

PROFESSIONAL SERVICE TAXES: What Architects Should Know

**The American Institute of Architects
State and Local Government Advocacy**

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*** Original research for this project was completed in 1992. Updated in 2004.**

I. What is a Professional Service Tax?

Introduction

Taxes on professional services are levied in seven states and a scattering of municipalities. A state has not enacted a broad-based expansion of the sales tax to services since Massachusetts in 1990 and Florida in 1987 (both were subsequently repealed). However, recent budget problems have hit the states hard. States' growing expenditures and weak revenues will keep states in a tight fiscal condition for the next few years.

The double hit on financially strapped states has sent legislators looking for new sources of revenue. For many legislators, the burgeoning service sector is an attractive target. As the fiscal crisis continues, it is not likely that interest in professional service tax legislation will subside any time soon.

Background

A professional service tax may have several labels depending on how the tax is applied or how the tax is collected. In general, however, taxes on professional services follow a formula based on a percentage of gross receipts. The taxes may apply to both professionals with offices within the jurisdiction and professionals with offices outside of the taxing jurisdiction but who provide services within it. Cities and states usually base their taxing authority on laws permitting sales and use taxes, so the tax may be on the provider of the services (gross receipts tax) or user of the services (general sales or use tax).

Although only a few states and municipalities tax professional services, the tax laws in others could be amended to include professional services. The states that already tax some professional services could attempt to expand that coverage to include architectural services.

Different Types of Taxes

As mentioned earlier, there are several types of professional service taxes levied in the United States. Here are a few general types of service taxes:

Gross Receipts Tax: A tax applied at a uniform rate on the gross receipts or sales of a firm. A gross receipts tax is applied on the **vendor**. This type of tax is applied at all levels of manufacturing or transactions between businesses and thus can tax a service or product several times.

General Sales Tax: A tax applied at a uniform rate on the dollar value of a broad range of transactions, mostly retail sales. Unlike the gross receipts tax, the sales tax is picked up by the **purchaser**.

Value-Added Tax: A tax applied at a uniform rate on the value added to a product or service at a specific stage of the manufacturing or production process.

II. Experiences With the Professional Service Tax

Attempts to tax professional services have been, if nothing else, steady in recent history. In the last decade alone roughly 20 states considered some version of the tax. Proposals came from a variety of sponsors: governors, mayors, legislators, budget committees and study groups charged with solving budget crises.

Although most proposals were either scrapped or met defeat in the legislature, the few bills that did pass drew enormous attention. In some cases, where the outcry was particularly great, court action and repeal efforts were initiated. This section is a sampling of experiences with professional service taxes in states as well as cities.

The Florida Experience

In 1987 Florida Governor Bob Martinez pushed through the most far-reaching tax on services the state and nation had ever seen, a 5 percent levy assessed on services as diverse as pest control, employment agencies, and, of course, architectural services. The tax had three basic components: an extension of the tax to services generally consumed by individuals; an extension of the tax to certain services consumed by business; and the application of a use tax on business services.

Perhaps the most eminent service taxed, one which many believe led to the eventual repeal of the legislation, was advertising. The Florida law attempted to tax advertising revenue from all mediums -- billboards, magazines, newspapers, radio, and television. In the process, it created a firestorm from national advertising groups, some of which pulled their ads from media outlets in Florida. This in turn led to massive opposition from media outlets, which lost ad revenue.

While the plight of advertisers gained the most notoriety, it was surely not the only problem brought on by the tax. On the contrary, the Florida tax seemed to underscore all that was wrong with taxing services. One major concern was the tax's pyramiding effect. For example: An architect "purchasing" consultant services was required to pay tax on those services. However, the consultant services were taxed again when the client was presented with the fee for the entire project. The double tax or pyramiding effect was later remedied in a "glitch bill," developed in part by the Florida Association/AIA.

Another concern for architects was the retroactive assessment of taxes on projects started before the tax was enacted. While a grace period of one year was allowed for completing such projects, the Florida Supreme Court issued an advisory opinion insisting that a "statute which retroactively turns otherwise profitable contracts into losing propositions is clearly . . . prohibited."

The Florida law lasted only four months before Martinez pushed for and subsequently won a repeal. In retrospect, it appears that Florida's biggest blunder was the scope of the tax. By drafting such an inclusive bill, the legislature managed to mobilize a vast army of opposition all at once, thereby ensuring the tax's defeat.

