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Date: Mon, May 5, 2014 at 3:40 PM

Subject: AIA|LA Supports Gross-Receipts Business Tax Reform :: Take a Bold Step to Ensure Longterm Fiscal Health for the City

To: Councilmember Mitchell Englander

<Councilmember.Englander@lacity.org>, councilmember.krekorian@lacity.org, Council Member Koretz <paul.koretz@lacity.org>, councilmember.bonin@lacity.org

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Councilmember Paul Krekorian - Chair, Budget and Finance Committee

Councilmember Mitchell Englander

Councilmember Paul Koretz

Councilmember Bob Blumenfield

Councilmember Mike Bonin

Los Angeles City Council - Budget & Finance Committee

200 N. Spring Street, Room 435

Los Angeles, CA 90012

RE: AIA|LA Supports Gross-Receipts Business Tax Reform :: Take a Bold Step to Ensure Longterm Fiscal Health for the City

Dear Councilmembers Krekorian, Englander, Koretz, Blumenfield and Bonin:

On behalf of the Los Angeles Chapter of the American Institute of Architects (AIA|LA) and the 3200+ design professionals that we represent, we are writing to share our strong support for **Mayor Eric Garcetti's budget proposal**, which integrates a proactive first step to phase out the city's gross receipts business tax. In fact, we are confident that City Council will have *the fiscal wisdom to take an even bolder first step* and initiate the 15-year phase-out as recommended by the **Business Tax Advisory Committee (BTAC)**.

Along the way, AIA|LA offers several key reform recommendations that can be enacted now (during the 15 year phase out) that specifically address the business of leading an architectural practice within the City's borders.

Attached, please find "**Modifications to the Gross Receipts Business Tax**" (PDF) for your review and consideration.

Business Tax Reform will:

- Stimulate job growth.
- Encourage businesses to locate, expand and remain in LA.
- Catalyze a more prosperous region.
- Nourish and sustain the City's revenue stream with increased economic activity from new and expanded business.
- Modernize a compelling narrative to market Los Angeles worldwide.

The City of Los Angeles offers its citizens an invaluable array of services, which must be sustainably funded well into the future to ensure the vibrancy and delight of Los Angeles as a world-class destination. Therefore, to generate the revenue streams essential to providing city services, proactive measures must be acted upon by city leadership that will facilitate the growth in revenue for a more prosperous city. The key mechanism to deliver that revenue growth is job creation, which will be a direct consequence of smartly phasing-out the

business tax and reforming it so that the City isn't unduly encouraging service professionals (especially architects) to locate their businesses elsewhere.

The City of Los Angeles' gross receipts business tax continues to be a major disincentive for job creation and for businesses starting up in, relocating to, staying in and/or expanding in the City of Los Angeles.

If Los Angeles is to remain a culturally vibrant, economically thriving community, the business tax needs to be gradually and responsibly phased out, as recommended by the BTAC and implemented in the Mayor's 2014/2015 budget proposal.

We trust that City leadership will take the bold step necessarily to reform and phase-out the business tax.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Andrea Cohen-Gehring', with a long horizontal flourish extending to the right.

Andrea Cohen-Gehring, FAIA
President, AIA Los Angeles

For more information, please contact:

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MODIFICATIONS TO THE GROSS-RECEIPTS BUSINESS TAX IN THE CITY OF LOS ANGELES

The Architectural Community has concerns with how the City of Los Angeles' Business Tax is levied. While it is the right of a city to levy taxes on its businesses, the manner with which this tax code is vague and confusing, resulting in subjective interpretations. As such, firms are being treated inequitably, are subject to double taxation, and where it may become financially beneficial for firms to locate outside of the City limits. The American Institute of Architects is seeking to assist the City in understanding the challenges Los Angeles-based Architects are facing and to develop alternative approaches to fairly implementing a business tax.

THE CHALLENGES

Due to the traditional contractual relationship Architects have with their clients, architectural firms typically have a wide range of independent engineers and specialty consultants as sub-consultants to their prime contract. Due to the current structure of the Los Angeles business tax as a gross receipts tax, an architectural firm is therefore obligated to pay business taxes on the billings of these consultants, even though the consultants' fees "pass-through" the architect to the consultant. In addition to the tax levied on the architect's gross receipts, the independent consultant is also obligated to pay tax on their gross receipts, resulting in double taxation.

