



# STATE BAR OF MICHIGAN

## Member Comment

### Member Name:

Stephen M. Kelley

### Issue:

Tax on legal services

### Date comment submitted:

February 13, 2007

### Member Position:

February 13, 2007

Dear President Cahill and Interim Director Welch:

I write in response to Governor Granholm's February 8, 2007 proposal to institute a new 2% tax on certain services including legal services. The Governor's services tax proposal is not the right solution for Michigan's budget issues for the reasons outlined below.<sup>1</sup>

### The Budget Problem

The Michigan Constitution (and common sense) requires that Michigan have a balanced budget. State expenditures are projected to exceed state revenues, including in part due to the repeal of the Michigan Single Business Tax (SBT) effective December 31, 2007. I am acutely aware of the state of our economy and the needs of our less fortunate citizens.

### The Governor's Proposed Solution

The Governor's February 6, 2007 State of the State address proposed, in part in general terms, a combination of spending cuts, government reforms, new taxes, and increases in certain existing taxes. When the Governor's proposed budget was sent to the Legislature on February 8, 2007, it suggested a new 2% tax on certain services, including legal services.

As more details of the proposed tax become available, particularly once actual legislation is introduced, we may be able to more specifically identify the actual impact of not only the Governor's proposed new tax on legal services but also the tax burden to be imposed on Michigan attorneys from the proposed new Michigan Business Tax. Our initial analysis suggests that the proposed legal services tax, whether called an excise or a sales tax, coupled with the new Michigan Business Tax, will substantially exceed our current tax burden compared with the now-repealed Single Business Tax and personal property taxes (to be paid in addition to

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<sup>1</sup> I am a lifelong Michigan resident and 25-year practicing Michigan attorney. This firm has six attorneys and twelve employees. I have supported the Governor in her campaigns. These comments are not necessarily the position of this firm, this firm's individual employees, or any client.

income and other taxes). Preliminary calculations reflect the Governor's proposal will result in perhaps a net 160% increase in tax liability for this firm, thousands of dollars per attorney.<sup>2</sup>

### The Governor's Justification for a Services Tax

The Governor's Tax Restructuring Proposal suggests that a services tax is appropriate because the Michigan economy has changed from a manufacturing economy to a service economy. The Governor's proposal argues that a services tax should be acceptable because "[t]he low tax rate would apply to a broad base of service activity, reducing the economic impact of the new tax." The Governor's own numbers, however, show only a 5% shift in the economy from manufacturing to services between 1990 and 2005, not a dramatic change.<sup>3</sup> Moreover, the Governor's manufacturing-versus-services argument really is an apples-to-oranges comparison. Many Michigan products are sold or resold out of state and many of the products we buy are manufactured elsewhere (including overseas). Unlike the sale of goods, however, most Michigan services are purchased by Michiganians.

### Societal Impacts of Reduced Use of Legal Services

A tax on legal services functionally will further restrict the access of everyday Michigan residents to legal services. Many in Michigan already cannot afford an attorney, and effectively increasing the costs of legal services through a services tax will make it even more difficult for folks to get the legal help they need.

Furthermore, access to legal services is vital to an efficiently-operating Michigan economy and for individuals to conduct their personal affairs. While others likely are better positioned to opine on the societal impact of reduced use of legal services, it is hard to understand why the State would discourage access to legal services. The wrongful conviction of an innocent accused, loss of a home because of a fraudulent mortgage, court proceedings caused by the lack of a will, discrimination or wrongful termination, and enforcement of contract rights are just some examples of legal issues which undermine life, liberty, and the pursuit of happiness in our society and require legal services. Timely access to legal services should be encouraged, not discouraged.

### Playing Favorites

We use tax policy to encourage and to discourage different behaviors, from economic redevelopment zones to so-called "sin taxes" on alcohol and cigarettes.

While argued as a broad based and therefore a fair new tax, the Governor's proposed services tax as currently understood in fact plays favorites, proposing to tax car repairs, haircuts, legal work, and other activities, but proposing to exempt other services such as healthcare (including medical and other professional practices), scientific research, computer design, education, and, of course, government.

