

HOUSE BILL REPORT

EHB 2030

As Passed House:

March 19, 2003

Title: An act relating to changing requirements regarding state and local tax to provide for municipal business and occupation tax uniformity and fairness.

Brief Description: Changing requirements regarding state and local tax to provide for municipal business and occupation tax uniformity and fairness.

Sponsors: By Representatives Kessler, Cairnes, Talcott, McDonald, Schindler, Shabro, Pearson and Holmquist; by request of Governor Locke.

Brief History:

Committee Activity:

Finance: 2/28/03, 3/10/03 [DP].

Floor Activity:

Passed House: 3/19/03, 73-25.

Brief Summary of Engrossed Bill

- Requires the Association of Washington Cities to adopt a model ordinance on municipal business and occupation taxes to address issues of uniformity and multiple taxation between municipal codes.
- Prohibits any city from imposing a business and occupation tax measured by gross receipts after December 31, 2004, unless the city has complied with all the requirements of the bill.
- Provides that by calendar year 2008, cities that impose business and occupation taxes must allow businesses to apportion income from non-service activities based on location and from service activities based on a formula with payroll and service income factors.
- Requires the Department of Revenue to conduct a study of the potential fiscal impacts of the provisions of the bill and to make reports to the Legislature by November 30 of 2003, 2004, and 2005.

HOUSE COMMITTEE ON FINANCE

Majority Report: Do pass. Signed by 7 members: Representatives Gombosky, Chair;

Cairnes, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Ahern, Morris, Roach and Santos.

Minority Report: Without recommendation. Signed by 2 members: Representatives McIntire, Vice Chair; and Conway.

Staff: Mark Matteson (786-7145).

Background:

City Business and Occupation (B&O) Taxes. City (or municipal) B&O taxes are imposed on the gross receipts of activities conducted by businesses located within cities without any deduction for the costs of doing business. The Legislature limited city B&O taxes on retail sales to a maximum of 0.2 percent in 1982, but higher rates are possible if approved by the voters in the city, or if a higher rate was in effect prior to January 1, 1982. Cities imposing a B&O tax for the first time after April 22, 1983, and cities increasing tax rates, must have a referendum procedure. Thirty-seven cities impose B&O taxes.

City B&O taxes, like the state B&O tax, include certain terms and definitions that provide the structure for the tax base and rate classifications. Common classifications include manufacturing, wholesaling, retailing, and services. Like the state B&O tax, city B&O taxes include provisions concerning the reporting periods for taxpayers to remit B&O taxes, the time period over which tax liabilities or refunds may be assessed, penalties, and interest rates for late payment or refunds. City B&O taxes may also provide exemptions from tax for a particular business activity.

A city with a B&O tax imposes the tax on a business if the city determines that there is nexus. Nexus has been interpreted to mean that the business has some sort of physical presence inside the city and that some portion of the business' activity (e.g., relating to a sales transaction) occurs within the jurisdiction. Cities have held that physical presence may be established a number of ways, such as by the rental of office space or through a salesperson who operates within the jurisdiction. Cities have held that sufficient activity for nexus purposes is also evidenced in various ways, from the signing of a contract with the jurisdiction, to the loading of items from a warehouse (even though the sale may not originate or be consummated in the city), to the occurrence of an actual sales transaction within the jurisdiction's boundaries. The court has upheld broad interpretations of nexus with respect to tax rationale.

If nexus is established, the city may assert B&O tax on the entire value of the transaction or particular activity involved. Thus, for example, in the case where items are loaded for delivery from a warehouse in a city with a B&O tax, the city could impose tax on 100 percent of the income derived from the associated sale, irrespective of whether the sales transaction or delivery occurs within the city's boundaries. Because of the broad

interpretation of nexus, two cities may simultaneously impose tax on income from the same sale or activity. Unless the cities' tax ordinances allow a credit for city B&O tax paid elsewhere on the same activity, the business may be subject to multiple taxation on income derived from a single activity.

In several state court cases, including *Dravo Corp. v. City of Tacoma* and *City of Seattle v. Paschen Contractors*, the court has upheld a city's imposition of its tax on an activity in which at least part of the value of the product or service that is taxed is derived outside jurisdictional boundaries. The court has provided, in part, that as long as a "reasonable relationship" exists between the tax imposed by the city and the benefits conferred upon the taxpayer by the city, due process is not violated and the tax is legitimate.

Apportionment. Generally, cities with B&O taxes in Washington State have not permitted businesses in the past to apportion income for taxation purposes. Apportionment refers to an approach under tax law whereby a multi-jurisdiction business is allowed to apportion, or divide, its taxable income among the jurisdictions in which it does business. Most apportionment laws involve use of a formula, in which the division of a business' income between jurisdictions is based on factors relating to sales income, property value, and/or payroll amounts. The effect is that a jurisdiction could only impose tax on a portion of the total income earned.