There are instances where the architect may hold a consultant's contract but have no actual fee for their own firm. In these instances, the architect is still obligated to pay LA business tax on the consultant's fees, resulting in a cost to the architect but no revenue. Furthermore, even when the consultant is located outside of the City of Los Angeles and the work is done outside of the city boundaries, the City would otherwise have no right to collect business tax but the architect is required to pay the tax due to the fees passing through their firm located within the City of LA. Together these instances represent an explicitly unfair system that disenfranchises an important and growing service sector of our economy. The double-taxation encourages architects and related design professionals to relocate to neighboring communities like Culver City and Santa Monica where the architect is only taxed on their own net receipts. Additionally, the City has adopted a policy of providing tax holiday incentives for firms to relocate to Los Angeles, creating a disadvantage for firms that were already located in Los Angeles and which did not have the benefit of any tax holidays.

PROPOSED SOLUTIONS

In 2012, the Los Angeles City Council commissioned the Business Tax Advisory Committee (BTAC) to recommend ways to reduce and eventually phase out the gross-receipts business tax. Although much effort went into that plan, the recommendations of the committee have yet to be implemented. The architectural community is unified in its opposition to the double taxation on pass-through income and requests that the gross-



receipts tax be phased out promptly.

AIA|LA encourages city leadership to do the following:

- Create consistency and fairness in the administration of the business tax.
- Revise the requirement that architectural firms must pay tax on the same receipts on which their consultants are paying (double taxation).
- Revise the requirement for gross receipts so that printing costs and other similar reimbursed expenses are recognized as another form of a “pass-through” expense and are not taxed. Sales tax is already being paid on applicable vendor expenses and they should not also be treated as professional services.
- Clarify provisions for apportionment for services provided for Projects that are not located within the City of Los Angeles
- Incentivize high-value, service sector job growth that will attract more high-paying jobs to Los Angeles.
- Administer a more streamlined audit and appeals process.
- Develop and adopt a Taxpayers’ Bill of Rights.
- Change the tax to be based on the Architect’s net receipts rather than gross receipts.
- Pursue a 15-year phase-out of the business tax.
- Clarify what constitutes a “new business” for the purpose of tax holidays and reward loyalty to firms that remain within Los Angeles.

Reforming the city’s gross-receipts business tax will lead to job growth, economic expansion and an increased sales tax base. Reform will also facilitate increases in property values and taxes, increase city revenue from permits, licenses and fees and encourage business location within the City of Los Angeles.

DISCUSSION

Background

Architects provide architectural, interior design, planning, urban design, environmental assessment, landscape architecture, community participation, and other professional services related to the built environment. Los Angeles Architects are engaged in architectural projects located both inside and outside of the City of Los Angeles and work with consultants typically under direct contract to the Architect that are located both inside the City as well as outside of the City.

Pass-Through of Consultant Fees and Expenses

Architectural firms routinely utilize independent contractor consultants in their business. Their consultants may be located within the City of Los Angeles or may be located in other cities or states. The Architect is charged LA City Business Tax on the value of the Consultant’s contract regardless of the location of the Consultant. In the instance where the Consultant is located within the City, the Consultant is also obligated to pay business



tax on their contract amount. In the case where a consultant is located outside of the City, the Architect is generally not permitted to exclude the value of their contract for the Architect's gross receipts for the purpose of calculating the business tax, even though the monies received "pass-through" the Architect to the Consultant.

In connection with their work, these consultants incur direct expenses that are either a part of their lump sum fee or charged to the Architect for reimbursement by the Client on behalf of the Consultant.

In either case, the Architect is liable for paying business tax on the amounts. Most clients do not allow any mark-up of Consultant's expenses so the Architect is unfairly charged tax on services where they have earned no revenue.