As much as the Florida law was heralded as an example of how not to draft a service tax bill, it was equally prominent in drawing national attention to the service sector as a possible source of revenue. Also, by examining what went wrong in Florida, legislators in other states had a much clearer concept of what a successful service tax package might include.

Taxing Services in Connecticut

In 1982, the Connecticut legislature extended its sales tax to include nonprofessional services. Among those taxed were interior designers. In voicing their opposition, interior designers claimed the law tilted the playing field in favor of architects, who were exempt. The legislature was unsympathetic and the tax remained. The Connecticut economy was strong, and legislators felt a modification or repeal of the law unnecessary. However, in 1988 the budget picture in Connecticut dimmed, and the state was forecasting a deficit. As the legislature searched for cash, the issue of taxing all services surfaced again. In 1989, the legislature passed a \$900 million tax package that included an 8 percent tax on architectural services.

The law generated loud opposition from the Architectural/Engineering (A/E) community for several reasons. Architects felt that the last thing a slumping building industry needed was an increase in the cost of architectural services that would result from a service tax. Furthermore, the law was extremely complex, particularly in the area of taxing reimbursable expenses. But what really concerned architects was the administration of the tax. For one, the tax was collected on an accrual basis 30 days after the billing date. Not only did this arrangement place the responsibility of collecting the tax with the

architect, but it also required the architect to pay the tax after 30 days whether or not the design fee had been collected from the client. Additionally, if a design fee remained unpaid, there was no mechanism in place for the architect to get a refund on the tax. The regulations provided only one solution: turn in delinquent clients to the department of revenue -- not a great method of generating repeat business.

Connecticut architects also pointed out several loopholes in the law. For example, while the tax applied to any architect who designed a project built in-state, tax administrators found it difficult to pursue an out-of-state architect who failed to pay the tax. Further, the billing process of design/build enabled contractors to hide the exact cost of A/E services, thus potentially lowering the tax liability of design/build firms.

In 1991, facing an enormous budget deficit, newly elected Governor Lowell Weicker repealed the tax on architectural services and in its place enacted the state's first income tax.

Michigan's 'Single Business Tax'

In 1975, the Michigan legislature enacted a much more complicated version of the professional service tax, a "Single Business Tax." The SBT is not a tax on gross receipts but a value-added levy that is computed with a formula that includes compensation, profits, depreciation, and interest.

The tax is levied on all forms of business and professional activities, both incorporated and unincorporated. The system, however, allows professionals a 10 to 20 percent credit on their state income tax.

In enacting the tax, the Michigan legislators were attempting to create a "better climate" for industry in the state by offering capital investment credits and, at the same time, transferring the tax burden to service-oriented businesses. The Michigan House of Representatives and the governor were strongly in favor of this proposal. Since the tax was established to cover all Michigan businesses and to replace an array of individual business taxes, Michigan A/Es could not argue inequity.

Michigan architects and engineers became involved early, consistently opposing the tax in committee hearings and through letter-writing campaigns, while other professionals -- doctors, lawyers, dentists, accountants, etc. -- remained aloof. Eventually all the professions combined to present an alternative

proposal, but it proved unsuccessful.

Chicago: The Service Tax Goes to Court

During the summer and autumn of 1981, architects and other professionals working in the city of Chicago faced an attempt to place a tax on their services.

Mayor Jane Byrne and her aides decided that taxing professional services would be a simple and straightforward way to increase revenues. They estimated that the city coffers would collect an additional \$110 million to help maintain the financially troubled Chicago Transit Authority and to help safeguard the city's credit rating. The City Council agreed, approving the "Chicago Service Tax Act" on July 20, 1981. The tax went into effect on August 1, 1981.

Description. The Chicago Service Tax imposed a 1 percent levy on the price of a service purchased in the city of Chicago. The tax, imposed on the purchaser, e.g., client, was to be collected by the seller.

To be considered taxable, the service had to be provided for "valuable consideration"; employee to employer services were excluded. The tax was imposed on the gross receipts from the sales of services, without deduction for the costs incurred in providing the service.

To be taxed, a service had to meet both of the following conditions:

- the service provider or purchaser had to be within the city limits during the transactions; and
- at least 50 percent of the service had to be rendered or used in the city.