Recent developments concerning city B&O taxes. For several years, the business community has expressed concerns about city B&O taxes. Major concerns include the lack of uniformity among municipal tax systems; potential multiple taxation of the same income by two or more cities; and the interpretation of nexus that permits cities to capture income from taxable activity conducted outside jurisdictional boundaries. Legislation addressing these concerns has been introduced in recent years and supported by the business community. Representatives from cities have, in turn, expressed concern that such legislation would entail a significant loss of local autonomy and flexibility needed to address unique local circumstances, as well as a significant loss of revenue.

In response to concerns, the Association of Washington Cities (AWC) developed a model municipal B&O tax ordinance in early 2001. The model ordinance provides a basis for the use of uniform terminology, definitions, administrative provisions, rate classification structure, and exemption structure. As of the end of calendar year 2002, a number of cities with B&O taxes have updated their ordinances to reflect the model ordinance that was available at that time.

In May 2001 the Governor directed the Director of the Department of Revenue to convene a working group of city and business representatives to develop a solution regarding municipal taxation issues concerning uniformity and multiple taxation. The working group's discussions were in large part centered on the model ordinance developed by the AWC in early 2001. While consensus was reached on some issues, there was not agreement in total. Nonetheless, HB 2658 was submitted at the request of

the Governor in the 2002 session to address some of the agreement reached by the working group, and was passed by the House. The proposal was not supported by the Association of Washington Business, and alternative proposals concerning municipal business taxation were also introduced.

Summary of Engrossed Bill:

The Association of Washington Cities (AWC) is required to adopt a model ordinance that will provide a more uniform system of municipal business and occupation (B&O) taxes. The intent of the model ordinance, in addition, is to eliminate multiple taxation of business income while continuing to allow some local control and flexibility to municipal governments. The model ordinance is to consider business taxes only, and not taxes on utility businesses.

In the development of the model ordinance, the AWC must form a model ordinance development committee. The development of the ordinance must include a public involvement process and must solicit input from stakeholders, including the business community. The Municipal Research and Services Center (MRSC) must post a copy of the model ordinance on its web site and make hard copies of the ordinance available upon request. In addition, the Department of Revenue and the Department of Licensing must post a copy of the ordinance on their web sites. Cities that impose B&O taxes must make copies of their ordinances available upon request.

The AWC may amend the model ordinance to comply with state law, but is restricted from otherwise amending the definitions and classifications in the ordinance more frequently than every four years. After December 31, 2004, any city that imposes a B&O tax must first comply with the provisions of the bill.

The model ordinance must include a number of mandatory provisions: a system of credits that prevent multiple taxation of the same income; a gross receipts threshold for small businesses; tax reporting frequency requirements; provisions for penalties and interest; claim and refund provisions; and certain terms with definitions from the state B&O statutes or to be based on comparable definitions within the state B&O statutes. Deviations from the state B&O definitions must be noted in the model ordinance.

With the exception of the system of credits to prevent the multiple taxation of business income, cities are allowed to continue to adopt their own provisions for tax exemptions, credits, deductions, and other preferences, as well as tax classifications and tax rates. With respect to any nonmandatory provisions of the model ordinance, cities that deviate must make a description of the deviations available.

In order to provide for the prevention of multiple taxation, the model ordinance must include a system of credits. A credit must be allowed against:

- Retail or wholesale taxes due on sales of products for any manufacturing or extracting taxes paid on the same products;
- Manufacturing taxes on the value of products for any extracting taxes paid, or manufacturing taxes previously paid, on the same products; and
- Retail or whole taxes due on the sales of publications for any printing or publishing taxes paid on the same publications.

The model ordinance must include provisions for credits that will prevent the multiple taxation of business service income and income of any other classifications of businesses.

The model ordinance must also include a de minimus business activity threshold. A city may only tax a business that has earned gross receipts in excess of \$20,000 in the jurisdiction. Cities with thresholds higher than \$20,000 as of January 1, 2003 and that choose to adopt a lesser threshold must first notify all businesses within the city.

The model ordinance must provide that cities with B&O taxes must allow for monthly, quarterly, or annual reporting of taxes. A city may require monthly reporting only in the case where the taxpayer also reports the state B&O taxes on a monthly basis. Payment is due at the same time that payment is required under state B&O statute.

The model ordinance must also provide that, with respect to assessments for underpaid tax and to refunds, cities must calculate interest in the same manner that the Department of Revenue (DOR) does for state excise taxes.

The model ordinance must provide that penalties must be imposed according the state B&O statutory requirements concerning penalties.

The model ordinance must also provide that the limitations on the length of the claim periods upon which assessments can be made or upon which refunds can be requested must be the same as the state B&O statutory requirements concerning such limitations.