Moreover, to the extent the Governor's proposal further plays favorites by excluding categories of legal service providers, e.g., government or in-house attorneys, the burden of a tax on legal services falls on the private sector, private law firms and solo practitioners and their clients.

### Anti-Competition

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<sup>2</sup> These figures do not take into account the fact that if adopted we expect to be asked to pay this tax on accounting, bookkeeping, computer, and other services routinely purchased by this law firm.

<sup>3</sup> "Our Moment, Our Choice: Investing in Michigan's People", page B-2, [www.mich.gov/budget](http://www.mich.gov/budget) (as of 2/9/07).

At the same time the Governor argues that Michigan must compete in a global economy, imposition of a services tax, at least on legal services, is entirely out of step with all other states.

Legal services are something Michigan can and does “export”. In any given year, up to one-half of this firm’s billings are for legal services in connection with litigation pending in other states, frequently but not exclusively in Indiana and Ohio. In those cases, clients hire us as primary counsel in those other states instead of hiring local or Indianapolis or Cleveland attorneys to serve as primary counsel (we hire local counsel as required or prudent). While we appear in court and attend depositions and meetings in those other states from time-to-time during the pendency of those cases, most of our day-to-day work on those cases takes place in Michigan. It is our practice to pay Michigan income taxes on all income from our work regardless of where performed.

Although we think we are pretty good attorneys, one reason we can compete for out-of-state legal work is price. A new tax on legal services would increase the effective rate for our legal work, reducing the competitiveness of law firms such as ours with out-of-state counsel. If we lose that work, we will need to downsize our offices, those employees will lose not only their paychecks but also their health insurance, and Michigan will lose the current income taxes received from those employees. Even worse, not only might we lose our out-of-state work, but our in-Michigan legal work may be at risk from then-less-expensive out-of-state law firms, requiring even further downsizing. We are not afraid to compete, but a Michigan-only legal services tax creates an uneven playing field.

Instead, Michigan (and the State Bar) should be actively working to encourage, not discourage, Michigan and non-Michigan businesses and individuals alike to retain Michigan attorneys for their legal needs. There is little reason for many of our larger corporations to routinely engage New York, Washington, or Chicago counsel when those same corporate legal needs typically can be met by competent Michigan attorneys, typically at significantly lower billing rates. Taxing Michigan legal services is completely contrary to what should be the State’s competitiveness agenda, encouraging -- not discouraging -- use of Michigan’s service providers.

### Additional Regulatory Burden

Further, collecting and remitting the proposed taxes will significantly increase our respective law office administrative burdens and costs, further reducing our competitiveness in the global economy. These additional administrative costs in all likelihood will most adversely affect Michigan’s smaller businesses.<sup>4</sup>

### A Better Solution

Michigan should make every reasonable effort to avoid reducing access to legal services and losing high-education, high-quality Michigan jobs through imposition of a tax on legal services.

In my personal opinion, a far better solution to help balance the State budget -- coupled with needed spending cuts and program reforms -- is a modest across-the-board state income tax increase. A modest income tax increase changes only the mathematical computation (and payment), without implementing a new tax with new forms and more state employees (or contractors) to check for compliance.

A modest state income tax increase in lieu of a services tax will:

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<sup>4</sup> Based on State Bar data, more than 45% of Michigan’s attorneys practice in small firm or solo practice settings. Taxing these small businesses regardless of actual income seems misguided.

1. Raise revenue from folks with significant income, not by imposing a misery tax on all residents regardless of ability to pay;
2. Avoid placing Michigan service providers at a competitive disadvantage with other states;
3. Encourage businesses and individuals to hire Michigan service providers, including attorneys;
4. Avoid creation of another bureaucracy and bookkeeping and accounting fees to implement collection of a new and different tax; and
5. Allow our colleagues in government, education, and healthcare -- huge parts of Michigan's economy -- to join other service providers in eliminating Michigan's projected budget deficit.

Please contact me with any further questions in this regard, and please forward the actual services tax and MBT legislation when introduced.

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**State Bar of Michigan Position:**

The State Bar of Michigan opposes the adoption of legislation that burdens the public's access to justice, including the adoption of a tax on legal services.