If these conditions were met, the entire transaction was taxed; if they were not, none of it was. The seller of the service was obliged to collect the tax and remit it to the city. Each seller was required to obtain a Certificate of Registration as a service tax collector, with each applicant required to furnish a bond disclosing net assets. It was one of the most sophisticated attempts to tax professionals.

First Reactions. Members of the professional organizations in the city immediately gathered to plan their strategy for fighting the action. The group was told by legal representatives that a coalition of business leaders had met with Mayor Byrne four days

earlier. She had affirmed her commitment to using the tax as a means of producing revenue, in spite of their expressed concern that the tax imposed a hardship on only a select group of professionals.

Deciding that a joint suit by all the professions would be strongest, each group committed \$5,000 to \$10,000 to the fight. The lawyers provided their services pro bono.

Subsequent Court Action. At the initial appearance before the Circuit Court of Cook County, Judge Richard Curry ruled against the plaintiffs. Curry commented that the Chicago Service Tax was not unprecedented as claimed, but was a "pure sales tax and nothing more," and that "nothing in this tax supports the conclusion that the tax is on a given occupation," an action specifically prohibited by the revised 1970 Illinois constitution.

After the August 31 decision upholding the tax, the plaintiffs appealed to the Illinois Supreme Court, where they successfully argued for the court to enjoin the city from imposing penalties for nonpayment of the tax until a decision was reached.

The arguments they presented to the court included:

- The tax was extraterritorial and not within the jurisdiction of the city.
- The tax was either an occupation or income tax, neither of which the city has the power to impose.
- Because the commodities and securities industries were exempt, the tax discriminated against one set of service users (an equal-protection claim).

On November 16, 1981, the Illinois Supreme Court declared the 1 percent tax on services unconstitutional by a four to three ruling. Explaining its vote, the court commented: "We cannot uphold the ordinance without violating the clear limitation of Article VII, Section 6(e) of the Constitution, which requires authorization by the General Assembly before a home rule unit (such as Chicago) can impose a tax upon occupations."

The judges also cited the record of the Constitutional Convention's Committee on Local Government. The majority of the committee felt that "the limitation on a home rule unit's authority to tax occupations was necessary to (1) prevent an evasion of the limitation on home rule units' authority to impose a tax

measured by income or earnings, and (2) to prevent a proliferation of taxes on various businesses and occupations at local levels which could impair the efficient operation of business within the state, believing that by vesting the authority to authorize such taxes in the General Assembly, these consequences should be controlled on a state-wide basis."

III. Component Action and Response

Arguments Against Professional Service Tax Legislation

Here are several arguments that have been used by architects and other professionals to dissuade government officials from extending taxes to the professional service sector. Not every argument can be applied to all service tax proposals, so consider your legislature's proposal when preparing your arguments.

1. Professional service taxes may be unconstitutional/illegal because:

- A professional service sales tax has a narrow tax base that applies to only a select class of persons. If your state also has a personal income tax, this is double taxation on the professional.
- A sales tax on professional services may exceed the taxing authority of the jurisdiction as provided in the state constitution or other applicable laws and court rulings. (In Chicago and Washington, D.C., professional service sales taxes were declared unconstitutional.) This applies primarily to city and county taxes on services; however, professionals should also research constitutional provisions when a state legislature is considering a tax.

2. The tax is inequitable compared to taxes in other jurisdictions. You may claim that the rate of taxation is burdensome as compared to that of other jurisdictions.

3. If the tax applies to firm principals living outside the taxing jurisdiction, the proposal could be fought as a "commuter tax."

4. In order to avoid the tax, more clients will resort to using nonprofessionals, which clearly conflicts with the goal of state laws that require licensing of design professionals to protect the health, safety, and welfare of the public. The tax, in addition, would deter nonregistered individuals from becoming registered professionals.

5. The tax may adversely affect the quality of the built environment.

➤ More clients will hire nonregistered individuals (see preceding argument), which will reduce the quality of both design and construction in the state.

➤ The tax will encourage re-use of old plans to cut costs, thereby reducing new and innovative building design.

6. Multistate firms can attract business in a state with a professional service tax and then farm the project out to one of their out-of-state offices. Not only will this practice escape revenue officials, but it will also put the small firm at a clear disadvantage.