The model ordinance must also include definitions for a number of terms. These include:

- business (with the same meaning as under the state B&O statutes);
- city;
- commercial and industrial use;
- business and occupation tax or gross receipts tax;
- eligible gross receipts tax;
- engaging in business;
- extracting;
- gross income of the business (with the same meaning as under the state B&O statutes);

- gross proceeds of sales (with the same meaning as under the state B&O statutes);
- to manufacture;
- manufacturing (which may not include software development as an activity);
- person;
- retailing;
- retail sale;
- services (excluding retail and wholesale services);
- value of products (with the same meaning as under the state B&O statutes);
- wholesale sale; and
- wholesaling.

For the terms that are not required to have meaning identical to those in the state B&O statutes, the model ordinance must use as a baseline the definitions for the same terms in the state statutes, and any deviation from the state definitions must be noted in the ordinance.

In addition to the provisions concerning the model ordinance, a requirement is imposed on all cities with gross receipts B&O taxes that, in order to impose the B&O tax on a business activity, there must be nexus. Nexus is defined to mean business activities that are sufficient to subject the business to the taxing jurisdiction of the city under interstate commerce standards.

All cities that impose gross receipts B&O taxes must allow for the apportionment of business income by January 1, 2008. For activities other than services or income from royalties, income is allocated based on the location of the activity. In the case of a wholesale or retail sale, the location is based on the location of delivery to the buyer. If the location occurs in more than one jurisdiction, credit must be allowed for taxes paid on the same activity, or, in the case where not all the affected cities impose gross receipts taxes, an allocation system must be allowed. For income from royalties, income is allocated to the commercial domicile of the taxpayer. For income from services, income is apportioned to a city by multiplying total taxable income by the average of a payroll factor associated with a city and a service-income factor associated with a city. The payroll factor is equal to the ratio of the compensation paid in a city to the total compensation paid everywhere. The service income factor is equal to the ratio of all service income of the taxpayer in a city to total service income of the taxpayer everywhere.

The taxpayer may petition the taxing jurisdictions to allow for an alternative method of apportionment if it is believed that the prescribed apportionment approach does not fairly represent the taxpayer's business activity. Alternative approaches may be based on methods relating to separate accounting; to a single-factor; to the prescribed approach, with the addition of other factors; or to another approach as may be deemed to provide an equitable allocation and apportionment of the taxpayer's income.

A city that fails to comply with the non-apportionment provisions of the bill by December 31, 2004, is prohibited from imposing a B&O tax.

The Department of Revenue is required to conduct a study of the potential net fiscal impacts of the bill. Emphasis must be placed on impacts attributable to the potential implementation of the apportionment requirements and the adoption of the model ordinance uniformity provisions. The department must consult with an advisory committee that includes representatives from business and from cities that impose B&O taxes. The department must report final results to the Governor and the Legislature by November 30, 2005, with progress reports by November 30 of 2003 and 2004. In its recommendations, the department must include options for mitigating any potential adverse revenue impacts to jurisdictions.

The Department of Revenue is required to evaluate the terms with definitions in the model ordinance, and report to the Governor and the Legislature by the end of calendar year 2004. The report must include the expected fiscal impact as the result of the adoption of the terms.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect 90 days after adjournment of session in which bill is passed, except for section 13, which is effective January 1, 2008.

Testimony For: I've worked on this issue for six years. To their credit and good faith, the cities have worked on the issues of uniformity and multiple taxation through the model ordinance that they have posted on their web site. The bill simply makes sure that all cities with B&O taxes would have similar provisions. Another important piece to this bill is the apportionment. We understand the issues with this and so it doesn't go into effect for another five years. I understand the cities' concerns and would be willing to incorporate a study in the bill. Fundamentally, this is about fairness. While multiple taxation has been cleared up, apportionment needs to be addressed still.

The Association of Washington Business is in favor of this bill. The Governor's Competitiveness Council has endorsed it. The elements of the bill should be viewed as guidebooks. However, the three fundamental aspects of the bill are predictability, uniformity, and fairness, and must be kept in mind. If any tax system is going to survive, it must include these three elements.

We feel that this issue has been studied to death. The cities will also tell you that they have their own model ordinance. However, it is not mandatory. We ask that the model ordinance contain certain mandatory elements that must be adopted, including certain core

definitions, common administrative provisions, and exemptions that prevent multiple taxation. But in addition, taxation without representation must be ended by the adoption of the apportionment provisions.

