



AMERICAN COUNCIL OF ENGINEERING COMPANIES

# SALES TAX ON PROFESSIONAL SERVICES

*A Legislative Guide for  
Member Organizations*



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## Introduction

**This legislative guide was created by ACEC to assist its Member Organizations in their efforts to oppose the imposition of a state and local sales tax on professional services.**

**This legislative guide is a compilation of new materials crafted by ACEC, as well as materials from past campaigns against professional service taxes. The guide includes a fact sheet, white papers, talking points, articles, studies, and correspondence on the issue.**

**ACEC will continue to send new products to add to this guide as they become available. ACEC encourages the Member Organizations to continue to send letters, testimony, bills, strategies, and other materials that can help others fight against a tax on professional A/E services.**



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## Overview

The deteriorating budget situation in the states has left many governors and state legislators pondering the imposition of new taxes on professional services, including A/E services. History has proven that taxing professional A/E services is very difficult to administer and fails to generate expected revenue. Not only does a sales tax on professional A/E services fall short of government expectations, but it also places a large burden on the A/E firms that design America's critical infrastructure.

In 2002, five states (OK, FL, NC, AZ, TN) faced the threat, and were able to defeat, implementation of taxes on professional A/E services. However, as many as 20 states are expecting legislation in the 2003 that would impose a sales tax on professional services.

Currently, only Hawaii, New Mexico, and South Dakota levee a sales tax on professional services. Two states, Florida and Connecticut, implemented a professional services sales tax during the 1980's only to repeal them due to public outcry.

### **What ACEC Is Doing To Help MOs**

- Disseminating testimony, articles, studies, and talking points on the issue.
- Participating in information sharing with trade associations at the national level.
- Providing financial assistance (Minuteman Fund) to the states battling the issue.
- Coordinating information sharing between State Member Organizations.
- Publishing article/news/position statements in opposition to the legislation.
- Using the models of Florida and Connecticut to show that the tax does not work.



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## Fact Sheet

### ISSUE

ACEC is opposed to the concept of levying a sales tax on businesses that provide professional services to their clients. Such taxation is regressive, inhibits competition, and is inherently difficult and burdensome to administer. Service taxes are generally applied at a uniform rate for all service providers within the taxing jurisdiction. Smaller firms suffer under such an arrangement, particularly for gross receipts taxes. Additionally, large firms often have the capability to provide comprehensive services in-house, while the small firm must rely on consultants, thus adding to their tax burden.

### KEY POINTS—Professional Service Taxes...

- Historically have failed to generate the amount of revenue expected prior to their implementation.
- Put in-state firms at a competitive disadvantage because out-of-state firms will be able to offer the same services without having to collect a sales tax.
- Will drive in-state firms to seek out-of-state work.
- Are difficult to administer and could lead to double and triple taxation on any given project.
- Would require a new level of bureaucracy needed by state governments to implement and enforce the tax.
- Will hurt the profitability of firms as they may be required to pay the tax on services before payment is received from the client.
- Would be detrimental to small firm owners.



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# Talking Points/Tactics

## TALKING POINTS

1. Imposing the state sales tax will drive professionals out of the state and limit the competitiveness of those remaining.
2. Firms outside the state would deliver services into the state, taking business from local firms with the state unable to enforce the tax except at greatly increased collection costs.
3. Small firms are hit particularly hard by this type of tax attendant regulation and filing. It may drive them out of business. Economics of most areas are dependent on small business.
4. Approximately 52% of all engineering fees are from traditionally exempt users (i.e. governments), thus revenues would be minimal.
5. It will be an administrative nightmare to determine where services took place. Unlike a product where point-of-sale can be identified, design consulting services are performed by many people in many locations.
6. Almost all professional firms (i.e. attorneys, accountants, engineers) pay taxes on a cash basis of accounting. Bills from consulting design professionals would have to reflect sales tax. Thus, the sales tax would be on an accrual basis of accounting. Result: the tax would have to be paid before the cash is received. This would be a serious burden on all consultants, especially smaller businesses.
7. The definition of what services are taxable becomes unenforceable without considerable state staff build-up. This adds to the regulatory burden and further offsets any net gain to the state.
8. The state imposing the tax would be perceived as anti-service oriented and placed at an economic disadvantage to other states.

