

# HOUSE BILL REPORT

## HB 2500

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### As Reported by House Committee On:

Finance

**Title:** An act relating to conforming Washington's tax structure to portions of the streamlined sales and use tax agreement not implemented by chapter 168, Laws of 2003.

**Brief Description:** Conforming Washington's tax structure to portions of the Streamlined Sales and Use Tax Agreement not implemented by chapter 168, Laws of 2003.

**Sponsors:** Representative McIntire; by request of Department of Revenue.

### Brief History:

#### Committee Activity:

Finance: 1/23/04, 2/6/04 [DPS].

#### Brief Summary of Substitute Bill

- Provisions are adopted that allow Washington State to conform to the Streamlined Sales and Use Tax Agreement (SSTA), including language that authorizes:
  - The on-line registration of remote sellers;
  - Monetary allowances or vendor compensation for sellers that participate in the SSTA;
  - Conditional amnesty for previously unregistered sellers;
  - New requirements for sourcing tax to the transaction location;
  - Confidentiality and privacy protections for participating sellers;
  - The development of a taxability matrix under the SSTA; and
  - A change in the manner delivery charges are taxed.
- Provides funding from state and local sources to mitigate the financial impacts to local jurisdictions attributable to implementation of the sales tax sourcing requirements, and includes both short-term and longer-term funding, as well as supplemental mitigation funds to address certain contingencies.
- Establishes a new system of local sales and property tax equalization, contingent upon action by the federal government to allow states to require that remote sellers collect and remit sales tax, and funded by an amount representing a portion of the new sales tax revenue that would accrue to the state following the federal action.

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## HOUSE COMMITTEE ON FINANCE

**Majority Report:** The substitute bill be substituted therefor and the substitute bill do pass. Signed by 5 members: Representatives McIntire, Chair; Hunter, Vice Chair; Conway, Morris and Santos.

**Minority Report:** Do not pass. Signed by 3 members: Representatives Cairnes, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; and Roach.

**Staff:** Mark Matteson (786-7145).

### **Background:**

In the 2002 session, the Legislature adopted the Simplified Sales and Use Tax Administration Act, which authorized the Department of Revenue (Department) to be a voting member in the Streamlined Sales Tax Project (SSTP), a multi-state effort to simplify state sales and use tax structures and make them more uniform. Many other states have also authorized such participation, and representatives have met to develop an agreement to govern the implementation of the SSTP. This agreement, called the Streamlined Sales and Use Tax Agreement (SSTA), was adopted by 34 states and Washington D.C. in November 2002.

During the 2003 legislative session, the Legislature enacted legislation at the request of the Department to implement the uniform definitions and administrative provisions of the SSTA. However, the legislation did not implement six additional provisions that are necessary for the state to conform fully to the SSTA. The provisions concern:

- On-line registration of remote sellers;
- Monetary allowance for sellers using certified service providers or tax compliance software. (Certified service providers are third parties that are authorized to collect and remit sales and use taxes to states that participate under the SSTA);
- Conditional amnesty for previously unregistered sellers;
- Requirements governing the location to which tax is attributed during a transaction (i.e., "Sourcing");
- Confidentiality and privacy protections for sellers using certified services providers;
- The development of a taxability matrix to facilitate the administration of tax for sellers; and
- An amendment to the original SSTA agreement concerning how tax is applied to delivery charges when a delivery includes both taxable and nontaxable items.

Under the sales and use tax in Washington, local sales and use taxes are sourced according to the following rules:

- Sales tax from the sale of goods is sourced to the retail outlet at or from which

delivery is made.

- Sales tax from the sale of a service, with or without a sale of goods, is sourced to the place where the service is primarily performed.
- Sales tax from the lease or rental of goods is sourced to the place of first use. In the case of short-term rentals, this is the place of business of the lessor. In the case of rentals or leases involving periodic payments, this is the primary place of use by the renter or lessee for each payment period.

In December 2003, the Department issued a study of the sourcing provisions of the SSTA. The study indicated that the sales tax base for most local jurisdictions would be affected by the sourcing provisions, either adversely or positively. The study estimated a shift in sales tax base of approximately \$12.9 billion in sales, resulting in gains to some jurisdictions of about \$36 million and losses in other jurisdictions of about \$33 million.