Apportionment is the most controversial portion of the bill, but is the most fair. Jurisdictions have been taxing income that was not earned inside their jurisdiction. Fair apportionment is one of only four requirements that a state tax must include for it to be constitutional under the United States Constitution. However, the State Supreme Court has ruled that intrastate business commerce is not afforded the same protections that interstate commerce is afforded. The idea of apportionment is that an item of income may only be taxed where it is earned and so first eliminates the possibility of double taxation, but also ensures that a jurisdiction would only fairly tax what is earned inside its boundaries.

Uniformity is one of the things that make this bill important. It is important to make the model ordinance mandatory, otherwise there is no level playing field. It is important to have the definitions tied to the state business and occupation (B&O) tax code.

We are a small floral business located in Snohomish that makes some deliveries to a few businesses in Tacoma. We received a letter six months ago that said that we were required to register, obtain a license, and that we owed back taxes for 10 years. We do not even keep records beyond seven years. The current system of taxes is patently unfair.

I'm a small business owner and employ 10 people. I have to break down all our jobs which are done through King County by taxing code area for state excise tax reporting purposes. The record keeping requirements for the local cities taxes is also terribly burdensome.

In the last year and a half, after the City of Seattle adopted the model ordinance, it put us in a position of being subject to double taxation in other jurisdictions. We wrote to the other jurisdictions, to explain the need to change in how we report income, but the other jurisdictions were unaware of the change in Seattle and the model ordinance generally. We think that this bill is necessary for uniformity and consistency among jurisdictions.

This bill promotes the uniform administration of local B&O taxes statewide, and helps remove the undue burden on small businesses. We would be willing to consider changing the administrative provisions to remove the direct link with the Department of Revenue administrative statutes. We are also amenable to a study to evaluate the impacts to local governments. Our intent is not to preclude cities from imposing B&O taxes.

Small businesses are supporting the bill with apportionment. We feel like cities are unfairly collecting taxes in the first place. This bill is particularly important to our members who do business in some cities with B&O taxes and some without. They are

having to pay based on all their income earned to the jurisdictions with B&O taxes, even if some of the income is earned elsewhere.

Testimony Against: The Association of Washington Cities is opposed to this bill in its current form. There are a number of problems with the bill, even aside from the apportionment section. First, section 4 includes a whole new process for development of a model ordinance. We already have a model ordinance, which has been developed over the last three years. The elements of that ordinance are identical to the requirements contained in section 4, with the exception of the apportionment requirements. We do not object that the provisions pertaining to the model ordinance would be made mandatory. We object that we would have to go through the process a second time. Second, the minimum small business activity threshold is locked in at \$20,000, or if they are currently above that, at a higher level. Cities are not allowed to deviate above or below that, which doesn't make much sense. Apportionment is a critical issue, with arguments on both sides, but if this is the preferred approach, the committee should amend the current statutory maximum rates so as to allow cities to recoup part of their losses. Fourth, the bill includes a study, but not one for local government impacts, and we feel one should be included. Finally, the bill preempts jurisdictions that have never imposed a B&O tax from doing so after 2004. This should be addressed.

For several years, the AWC has worked on a model ordinance. We have hewed to the principle of cutting red tape, but at the same time with a revenue neutral approach. This is a problem with this bill, as there is no mechanism for cities to recoup losses from apportionment. Multiple taxation is no longer an issue.

We were surprised by this bill. Last year, the Governor met with the mayors and was appreciative of the work done by AWC on the model ordinance. Tacoma had adopted the model and has lost about \$1 million annually because of that. We heard the Governor say that he would not support a bill with further negative impacts on cities. Not one business or individual has come to the city council to complain about lack of apportionment or the business climate in the city.

We are in support of the model ordinance provisions but against the apportionment provisions. We have never been aware of a business coming to us to request apportionment. Business needs to realize that there's a two-way street, that businesses receive services from the cities. This bill is not revenue neutral.

Seattle has implemented the model B&O ordinance and cost us about \$2.5 million per year. The provisions in this bill relating to the model ordinance would make things worse. With respect to the manner in cities that have taxed businesses, the practice has been the same for the last 50 years. Apportionment is not about double taxation. The model ordinance eliminates the possibility of double taxation. Apportionment is not necessary to do that, and in fact, is simply a tax cut. The question is who is receiving the benefit from this.

Testified: (In support) Representative Kessler, prime sponsor; Jim Hedrick, Governor's Office; Carolyn Logue, National Federation of Independent Business; Gary Smith, Independent Business Association; Wes Uhlman; Ron Bueing; Chuck Mosher, David Walton, and Paul Shinoda, Association of Washington Business; Ken Ward, The Fence Connection; and Sharon Appelt, Association of Washington Business and Dairygold;

(Opposed) Stan Finkelstein, Association of Washington Cities; Chuck Mosher; Bill Baarsma, Mayor, City of Tacoma; Frank Anderson, Mayor, City of Everett; and Dwight Dively, Finance Director, City of Seattle.