## LESSONS AND TACTICS

1. Including the advertising industry on a coalition gains access to the media.
2. Coalitions of lawyers, accountants, veterinarians, advertising firms, medical practices, and like professionals can be very powerful.
3. The double tax on professions (i.e. sales tax plus an income tax) is inflationary. It may be more effective to simply raise income taxes.
4. Sales taxes may create vertical integration of design firms for the wrong reasons, to wit: taxes.
5. Design firms must support taxes that are reasonable and appropriate for state and local needs.
6. The tax should be widespread, neither focused on nor exempting a given group. Once a group is exempt, all groups tend to want to be exempt.



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## Nexus (Point of Sale)

### DISCUSSION

There are three possible points of sale for design service transactions: the design firm office, the client's office, or the project site.

The problem arises from the fact that these three possible locations are not always within the same tax jurisdiction. In fact, it is common for design firms to perform services for out-of-state clients and/or for out-of-state projects.

**Nexus = Location of Design Firm** If the point of sale (Nexus) is the design firm office, local firms would have to charge owners for all services, both local and out-of-state, while firms located out-of-state would not have to charge sales taxes, even on local projects. This would place local firms at a competitive disadvantage to out-of-state firms. Not only would in-state fees be higher because of the tax on services, but their base fees would be higher because the firms would have higher overhead rates based on administration of the tax.

**Nexus = Location of the Client** If the client, design firm, or project site are located in different areas of the state, or different states then problems will arise. Assessing the tax based on the client's location could mean that a state would be required to collect a tax from an out-of-state design firm. It would also mean that in-state clients would be charged at a higher rate, not only because of the tax, but because of overhead rates associated with administering the tax. In short, clients would be charged more for building their infrastructure in a state with a tax on professional design services. Hence, large corporations that invest heavily in infrastructure may decide to move their business out-of-state. The resulting migration of businesses out-of-state could further harm the state's economy.

**Nexus = Location of the Project** A first glance, assessing a tax on professional services based on the project location makes the most sense. However, there are some serious drawbacks. Again, the state would be required to collect a tax from out-of-state firms that performed work on in-state projects. The state would not be able to collect a tax on projects in which the client and design firm are located in the state, but the project site is out-of state.

### CONCLUSION

By nature, design services do not have to be provided by a local supplier. Design services can be and are performed anywhere in the world. Most major projects draw competitive firms from all over the country. Additionally, design firms try to serve their clients wherever their clients' projects are located. It is very common in the design community for the client, design firm, and project location to be located in different states, and often, in different countries. Regardless of where a tax on design services is assessed, collection and administration of the tax would be cumbersome. In addition, the tax would severely hinder in-state firms ability to compete with firms from other jurisdictions.



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Sales Tax on Professional A/E Services

The list below is a sample of announcements, over the course of a few days, of design firm selection on major projects. It indicates how frequently design services are sold across state lines, with multiple jurisdictional issues raised on taxability.

**California** - Thompson Centulett & Stainback Associates, Atlanta, Ga., completed preliminary schematic drawings for 1,500-space parking structure located at 500 E. Ocean Blvd. in Long Beach. The four-story, approximately 511,000-sq-ft structure is planned by City of Long Beach Redevelopment Agency. Estimated cost, \$15 million. Construction start tentatively scheduled for fall 1991.

**Connecticut** - Alan Lapidus Associates, completed construction documents and Desimone, Chaplin & Dobryn, is structural engineer. Both New York City based firms are working on the new eight-story, 296,000-sq-ft Vivatat institute to be built on 86.7-acre site on Rte. 34 near Maltby Lakes in West Haven. The

new facility will include 500 suites for persons recovering from heart ailments, an educational facility and health club. Planned by Sursum Corda Pavilions, New York City.

**Florida** - RTKL Associates Ind., Fort Lauderdale and Skidmore Owings & Merrill, Washington, DC., are architects for phases 2 and 3 of the three-phase Crocker corporate center, which will include office buildings and drive-in bank located at northwest quadrant of S. Federal Highway and S.E. Second St. in Fort Lauderdale. Planned by Crocker Tower Associates inc, Boca Raton. Estimated cost, \$23 million. Phase 2 construction start scheduled for 1993-1995 and construction of phase

3 tentatively scheduled for 1995-1997.

**Florida** - Ramp Engineering Associates, Manhasset, N.Y., is preparing for a new parking garage at the Raymond F. Kravis Center located in Vicinity Okeechobee Blvd. east of the FEC Railroad in West Palm Beach. The 1,012-car parking garage is planned by the City of West Palm Beach. Estimated cost, \$10 million.

