Commission* (Tallahassee, Fla.: April 1987).
10. A second bill (Chapter 87-101, Laws of Florida), commonly known as the Glitch Bill, was passed on June 6, 1987. The bill originally was intended to provide minor technical corrections. As passed, it also contained a number of new exemptions and an industry-favored rewrite of the provisions applicable to construction services.
11. From the onset, controversy existed over the legal reach of the sunset legislation. The numbers in the nest are based on inclusion of all services except pure labor, the interpretation given the bill by the Department of Revenue. If, however, the service tax also had functioned as a payroll tax (i.e., had reached labor services), its yield would have exceeded \$7.6 billion in fiscal year 1988-89.
12. Considering labor services as a potentially taxable item, the taxed percentage would be 18.6 percent.
13. Two competing views existed as to the nature of transactions. The first held that all transactions fall into three categories: 1) purchase or use of property, 2) the purchase of services, and 3) the purchase of rights or intangibles. The second saw only essential distinctions: 1) the purchase of property, either real, tangible personal, or intangible; and 2) the use of property, with the same three property types.

Under the second scheme, all uses of property are considered services since no permanent ownership rights are conveyed in the transaction. This latter system derives from the economic notion of capital—the embodied result of investment—and the benefits that accrue from ownership and/or control of capital. Capital can take the form of material capital (such as realty or tangible personal property), human capital (skills of persons, either intellectual or physical), or financial capital (money or stored purchasing power).

A transaction that gives the purchaser permanent control over capital and its attendant benefits is clearly different from one that vests only temporary control or benefit. The first classification scheme is flawed because use of property (e.g., rental of an automobile) is not distinguished from ownership and because no clear distinction exists between property use and services. The second classification more properly provides that temporarily purchasing the benefits of capital is a service, irrespective of the form of the capital. Therefore, renting an automobile, employing the skills of a lawyer, and borrowing money for a fee (interest) all are service purchases because they bequeath upon the buyer the benefits of capital for a limited time without providing permanent control.

The point for legislators is that when considering broadening sales tax bases to generally tax services, in parallel with the general taxation of goods, there is no a priori reason to exclude interest paid for the use of money. (Of course, social policy considerations may dictate certain exclusions, such as interest on home mortgages, student loans, and so forth.)

14. See, for example, Jerome H. Hellerstein, "Significant Sales and Use Tax Development During the Past Half Century," *Vanderbilt Law Review* 39 (1986): 962-972.
15. Remarks presented December 17, 1986. Tape recording on file with Florida Department of Revenue, Carlton Building, Tallahassee, Florida.
16. An exception exists whereby packaging materials used one time are exempt.
17. The enacted criteria provide that "a sale of a service shall be considered a sale for resale only if:
 - 1) The purchaser of the service does not use or consume the service but acts as a broker or intermediary in procuring a service for his client or customer;
 - 2) The purchaser of the service buys the service pursuant to a written contract with the seller and such contract identifies the client or customer for whom the purchaser is buying the service;
 - 3) The purchaser of the service separately states the value of the service purchased at the purchase price in his charge for the service on its subsequent sale;
 - 4) The service, with its value separately stated, will be taxed under this part in a subsequent sale, unless otherwise exempt pursuant to Section 212.0592(1); and
 - 5) The service is purchased pursuant to a service resale permit by a dealer who is primarily engaged in the business of selling services. The department shall

provide by rule for the issuance and periodic renewal every five years of such resale permits” (section 212.02(19)(a), Florida Statutes, 1987).

The proposed revised criteria were “a sale of a service shall be considered a sale for resale only if:

- 1) The service provides a direct and identifiable benefit to a single client or customer of the purchaser;
 - 2) The purchaser of the service buys the service pursuant to a written contract with the seller or other written documentation which identifies, by name or other evidence sufficient for audit purposes, the client or customer for whom the purchaser is buying the service;
 - 3) The purchaser of the service separately states the value of the service purchased in his charge for the service on its subsequent sale; and
 - 4) The service is purchased pursuant to the service resale permit by a dealer who is primarily engaged in the business of selling services” (Section 73, CS/CS/S.B. 5B, 1987 and Special Session).
18. The broader resale language if tightly enforced was estimated to reduce fiscal year 1988-89 revenues by about \$135 million. If all business purchases were exempted, the reduction would have approached \$900 million.
19. A related concern was whether expenses incurred by a service provider when passed on to his client and separately stated on the invoice to the client would be excluded in calculating the tax due on the transaction. Some members of the legal professional were particularly vexed that such charges were included in the taxable base, even though the tax on goods never provided such an exclusion, whether or not “pass through” charges were stated separately.
20. Discussions with tax administrators in Hawaii and New Mexico also heightened the Florida Department of Revenue’s interest in an unambiguous statute that would be policed via readily ascertainable factual criteria, given the ephemeral nature of services and the lack of records comparable to those used to enforce resale provisions for goods transactions.
21. The physical incorporation criterion applies to component parts of a manufactured or fabricated good. It does not include tangible personal property that is merely “used up” in the production process, irrespective of how essential such inputs are to the final output.
22. If, however, the client expressly sought transcribed copies of depositions or testimony, the service resale exemption would apply to the court reporter’s fee.
23. See note 17. Also, note that the fifth criterion dealt with the purported reseller’s business activities. Legislative staff strongly argued that businesses whose primary source of receipts was not from sales of services were at best incidental resellers. Eliminating them from eligibility for the resale exemption would allow for more effective enforcement with respect to the remaining firms.
24. A credit from sales or use taxes paid to another state with respect to a given transaction has the same effect as an exemption for out-of-state sales, provided