The Legislature established a system of local sales tax equalization in 1982, funded by a portion of the motor vehicle excise tax. Under the system, for jurisdictions that imposed tax and whose local sales tax collections per capita were less than 70 percent of the statewide average, funding was provided to increase funding to a level equal to the 70 percent figure. In 1999, the voters repealed the motor vehicle excise tax in Initiative 695, ending the source of funding for the sales tax equalization program.

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### **Summary of Substitute Bill:**

Provisions are included that would allow the state to fully conform to the SSTA.

Sellers are authorized to designate an agent to register the seller with the state, if not already registered. Sellers who agree to collect and remit sales and use taxes under the SSTA may register through an on-line system authorized under the SSTA.

The Department is required to adopt rules providing for monetary allowances for sellers who use certified service providers, tax compliance software, or another means of collecting and remitting tax that is authorized under the SSTA. In addition, the Department may adopt rules to provide vendor compensation for sellers who collect and remit sales and use taxes to the state, but this authority is contingent upon action by Congress or the courts that would allow states to require remote sellers to collect sales or use taxes.

The Department is prohibited from making assessments for past uncollected sales and use taxes against an unregistered seller who, within 12 months of the effective date of the state's participation in the SSTA, registers under the agreement and then collects and remits sales and use taxes to the state for a period of at least 36 months. This amnesty does not apply if the seller has already received an audit notice from the Department, if the seller has in fact collected sales and use taxes but not remitted them to the state, or if

the seller is liable for sales and use taxes in the seller's capacity as a buyer.

The SSTA general sourcing rules are adopted. The rules provide:

1. If a good or service is received by the purchaser at the business location of the seller, the sales tax is sourced to that business location.
2. If the good is not received by the purchaser at the business location of the seller, the sales tax is sourced to the location where receipt occurs, if known by the seller.
3. If neither of the first two rules apply, the sales tax is sourced to the address indicated for the purchaser in records normally maintained by the seller, if the use of this address by the seller does not constitute bad faith.
4. If none of the first three rules apply, the sales tax is sourced to the address for the purchaser obtained during the consummation of the sale, including the address of the purchaser's payment instrument, if the use of this address by the seller does not constitute bad faith.
5. If none of the first four rules apply, the sales tax is sourced to the address from which delivery is made.

The general sourcing rules do not apply to purchases of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, and mobile homes. In such purchases, the tax is sourced to the location from which delivery was made.

For the lease or rental of tangible personal property, tax is sourced depending on whether the lease or rental requires periodic payments. If periodic payments are required, tax on the first payment is sourced like sales of tangible personal property, but tax on subsequent payments are sourced to the primary property location of the lessee. If payments are not periodic, then tax is sourced like sales of tangible personal property.

Special sourcing provisions apply to sales of digital goods, electronically delivered software, direct mail, or services, where the property or service sold is delivered to multiple jurisdictions concurrently. In these circumstances, the purchaser is obligated either to provide a form to the seller relieving the seller of the requirement to collect and remit tax or to provide sufficient information to the seller to allow the seller to determine the proper amount of tax to collect. If the seller is relieved of the requirement, the purchaser must remit tax directly.

Protections are provided with respect to confidentiality and privacy for businesses that use certified service providers under the SSTA. Certified service providers are required to perform tax calculations, remittance, and reporting functions and may not retain the personally identifiable information of consumers, with very limited exceptions. The Department will provide public notification to consumers of its practices relating to the collection, use, and retention of personally identifiable information. Personally identifiable information will not be retained any longer than required to ensure the validity of exemptions. This provision may be enforced by petitioning the superior court of Thurston County for injunctive relief.

The Department is required to complete a taxability matrix and will provide notice of changes in the taxability of products or services listed in the matrix. Sellers and certified service providers are relieved from liability to the state and to local jurisdictions for having charged or collected the incorrect amount of sales or use tax if the error resulted from reliance on erroneous information provided by the Department in the matrix.

The taxability of delivery charges is changed to allow sellers to apportion their delivery charges between taxable and nontaxable property within a shipment and apply tax to only that portion that represents delivery charges for taxable property.