**Massachusetts** - The Irving, California based firm Fluor Daniel Inc. has been retained to provide preliminary engineering for the Island End 23-Mw cogeneration facility located at 156 Rower St. in Everett. Planned by Cabot Power Corp., Boston. Total project cost, \$200 million. Filed for ENF approval with possible construction in fall 1992.

**Montana** - The Denver, Colo. office Stone & Webster Engineering Corp., a subsidiary of Stone & Webster Inc. of New York City, has

been awarded a \$3-million contract to provide engineering and construction management services for a new coal drying and cleaning demonstration plant at Western Energy's Rosebud mine located near Colstrip. Planned by Western Energy Co., division of Entech Incl., Butte. The plant would produce approximately 500,000 tons per year of upgraded, synthetic bituminous coal. The U.S. Dept. of Energy, through the Clean Coal I Technology Program, will finance up to \$34.5 million of the cost of the five-year demonstration project.

**New Jersey** - Architectural Resources Cambridge Inc., Cambridge Mass., is architect for addition to laboratory located at One Malcolm Ave. in Teterboro. Planned by Metpath Facilities Planning Dept., Teterboro. Estimated cost, \$5 million to \$10 million. Construction start anticipated for spring 1991.

**Example of Sales Taxation Problem**

Design services are able to be provided from any place in the world and are often combined with many other services into a single service contract.

As shown in the following article, one design project includes companies from three nations and in addition to A/E services, the single contract includes purchasing management services, project management, construction and equipment design and installation management.

Any sales tax on design services must address international jurisdiction on point of sale and clearly define the services that are taxable.

Ford builds new paint plant in Ontario  
Ford Motor Co. of Canada Ltd., will spend \$439 million, its largest capital investment ever, to build a new 800,000-sq-ft paint facility that will be connected to its existing, 2.4-million-sq-ft auto assembly plant in Oakville, Ontario. The three-story addition is expected to be completed by May 1992. Last month, Ford awarded the construction contract to for the job to a joint venture of Fluor Daniel Inc., Greenville, S.C., and ABB Flakt Alpha, of Sweden. Fluor is providing the engineering, procurement, construction and project management for the building. ABB is managing all of the internal equipment installation and coordination.



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### An Example of the Uncertainty of Sales Tax Transactions

The accompanying article illustrates some of the difficulties of applying sales taxes to design services. In this instance, the proposed project is a new convention center. Facts on the project include:

- √ The county has unofficially established an authority to explore the feasibility of building a new convention center.
- √ Six developers have proposed the facility be located on their property.
- √ Of the six developers, four are local companies, the other two have no in-state offices or employees.
- √ Of the six developers, four used architectural firms to study the feasibility of the project and prepare proposed concepts.
- √ One of the developers used an accounting firm to prepare the feasibility study.
- √ Of the four architects, two have local offices. The other two have no in-state offices or employees.
- √ Of the four architects, one was paid by the developer for services rendered, one will be paid if the proposal is accepted, one will be paid if the proposal is unsuccessful, and the fourth will not be paid and hopes it will be selected if its proposal is accepted. The accounting firm will be paid for its work.

Owners of the Galleria Specialty Mall have enlisted one of the world's premier architecture firms in their bid to land the \$55 million Cobb Convention Center.

Childress-Kline Properties wants to erect a convention center adjoining its mall on Cobb Parkway and Interstate-285, said company spokesman Tad Leithead on Thursday.

The Leo A. Daily Co., of Washington D.C., has drawn plans for a 110,000-square-foot exhibit hall and a 2,000-seat performing arts facility, said project manager Rick LaRosa of the firm's Cobb County office on Thursday.

Those specifications were included in a request for proposals sent out this week by the Cobb Coliseum and Exhibit Hall Authority.

The project options include:

- √ The successful developer will build the project on a turn-key basis for the authority.
- √ The authority will build the facility in the normal process of government design and construction.
- √ The authority will be officially created as a joint venture with the developer to build the facility.
- √ The project may proceed at a totally different site than any of the proposals.
- √ The project may not be built.

The desired completion date is six years from the beginning of the process. Note that the authority is presently unofficial, and its status as an official government agency is also contingent on future decisions on the feasibility of the project and the best method for accomplishing the project.