- that the receiving state has a tax at the same or a higher rate. The lack of taxes on services in other states led to the exemption approach in Florida's law. Legislators should note the importance of requiring tangible evidence of use in another state, lest in-state dealers indiscriminately grant the exemption.
25. The statute provided that use or consumption occurred where the benefit of a service was enjoyed (Sections 212.059(2) and 202.0592(1)(b), Florida Statutes, 1987). The terms use, consumption, and benefit generally are used interchangeably in this chapter.
 26. For example, an Atlanta resident purchasing goods from a Jacksonville business would owe a Florida sales tax and a Georgia use tax, absent a credit or an exemption from the Florida tax. Shifting the purchase to a Georgia dealer would give rise only to a Georgia sales tax obligation, since the complementary nature of a use tax precludes its imposition if the same state's sales tax applies.
 27. All provisions as to localizing consumption were made rebuttable to avoid due process problems and in recognition of the lack of administrative experience under these provisions.
 28. This provision did not apply to services related to tangible personal property without situs, such as vehicles involved in interstate commerce.
 29. For example, noncable radio and television advertising was apportioned based on the ratio of in-state population to total population within the signal coverage area was based on engineering maps filed with the Federal Communications Commission. See Department of Revenue emergency rule 12AER87-44, Florida Administrative Code.
 30. A factor that aggravated compliance cost concerns arose because multistate firms convinced the legislature to exempt service transactions between commonly owned and controlled corporations. In arguing that such transactions involved internal activity within what was essentially a single business, the seeds were sown for treating integrated businesses composed of multiple corporations as single entities for other purposes as well. When applied to the allocation and apportionment provisions, this meant even more clerks would require training.
 31. Gary J. Jugum, "Taxing Services" (Paper delivered at the 1987 California Tax Policy Conference: Issues in State Taxation, San Francisco, November 13, 1987), p. 149.
 32. Legislative interest in use tax enforcement was so keen that two provisions were inserted, purely by legislative initiatives. The first prohibited the issuance of state, county, or municipal licenses or permits unless the applicant attested that all applicable uses taxes had been or would be paid (s. 212.059(7), Florida Statutes, 1987). The second required the use tax to be collected from a Florida purchaser by out-of-state selling office of a multistate corporation with Florida nexus if the product of the service was represented by or embodied in tangible personal property delivered into the state, as well as under two other circumstances (Section 212.059(3), Florida Statutes, 1987).
 33. A south Florida attorney had begun a fledgling petition drive under the banner "STOP" (Sales Tax Oppressing People).

34. The most comprehensive revision was contained in Part II of Committee Substitute for Senate Bill 5B, a bill passed by both houses during the second special tax session but vetoed by the governor.
35. Widely quoted remark made during one of three televised debates between Bob Martinez and Steve Pajcic, candidates for governor in 1986.
36. Vicki L. Weber, "Florida's Fleeting Sales Tax on Services," *Florida State University Law Review* 15, no. 14 (Winter 1987): 618-619. See, in particular, notes 37 and 38.
37. See, for example, "Critique of the Wharton Econometrics Study of the Impact of the Sales Tax on Advertising," Division of Economic and Demographic Research, Joint Legislative Management Committee, September 28, 1987: interoffice memorandum.
38. In an advisory opinion on the constitutionality of the tax on services, the Florida Supreme Court found the tax to be facially constitutional as to its application to advertising services, notwithstanding First Amendment arguments to the contrary. In Re: Advisory Opinion to the Governor, Request of May 12, 1987, Supreme Court of Florida, No. 70,533, July 14, 1987.
39. It was common knowledge that considerable pressure was exerted by out-of-state advertisers on Florida broadcasters. Even after the national advertising boycott was terminated, Florida broadcasters complained that local "spot" advertising by such firms continued to be curtailed.
40. Television advertisement developed by the Florida Association of Broadcasters.
41. "Martinez Still Maintains Bad Public Image," *St. Petersburg Times*, November 2, 1987.
42. "Signs Point to Trouble for Martinez," *The Orlando Sentinel*, August 30, 1987.
43. Martin Dyckman, "Cheap Shots on Sales Tax Won't Serve Democrats," *St. Petersburg Times*, September 20, 1987.
44. Outright exemption of advertising services appears questionable on equity grounds unless all business services are exempted—the "pure" sales tax approach.
45. Note that this approach automatically provides for apportionment of advertising services, although it would use the ordinary corporate formula rather than the special audience-based formula contained in the Florida law.