Sourcing mitigation. State and local funding is provided to mitigate the adverse impacts to certain jurisdictions as a consequence of the implementation of the local sales tax sourcing provisions. Funding is provided in part from diverting the Department administrative fee, derived from 1 percent of local sales tax collections, and the expected collections resulting from the implementation of the amnesty provisions of the bill, from the state general fund into a new account. The new account is also funded in part by a new deduction on local sales tax collections for certain jurisdictions, equal to the lesser of 2 percent of the collections or a cumulative amount equal to 80 percent of any gain in revenues realized by a jurisdiction as a result of the implementation of the new sourcing provisions.

Short-term funding is provided to most jurisdictions for which the Department estimates in its December 2003 study, a loss in sales tax revenue attributable to the implementation of the sourcing provisions. Over a four-year period, funds equal to a portion of estimated lost revenue is provided; the backfill is reduced in each of the four years. The amount of backfill is based on the percentage of estimated sales tax that is lost, relative to the amount of calendar year 2002 unrestricted general fund revenue.

Supplemental short-term mitigation funds of \$2 million are also provided. The Department is directed to evaluate whether actual changes in sales tax collections are different than those estimated in the December 2003 study. The Department is to obtain feedback from an advisory committee with representatives of local governments. If the actual impact to a local jurisdiction of the implementation of the sourcing provisions is more adverse than expected, the treasurer is directed per Department instruction to distribute a portion of the additional funds to compensate.

Long-term funding over 10 years is provided out of state funds to jurisdictions that are expected to have relatively significant net losses in sales tax collections following both sales tax sourcing changes and presumed federal action to allow states to require remote sellers to collect and remit sales taxes. For these jurisdictions, additional funds are provided in each year for seven years so that the total backfill received is equal to 60 percent of long-term losses. In the next three years, the backfill received is equal to 30 percent of long-term losses.

Equalization. A new local sales and property tax equalization program is established. A new account created for the purpose of making distributions to local governments to assist in the provision of core services. The State Treasurer is directed to deposit \$80 million from state sales and use tax collections annually once the state begins to require remote sellers to collect and remit sales taxes, pursuant to federal authorization. A committee, including executive, legislative, and local government representatives, is created to determine a mechanism for the distribution of funds and to provide a recommendation to the Governor and the Legislature by December 2005.

**Substitute Bill Compared to Original Bill:**

Provides funding from state and local sources to mitigate the financial impacts to local jurisdictions attributable to implementation of the sourcing provisions of the bill. Requires the Department to direct the State Treasurer to distribute to impacted jurisdictions a portion of estimated lost sales and use taxes, based on the impact to the jurisdiction's current expense funds. Provides longer term relief over 10 years for certain jurisdictions. Requires the Department to reserve \$2 million in funds to address significant losses in small jurisdictions' revenues unanticipated in the Department's 2003 study. Creates a new sales and property tax equalization account and transfers \$80 million to the account in the fiscal year after federal authorization of states to require remote sellers to collect and remit sales taxes.

Makes the sourcing provisions of the bill effective July 1, 2005. Provides that the bill is null and void unless funding is provided in the budget.

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**Appropriation:** None.

**Fiscal Note:** Available. Requested on substitute February 9, 2004.

**Effective Date of Substitute Bill:** The bill takes effect July 1, 2004, except: (1) section 501-503, 601-606, and 1102, relating to sourcing provisions, which takes effect July 1, 2005; (2) section 401, relating to the amnesty provisions, which takes effect on the date that Washington becomes a member state of the SSTA; and (3) section 302, relating to the provisions concerning vendor compensation, which take effect when Congress or the court determine that the state may impose sales and use tax collection and remittance duties upon remote sellers. However, the bill is null and void if not funded in the budget.

**Testimony For:** The Retail Association supports this measure. By 2008, nearly \$22 billion in sales taxes will be lost without further action. Washington needs to take steps now to conform to the SSTA. Our principles, with respect to the sourcing provisions, are that the state needs to be in compliance with the SSTA provisions and that no additional reporting requirements be put on retailers. It is necessary to simplify

administrative requirements for retailers, and this will help accomplish that.

JC Penney and other brick and mortar retailers are at an unfair disadvantage relative to remote sellers who compete for the same customer base, but without the sales tax collection requirements. Moreover, companies like ours, because of our presence, collect taxes on our own remote and catalog businesses. This bill helps level the playing field.