7. The tax will favor out-of-state firms that will not be subject to the tax. Since architectural services are high-cost items involving long-term capital expenditures, more clients will turn to out-of-state firms to avoid paying the tax. Even if the tax is applicable to out-of-state firms, the state would find it difficult to collect. (Cite in-state projects already done by out-of-state firms, using statistics if possible.) This will be particularly detrimental to small firms, which tend to rely primarily on in-state business and must already compete for in-state projects against larger out-of-state firms.

8. The tax will produce much less revenue than expected:

➤ The tax may encourage architects and other professionals to relocate their businesses out of state to avoid paying the tax, resulting in substantially lower tax revenues than projected.

➤ Revenues will be offset by the cost of additional administration, enforcement, and litigation.

➤ The many ways of avoiding the tax and the decreased use of architects' services will lead to significantly less revenue than estimated.

9. Architects can pass through as much as 45 percent of their gross revenues to consultants on any given project. The structure of a gross receipts tax can hold an architect liable for the tax on the consultant's revenue. The consultant can then be taxed on the fee after it is collected from the architect. Not only does this place a double tax on a portion of the design fee, but also requires a second party, the architect, to absorb the tax liability of another business. This can be particularly damaging to the smaller firm that relies

heavily on consultants for services that a larger firm may be able to do in-house.

10. Profitability rates are not the same for all professions. Therefore, applying a tax on gross revenues will place a disproportionate burden on professionals with lower profitability rates. This is particularly unfair to the architect with high pass-through costs.

11. Service businesses should be encouraged by the state, not taxed. By their nature, service businesses cost few dollars; they are clean and nonpolluting, and do not require a wide array of governmental services. In addition, the business and the employees constitute an important part of the local and state tax bases. Thus, the state should encourage service businesses to locate and expand in the state. In states that provide incentives for business and industry in the form of capital gains tax reform and liberalized depreciation allowances (or other incentives used in your state), proposing a tax on professional services is both contradictory and self-defeating.

12. A tax can adversely affect a consumer's purchasing decision. In the case of architects, where a fee can mean a significant outlay of cash, this additional cost could be an important factor in a prospective client's decision to forgo hiring an architect, or worse, not build at all.

13. Try to propose alternatives before support for a professional service tax proposal can gain strength. By examining your state's budget you may find that what is needed in your state is program cuts rather than base-broadening measures. Rate hikes in existing taxes can also be acceptable alternatives and are easier to administer because a collection mechanism already exists. However, if your legislature seems bent on taxing professionals, a one-time registration or licensing fee similar to that imposed in Texas in the late 1980s might be acceptable. Again, a review of your state's budget will help you determine what alternatives are best.

Organizing Your Opposition

Here are some specific actions taken by AIA components, along with other ideas for countering professional service tax proposals:

➤ *Have your members write their elected officials.*

Mobilize your members immediately. Many AIA components have established legislative contact systems that appoint specific members to contact specific legislators in writing or by telephone. Be sure

to send all members a memorandum alerting them to the problem, and include background information and/or a sample letter.

➤ *Find out who is really proposing the tax.*

Sometimes it will be apparent that a tax proposal on professional services is directly the product of one legislator or one regulatory office, but not always. Even if a bill has a sponsor, that sponsor may be proposing the tax for the governor (or mayor), a department head in the administration, or even an outside organization.

If it does prove to be an administration proposal, never assume that the governor or mayor is solidly behind it or even that he or she knows about it. And never assume that such a bill is "written in stone." The proposal may simply be a flag with which to measure potential opposition or support.

Again, an adequate component/government liaison structure can often stop a service tax proposal before it begins to wind its way through the legislative process and before the proposal's sponsor has made a total commitment.

➤ *Join forces with other professionals.*

In most cases, proposals to tax professional services have targeted not only architects, but also engineers, doctors, attorneys, dentists, accountants, and others. One of the first actions necessary is to increase your strength through numbers via a coalition. In one state the professions set up a multiprofessional "service tax committee" to monitor the proposal and determine actions to be taken on behalf of all the professional organizations.

➤ *Get a mandate from the AIA component board.*

Once you determine who is going to spearhead the attack and how the issues should be approached, go directly to your board of directors for official approval. A mandate from them is vital for your campaign to carry weight. Request an emergency meeting if necessary. Also request any funds needed for printing, mailing, lobbying, or legal assistance.