This example clearly illustrates the difficulty of writing a sales tax law since the types of firms are different, several of the participants have no local tax presence, the future events in the project are not definable, and the period of time involves several years.

How can a sales tax treat all of the transactions fairly?



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## Sale for Resale (Pyramiding)

### DISCUSSION

Most general sales tax laws provide a tax exemption for goods that are used without substantial change, in a product that is sold to another user. The most common example is wholesalers selling goods to retailers who in turn sell the goods to a final user. These sale for resale provisions are intended to avoid the pyramiding of taxes and result in goods and services being taxed only once, when they pass from the end of the manufacturing/distribution chain and are sold to the final user.

A/E and related design firms conduct their business in a manner that does not easily fit within the guidelines of typical sale for resale exemption.

### FACTS

It is normal for several firms to team up to design a project. Typically, one firm will be the 'prime' design professional, with the other team members acting as subconsultants.

The overall level of subconsulting within the profession is 30%. Only the smallest projects do not have multiple providers. The biggest construction projects will have 15 to 20 firms with up to five tiers of contractors.

Design service providers also typically purchase goods and services other than design services for part of the project. Examples include computer services, testing, temporary employees, airfare, printing, models, lodging, rental cars, shipping, and telecommunication services. These are routinely incurred on almost all projects, by all tiers of contractors.

Without close regulation of the tax, double or triple taxation on a single project is possible. This means that as an individual service is passed from prime contractor to subcontractor, and maybe to an additional subcontractor, the tax may be applied at all levels.

In addition, a prime contractor's gross receipts for a particular project may not illustrate how much money the prime paid out to subcontractors. This makes it very difficult to determine how much tax is owed by the prime contractor.

### CONCLUSION

Failure to allow sale for resale exemptions will impact small business enterprises (SBEs) most heavily, as they are more likely to team with other firms than large full service firms.

Failure to allow sale for resale exemptions on all project costs results in tax pyramiding as each level of contractor has to charge sales tax. This is a more significant concern to SBEs.

Placing detailed administrative rules on sale for resale exemptions (formal certification for each project, itemized invoice requirements) results in heavy administrative burdens on all firms.



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# Local Option Sales Tax

## DISCUSSION

Many states allow cities, counties, or other local jurisdictions to add a local option sales tax in addition to the statewide tax.

Since design firms commonly provide services beyond the boundaries of their local tax jurisdictions, potential problems arise, including:

- Firms may be required to tax projects at different rates based on the local jurisdiction if project taxability is based on project site.
- Firms may be at a competitive disadvantage to firms in adjacent local jurisdictions if the taxable status is determined by the location of the design firms.

If firms are taxed based on the project site, extensive reporting requirements would be required (examples: New York State has 86 separate local sales tax jurisdictions, the Atlanta SMSA has a dozen different sales tax jurisdictions, and the Direct Mail Association has identified 7,000 local sales tax jurisdictions).



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# Reporting and Payment

## DISCUSSION

Many states require sales taxes be reported at the time of sale on a monthly basis. This is effectively an accrual basis tax. This has the effect of requiring design firms to report and pay sales taxes at the time of invoicing rather than at the time of collection.

## FACTS

Over 80% of all design firms use cash basis for tax reporting.

Twenty-percent of all design firms use only cash basis accounting in their firms.

The firms using cash basis accounting are predominantly small business enterprises (SBEs) and therefore, an accrual sales tax requirement will impact small firms more heavily.

The average elapsed time from performance of work to collection of fees is 96 days. Accrual basis sales tax reporting would force firms to pay taxes up to three months before collecting from clients. This forces firms, especially small firms, to produce funds they do not currently possess.

Approximately 15% of all design fees are performed on a contingent fee basis, where actual fees are not determined until a future time (typically, percentage of construction cost). The actual amount of taxes due often cannot be determined until cash is actually received.

Laws requiring accrual basis tax reporting often only allow reduction of taxes due to bad debts when the account is written off on the federal tax return. Cash basis tax reporting does not allow the write-off of bad debts. Therefore, taxes would have to be paid on bad debts for the 80% of firms using cash basis tax reporting.



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# Exemptions

## DISCUSSION

In traditional goods-based, retail sales taxation, it is normal for almost all transactions to be subject to the sales tax. Thus, the transactions not subject to taxation are subject to additional documentation in order to verify that the exemptions are proper.

While this basis of documenting tax transactions is appropriate in a business where the great majority of transactions are taxable, A/E services will not fall into this category.

