

Department of Legislative Services
Maryland General Assembly
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FISCAL AND POLICY NOTE

House Bill 670
Ways and Means

(Delegate Barve)

Sales and Use Tax - Computer Services Used in Production Activities and
Research and Development

This bill exempts from the sales and use tax the sale of a computer service that is used directly and predominantly in specified production activities and for use or consumption in research and development.

The bill takes effect July 1, 2008.

Fiscal Summary

State Effect: General fund and Transportation Trust Fund revenues could decrease by a significant amount beginning in FY 2009. Under one set of assumptions, total sales and use tax revenues could decrease by at least \$7.3 million. Expenditures would not be affected.

Local Effect: None.

Small Business Effect: Potential meaningful.

Analysis

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 30, 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Chapter 3 repealed the sales and use tax exemption for sales of custom computer software services and optional computer software maintenance contracts, but exempted computer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.

The sales and use tax does not apply to the sale of tangible personal property used directly and predominantly in a production activity at any stage of operation on the production activity site from the handling of raw material or components to the movement of the finished product, if the tangible personal property is not installed so that it becomes real property.

The sales and use tax does not apply to the sale of tangible personal property for use or consumption in research and development.

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.

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

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.

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 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: The bill exempts from the State sales and use tax the sale of computer services for use in either a production activity or for research and development purposes. Purchases of tangible personal property used in these activities are currently exempt from the State sales and use tax.

While general fund and TTF revenues would decrease by a significant amount beginning in fiscal 2009, the amount of the decrease cannot be reliably estimated. The actual decrease depends on the amount of taxable computer services purchased and used by Maryland businesses for either production activities or research and development.

As a point of reference, and *for illustrative purposes only*, the exemption provided by the bill could reduce total sales tax revenues by \$7.3 million based on the following facts and assumptions:

- *The Tax Expenditure Report* for fiscal 2006 indicated that the current sales and use tax exemption for goods purchased for use in a production activity would result in approximately \$105.3 million in foregone sales and use tax revenue in fiscal 2006; this amount equates to 3.1% of total sales and use tax revenues for that year.

- *The Tax Expenditure Report* for fiscal 2006 indicated that the current sales and use tax exemption for goods purchased for use in research and development activities would result in approximately \$9.7 million in foregone sales and use tax revenue in fiscal 2006; this amount equates to 0.3% of total sales and use tax revenues for that year.
- Sales taxes on the purchase of computer services used in production activities and research and development are assumed to be 3.4% of the estimated \$214.0 million generated by the sales tax imposed on computer services.

If the purchase of various computer services for production activities and research and development activities represents a larger or smaller percentage of expenditures than tangible personal property used in these activities, the actual revenue loss from these exemptions would vary accordingly. For example, if it is assumed that these exemptions account for 7.0% of sales made for computer services then total sales and use tax revenues would decrease by about \$15.0 million annually.

In addition to increasing the sales and use tax rate from 5% to 6%, Chapter 6 of the 2007 special session also altered the distribution of sales and use tax revenues by requiring that 6.5% of revenues, after specified distributions, be diverted to the TTF beginning July 1, 2008. As a result, the exemption proposed by the bill would reduce TTF revenues by 6.5% of the total revenue decrease.

Small Business Effect: To the extent that small business providing computer services would be adversely affected due to lost sales resulting from the tax imposed on these services, providing the exemption under the bill would mitigate 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.

Additional Information

Prior Introductions: None.

Cross File: None.

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