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MTF **The Folly of Taxing Our Innovation Economy**

On July 31, Massachusetts imposed the largest and broadest tax on computer and software services in the nation. The tax targets innovation—the very core of the state's economic future—impacting thousands of businesses, large and small, in every sector of the economy. Many of our competitor states are moving in the opposite direction—at least 15 states offer tax incentives related to software, computer services, or data centers because the jobs are highly mobile and can be performed remotely.

For the purposes of taxation, the law creates three new categories of services: (1) computer system design services, (2) services to modify, integrate, enhance, install, or configure standardized software, and (3) data access, data processing, and information management services. The first two categories are now subject to the sales tax, while the third category is exempt.

The law defines computer system design services as "the planning, consulting or designing of computer systems that integrate computer hardware, software or communication technologies and are provided by a vendor or a third party." The legislation does not provide definitions for the modification, integration, enhancement, installation, or configuration of standardized software; nor does it define data access, data processing, or information management services. As a result, the application of this tax is almost entirely dependent on the Department of Revenue's (DOR) interpretations.

As discussions with legislators, the administration, media, and businesses continue, several points should be highlighted:

- The tax affects virtually every industry in the state—not just high tech—because these services are an integral part of modern business. Employers in the health care, life sciences, biotechnology, finance, manufacturing, hospitality, restaurant, retail, grocery, and other industries will all pay more to improve productivity, generate growth, be more competitive and, most importantly, create jobs.

  For example, retailers rely on vendors to design and integrate systems to track sales and manage inventory, health care insurers and providers manage costs with electronic health data systems, biopharmaceutical companies use complex computer systems to analyze data, manufacturers rely on computer aided design for production, and other businesses increase productivity by modifying standardized computer programs to meet their specific needs.

- The administration and legislators continue to make the inaccurate claim that this tax merely aligns Massachusetts with many other states. Only four other states tax these services and all at a lower rate. The Foundation's analysis—which has not been disproved—is the result of exhaustive research on all 50 states, including reviews of statutes, regulations, technical releases, and other revenue department guidance.

- There is massive confusion about the tax across thousands of employers because of the broad legislative language, the complex and ever-changing nature of technology, and the reliance on these services by virtually every industry in the state. DOR has already issued a nine-page list of 55 frequently asked questions and final regulations are not expected until October.

  The vague and confusing legislative language is particularly problematic because DOR has the sole authority to determine how to apply the tax and has a track record of broad interpretation. The letter from legislative leaders sent to DOR following the adoption of the tax is a futile attempt to limit the scope of the law. Not only does the letter have no legal authority, it actually reinforces the sweeping legislative language and gives a stamp of approval on the policy of taxing innovation.

- Over the past several months, the Foundation has worked with tax experts and businesses to determine whether there is a reasonable fix short of repeal. Based on this extensive work, there is no reasonable way to tax any of these services without causing severe harm to the state's innovation economy and tying businesses in knots for years to come. Focusing on a fix ignores the reality that taxing software services in any form is bad economic policy.

- Much of the public discussion surrounding the issue has been about how much money it will raise rather than the wisdom of taxing a centerpiece of the Massachusetts economy. Furthermore, the impact of that tax is at least $500 million and not the $161 million that DOR has estimated. The $161 million is based on assumptions that do not capture the full burden of the tax.

  - DOR's estimate does not account for purchases that Massachusetts-based companies make from out-of-state businesses for which they would have to pay the use tax. Instead, it only accounts for revenues raised from purchases made by Massachusetts companies from Massachusetts companies.

  - DOR reduced its revenue estimate by 30 percent because it assumed just a 70 percent compliance rate, despite no apparent evidence to support it. Regardless of what happens in the first year of implementation, over time compliance would reach close to 100 percent, bringing DOR's estimate to $230 million based on this factor alone.

  - The $161 million estimate only accounts for the taxes collected on computer system design services and not those collected from taxing modification, integration, enhancement, installation, or configuration of standardized software.

In the end, regardless of the amount collected, the costs of the software services tax will be far greater in terms of lost jobs, stifled growth and innovation, and a black mark that will mar Massachusetts for years to come.

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