## FACTS

Typical sales tax laws exempt governmental units from paying sales tax. Also exempt are educational, charitable, and religious purchasers.

Government sector clients typically represent 50% of all use of A/E services. The other typically exempt purchasers represent 10% of A/E sales. Thus, the typical firm would be faced with the additional documentation requirements for the majority of its sales to final users.

Additionally, the heavy volume of subcontracting as multiple firms team to perform a project will create a significant additional volume of documentation requirements for exemptions if sale for resale non-taxable status is allowed. Other direct project purchases also may create heavy administrative burdens if detail exemption paperwork requirements are included.

Since A/E services are not always sold within the local tax jurisdiction, an additional portion of sales will not be subject to local sales tax.

Some states (Massachusetts, Florida) enacted, and have since repealed, laws requiring each exempt sale to be documented with a copy of the purchaser's exemption certificate. The ill-fated Florida services sale tax included a different type of exemption certificate for tax exempt users, out-of-state users, and sale for resale exemptions, creating a very significant burden on design firm administration and costs. Massachusetts enacted separate exemptions for traditionally tax exempt users, sales for resale, small business purchasers, individual (non-business) users, and an annual exemption for all users on the first \$20,000 of taxable services purchases. Each exemption is documented differently, creating an enormous administrative burden for firms.



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# Revenue Estimates

## DISCUSSION

Several states that considered sales taxes on design services in the past developed estimates of the revenue gains through the use of faulty logic or assumptions on the value of services to be taxed.

The use of this misinformation resulted in widely overstated estimates of the revenues the state can expect to receive.

For example, in 2002 the Oklahoma Legislator and Citizen Task Force on Tax Reform used Census Bureau data to develop their estimates. There were two inherent flaws in the assumptions made by the Task Force:

1. Census Bureau data is the reported revenue of professional design services by firms located in Oklahoma, not the value of professional design services on projects in Oklahoma. This data is inaccurate because it assumes taxes would be collected on projects done within Oklahoma and elsewhere. However, if the tax were levied based on project location, out-of-state projects would be tax exempt resulting in overstated revenue predictions.

2. The Census Bureau data used for revenues that would be subject to the tax is gross revenues, including subcontractors. Thus, subcontractor revenues are double counted. First when the subcontractor reported its actual revenue, and second when the "prime" contractor reported its revenue including that paid to the subcontractor.

A 1991 study by PSMJ Resources, Inc. showed that 52% of fees for engineering services are paid by government. "Government" includes federal, state, county, local governments and other political subdivisions including school districts, public colleges and universities, water districts, public trusts, etc. Should government be exempt from paying a tax on professional design services the revenue generated would be tax exempt, thus further inflating estimates.



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## Conclusion

ACEC is opposed to the concept of levying a sales tax on businesses that provide professional services to their clients. Such taxation is regressive, inhibits competition, and is inherently difficult and burdensome to administer. Service taxes are generally applied at a uniform rate for all service providers within the taxing jurisdiction. Smaller firms suffer under such an arrangement, particularly for gross receipts taxes. Additionally, large firms often have the capability to provide comprehensive services in-house, while the small firm must rely on consultants, thus adding to their tax burden.

Assessing a tax on professional A/E services is extremely difficult for government to achieve. Tax reporting procedures could lead to firms having to pay taxes on revenue they have not yet, or may not ever, receive. Furthermore, taxes on professional A/E services have historically fallen short of expected tax revenue. The revenue shortfall coupled with the large bureaucracy state governments would have to create to administer the tax should further deter legislatures from attempting to implement a tax on professional A/E services.

### KEY POINTS

1. The tax will drive in-state design firms out of the state and limit the competitiveness of those remaining.
2. The tax will allow out-of-state firms to deliver services at a cheaper rate, effectively taking business from local firms.
3. Filing and administrative burdens of the tax would be especially detrimental to the small design firms that help drive the local economy.
4. Historically, revenue shortfalls and administrative costs associated with the tax have led to its repeal.
5. It will be an administrative nightmare to determine where services took place. Unlike a product where point-of-sale can be identified, design services are performed by many people in many locations.
6. The definition of what services are taxable becomes unenforceable without considerable state staff build-up. This adds to the regulatory burden and further offsets any net gain to the state.
7. The state imposing the tax would be perceived as anti-service oriented and placed at an economic disadvantage to other states.