Appendix

Chronology:

Florida Sales Taxon Services

Excerpted from the *St. Petersburg Times*, *The Orlando Sentinel*, and other news sources.

June 6, 1986—Legislature passes a bill repealing more than 100 exemptions from the 5 percent sales tax, including those for personal and professional services, effective July 1, 1987. Bills call for a Sales Tax Exemption Study Commission of 21 persons to review exemptions and recommend which should be kept.

January 29, 1987—After a two-year study, a different group, the State Comprehensive Plan Committee, says public services are falling far behind population growth. The committee, chaired by Charles J. Zwick of Southeast Bank, recommends a sales tax on services to help meet \$52.9 billion in state needs over the next 10 years.

February 10—New governor, Bob Martinez, in Tampa, announces his support for the tax.

February 18—Governor proposes a budget for 1987-88 that includes money from services and proposes cutting the sales tax rate from 5 to 4.5 percent.

March 2—Department of Revenue submits to the legislature the results of its year-long study of the legal, administrative, and revenue implications of taxing services.

April 6—The Sales Tax Exemption Study Commission issues its report after four months of study and public hearings. Its recommendations would provide service tax revenues of \$934.8 million and \$1,454.2 million in the first two years, respectively.

April 9—The service tax survives its first serious challenge and is approved by the Senate Finance and Taxation Committee.

April 15—The senate passes service tax package, 28-12.

April 23—Following a flurry of activity, the full legislature approves a service tax package to generate an estimated \$761 million the first year and more than \$1.2 billion the second. The senate approves the tax 25-15 and the house 83-31. Governor quickly signs the bill.

April 29—NBC television network announces it will pull its 1988 affiliates' convention out of Orlando because of the service tax.

May 1—The Florida Bar sues the state, claiming the new law is unconstitutional.

May 5—The Florida Association of Broadcasters announces an advertising campaign calling for repeal of the tax.

May 6—A coalition of advertising and other groups called Sales Taxes Oppressing People announces a petition drive to prohibit the tax constitutionally. Meanwhile, the Association of National Broadcasters backs down from a possible advertising boycott.

May 12—Governor asks the Florida Supreme Court for an opinion on the constitutionality of the tax.

June 18—After four public workshop hearings, the Department of Revenue issues services tax rules.

July 1—The tax goes into effect.

July 2—Two major television networks ask their Florida affiliates to black out some nationally broadcast commercials to protest the tax.

July 14—The Florida Supreme Court, after briefs and oral arguments from affected parties, issues its advisory opinion saying most of the tax is constitutional.

July 23—Governor vows to veto any bill the legislature tries to substitute for the service tax.

July 29—Johnson and Johnson, the nation’s 21st largest advertiser, ends its boycott of Florida advertising.

August 22—Facing falling approval ratings in polls, governor proposes a March 1988 referendum to let voters decide whether the tax should be banned in the state constitution.

September 3—Governor calls for a special session of the legislature to address the tax question.

September 14—Governor says he doesn’t have the vote to force the referendum and says he’ll work with lawmakers to study repealing or revising the tax.

September 18—After legislators rejects his plan for a referendum, governor calls for legislators to repeal the tax and give him more control over the state budget.

September 21—Legislature convenes in first special tax session.

September 23—Standard and Poor’s bond rating agency puts Florida on “credit watch” because of uncertainty of future state revenues. The watch could lead to lower bond ratings and higher costs for borrowing.

October 1—Governor announce that if the legislature will repeal the service tax and adopt some budget reform, he will support increasing the sales tax on goods from 5 percent to 5.5 percent. His plan would allow county commissions to impose an additional half cent for local use.

October 8—The house and senate approve a compromise measure giving voters the chance to choose between a revised service tax or an increase in the sales tax on merchandise. Governor vetoes it and calls the legislature into a special second session.

October 12—Lawmakers begin their second attempt to find an acceptable solution to the tax issue.

October 14—Hopelessly deadlocked, the legislature adjourns after nearly four weeks of special sessions. The service tax remains in effect. Governor hedges on whether he will try another session, but senate and house leaders set their own for December to wade into the issue once again.

November—House speaker and senate president hold public hearings around the state on the service tax and are met with orchestrated opposition to the tax.

December 8—Legislators begin third special session.

December 10—After 37 hours of wrangling, the legislature repeals the service tax, effective January 1, and increases the five-cent sales tax by one cent as of February.