➤ *Call a special meeting*

Hold a special meeting with your membership to discuss the situation. Not only will this help educate your membership on the specific problem and its implications, but a meeting may also be a source of new ideas from members who are not a regular part of the leadership structure.

➤ ***Publicize your cause.***

If you become involved in a lengthy battle, you may want to prepare a press release and call a press conference. Invite television and radio news as well as representatives of related publications and organizations. A word of caution: Publicizing the problem will show the seriousness of your opposition to the proposal but will also open your argument up to the scrutiny of reporters, so be certain you have done your homework, tried to anticipate questions, and are prepared with statistics and visuals if possible.

➤ ***Prepare testimony.***

After the tax proposal is introduced, one of the first steps in the legislative process will be committee hearings. Ask to testify before the committee involved.

➤ ***Identify your supporters.***

Having the loyalty of one or more key legislators and officials can be most helpful. Try to find someone who is in a leadership role, is on the committee considering the tax measure, or is skilled in legislative maneuvering. A considerable amount of legislation is not defeated on consideration of merit but through political and parliamentary maneuvering. This can be done by holding up a bill in committee, by attaching it as a "rider" to another proposal, by adjusting the legislative calendar, or through simple legislative bargaining.

➤ ***Investigate "specifics" of the proposal.***

Investigate the methodology behind projected revenue figures and other applicable statistics. There may be fallacies in the proposers' assumptions and calculations. For instance, in estimating total revenue, have they taken into account tax avoidance, business lost to out-of-state firms, and exempt clients, e.g., government and nonprofits? This is also a good time to develop statistics of your own from members in your state. Include statistics such as the percentage of projects done out of state by member firms, percentage of loss on net revenues, and comparative studies showing any inequities in the share of tax burden between professional groups.

➤ ***Have your members contact clients.***

Professional service taxation also has a profound effect on architects' clients. Have your members contact their clients to get their support and involve them in letter-writing campaigns. It will broaden your constituency substantially.

IV. Jurisdictions Taxing Professional Services

According to the *2000 State Tax Handbook*, the following states tax architectural services:

State	Type of Tax	Rate of Tax
Delaware	Occupational License Tax	4/10 of 1%
Hawaii	Excise Tax	4%
Michigan	Single Business Tax	2.35% ¹
New Hampshire	Business Profits Tax	8% of net profits ²
New Mexico	Gross Receipts Tax	x% ³
South Dakota	Gross Receipts Tax	x% ⁴
West Virginia	Gross Receipts Tax	6%

¹ 2.35% of federal taxable income, with adjustments, allocated or apportioned to Michigan. The first \$45,000 of the tax base is exempt.

² Architects in New Hampshire may take a portion of their net income as "reasonable" salary and thus are not severely affected by this tax.

³ New Mexico's rate is levied on a county-by-county basis.

⁴ South Dakota's rate is levied on a city-by-city basis.

V. Conclusion

The economy of the United States has steadily grown away from its traditional manufacturing base. And as manufacturing declined, so too did the tax revenue generated from these enterprises. Conversely, the last several decades have seen unparalleled growth in the service sector. That spurt has made the service sector a victim of its own success, forcing legislatures to take a new look at the old philosophy of not taxing services.

Unfortunately, while tax revenues have been shrinking, the cost of state programs has skyrocketed. The states' share of Medicaid, for example, rose from 12 percent of the state budget general fund in fiscal year 1995 to 16.3 percent of the state budget general fund in fiscal year 2004. Twenty-six state legislatures plan to overhaul their public education systems during the 2005 legislative session because their systems are inadequate. And the federal government has backpedaled on funding to the states, requiring them to pick up even more of the tab for programs and services.

All this has led state legislatures on a search for revenue. And, as could be expected, professional service tax proposals have steadily increased.

AIA components have responded in kind with aggressive lobbying efforts that, for the most part, have been successful. But budget problems are not likely to go away soon, so many components may find themselves battling professional service taxes this year.

This publication is meant to provide a broad overview of the professional service tax issue. It is not a comprehensive resource guide, but rather a starting point to help components learn basic service tax information and begin to map their legislative strategy. For further information and additional materials, please contact *State and Local Government Advocacy* at 202-626-7373.