For jewelers, the 8.5 percent advantage over the internet can really sway customers who make purchases of \$5,000 to \$15,000. Small businesses also support this. Passage is important because of the double bookkeeping requirements now necessary after the legislation passed last year requiring apportionment for municipal business taxes. In addition, the bill allows vendors to be reimbursed for administrative expenses.

This bill is about fundamental sales tax policy. It's important to pass this to allow the state to continue to have a seat at the table.

The Washington State Association of Counties has endorsed the draft mitigation measures to address the sourcing impacts to local jurisdictions. We understand that there are winners and losers, but the need for this with respect to bringing in more remote retailer revenues in the future is important.

The City of Tacoma believes that we can manage the impacts of this bill in the short term. We should be able to grow out of it. We have spent a lot of time developing our business districts, and small businesses there are hurt by the advantage that internet retailers have.

One thing that has not been addressed is the perspective of the taxpayer. There is a fundamental problem with the existing tax structure. The SSTA bill is fair and moves us in the right direction.

If the Legislature does not act this year, the state will no longer be a voting member in the discussions on the SSTA governance. We were given a grace period for one year to get into conformity with all the provisions. The project is expected to begin in January 2005.

The transit association supports changes as long as there is mitigation. Several systems will be greatly impacted.

(Neutral) The Association of Washington Cities is grateful for the mitigation proposal but has concerns about the temporary nature of the assistance.

**Testimony Against:** (With concerns) There are about 30 cities that are heavily impacted by the new sourcing requirements. We respectfully request that committee members consider these. We would like to engage members in dialogue to discuss ways to make

this a win-win situation.

If there is no lasting mitigation, we will have difficulty. In the long-term, there are great benefits to the state and the cities. However, in the short-term, we need a mitigation solution for the sourcing impacts. There need to be provisions to make us whole.

Main street businesses have concerns about the sourcing shifts as well. There would be a devastating impact to public services in some communities. The loss of revenue would leave us no real options except to drastically cut budgets. If these sourcing changes are made without consideration to timing and mitigation, economic development efforts are undermined.

There is also a potential bond repayment issue. Existing revenue streams are used to support financing of bonds. To be put in the position where we could default on our bond obligations would be disastrous.

There are two key concepts here. This should not be a win-lose scenario. The state is voluntarily putting us in this position. It is unreasonable to allow this to happen without mitigation. Also, there is no need to do this at this time. We support implementation of the sourcing changes concurrently with federal action to allow the state to require remote sellers to collect tax. We believe that we could still have a seat at the table.

We calculate that Auburn would lose over \$14 million. For us, this is far more of a dramatic issue than I-695 or I-747. We ask that legislators provide careful and deliberate consideration to the issue. The industrial and commercial areas that currently produce tax revenue also come with costs. These needs won't go away.

(Opposed) While we don't lose a big amount of money, Sedro-Woolley does lose a significant proportion. Over the last several decades, Lynnwood has put a lot of effort into planning and investment to make the city the commercial center of south Snohomish County. For planning and economic development purposes, a business friendly climate is important. We would like legislators to make sure that cities and counties are fully compensated, and would request that you delay implementation of sourcing requirements to allow concurrence with federal action on the matter.

**Persons Testifying:** (In support) Randy Lewis, City of Tacoma; Candice Bock, City of Lakewood; John Ladenburg, Pierce County; Maureen Morris, Washington State Association of Counties Commissioners; Julie Sexton, Department of Revenue; Iwen Wang, City of Federal Way; Rich Prem, Amazon.com; Bob Jean, City of University Place; Peter Thein, Washington State Transit Association; Jan Teague, Washington Retail Association; Bob Lane, JC Penney; Madelin Kolb, Merle Norman Cosmetics; and Perry Saueressig, Ben Bridge Jewelers.

(Opposed) Sharon Dillon, City of Sedro-Woolley; and Ted Hikel, City of Lynnwood.

(Opposed with concerns) Doug Levy, City of Everett; Paul George, City of Yakima; Kathy Turner, City of Puyallup; and Pete Lewis, City of Auburn.

(Neutral) Jim Justin, Association of Washington Cities.

**Persons Signed In To Testify But Not Testifying:** None.