Pass-Through of Architect's Direct Expenses

Architects direct expenses are also often required by contract to be reimbursed without allowing the Architect to apply a mark-up to the expenses. These expenses include things such as reprographics costs paid to a third party, telephone costs, mileage costs, etc. Additionally, business tax is also paid on the value of renderings and models which are often created by specialists in these crafts who are likewise subject to paying City of LA Business Tax, if they work in Los Angeles, on top of the business tax paid by the Architect. Similar to the situation with the Consultant, this unfairly levies a tax on services where the Architect retains no revenue as the revenue is paid out to the vendors providing the services for the Architect. Additionally, State and City sales tax is paid out on items such as reprographics and telephone charges, amounting to double taxation.

Architect's Work performed outside of the City of Los Angeles

Architects are often required to pay business tax in other cities they work in, even when the work is performed within the City of Los Angeles. It is recognized in the Municipal Code that the portion of the Architect's fees associated with work outside of the City should be excluded from the gross receipts calculation but the methodology for doing so is unclear and, as such, the application of the exemption is inconsistently and often incorrectly understood. There are several identified methods, including a "Payroll Method," "Architectural Apportionment," and "City Clerk's Ruling No.15" found in the City's Tax Auditor Training Manual, but little specific authority or guidance on the use of any particular method. All these varying methods are confusing and lead to misapplication of the provisions by Architects and City Auditors. It is recommended that, in lieu of one of these methods of apportionment, the value of work on projects located outside of the City be excluded from the Architect's gross receipts for the purposes of calculating the Architect's City of Los Angeles business tax obligations.



Proposed Revisions in Business Tax Code

As currently written, Los Angeles City Municipal Code § 21.49(c)(3.)(vi) provides the following exclusion from the definition of "gross receipts" for City business license tax purposes:

"As used in this section, the term "gross receipts" does not include ... Receipts of persons acting as agents or brokers for other persons to be paid over to those other persons, or to pay for those other persons' legal obligations, or as reimbursements for sums advanced by the agent for those other persons' legal obligations, or to be invested on behalf of those other persons."

This language can be interpreted differently by different parties, although it appears as though the intent is that any portion of the Architect's receipts which are "pass-through" expenses (expenses for which the Architect is acting as the Consultant's "agent" with respect to the client) should be excluded from the business tax. It is recommended that this language be modified to state this clearly so that the subjectivity of interpretation is eliminated.

Further, failure to exclude the consultant's fees and direct expenses from the Architect's gross receipts calculation is expressly prohibited by the U.S. and California Constitutions, as provided under LAMC 21.02, since it amounts to double taxation. That is, if subject to business tax, both the Architect and the consultant would be obligated to pay tax on the same gross receipts to the City.

CASE STUDIES:

The following examples are provided to better illustrate some of the situations encountered by Architects which lead to inconsistent or unfair business tax burdens.

1. An Architect is under contract to a nearby City who requests that, as a favor, the Architect bring on a specialty consultant to do some existing conditions testing under their contract as it facilitates the City getting the testing done sooner than if they would go through a separate procurement process. The Architect has no responsibility for testing and is not even managing their work. The Architect does the favor but ends up costing them money as they have to pay business tax on the monies received but directly paid out to the testing consultant.
2. The Architect is doing on-call work for the City of LA and the task order is fundamentally an electrical engineering task. The City does not want to pay the Architect any mark-up. Because of their relationship with the City, the Architect acquiesces but it ends up costing them money as they have to pay business tax on the monies received on behalf of the electrical engineer.
3. The Architect uses a model maker who is located in Los Angeles. A professional model is included in the Architect's lump sum fee. They pay business tax on the value of the model and so does the model maker.
4. The Architect's printer is located in Los Angeles. The Architect has to pay sales tax to the printer (which includes both state and local sales tax) and business tax on the Architect's gross receipts which include the printing costs, regardless of



- whether they are reimbursable or not. The Architect actually pays business tax on the sales tax!
5. The Architect utilizes a consultant whose office is outside of the City of Los Angeles. The Architect is taxed on the consultant's entire fee even though their work is fundamentally done outside of the City.
 6. The Architect is doing a project located outside of the City of Los Angeles. Although a specific fee is contractually awarded to the Architect, the City Auditors are allowed to utilize a variety of methods for calculating the value of the fee to be exempted, all of which are likely to differ and be less than the actual fee.

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