

FINAL BILL REPORT

EHB 2030

C 79 L 03

Synopsis as Enacted

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.

House Committee on Finance
Senate Committee on Ways & Means

Background:

Thirty-seven cities impose business and occupation (B&O) taxes on the gross receipts of activities conducted by businesses without any deduction for the costs of doing business. The Legislature limited city B&O taxes to a maximum rate of 0.2 percent in 1982, but higher rates are allowed 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 provide for a referendum procedure to apply to the ordinance imposing or increasing the tax.

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. Also 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 within 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 the rationale for imposing taxes.

If nexus is established, the city may assert a 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 the 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, 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 held, 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 allowable.

Generally, cities with B&O taxes in Washington have not permitted businesses 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 impose a tax only on a portion of the total income earned.

In response to concerns regarding city B&O taxes, the Association of Washington Cities (AWC) developed a model municipal B&O tax ordinance in 2001. The model ordinance provides a basis for the use of uniform terminology, definitions, administrative provisions, rate classification structure, and exemption structure. A number of cities with B&O taxes have updated their ordinances to reflect this model ordinance.

Summary:

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 stated 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, not taxes on utility businesses.

In developing the model ordinance, the AWC must form a model ordinance development committee. The development of the ordinance must include a process to involve the public 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 paper 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 comply with the provisions of this act.

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 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 for:

- 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 wholesale 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 that have a threshold 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. For terms that are not required to have a 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. After December 30, 2004, a city that fails to comply with the non-apportionment provisions of the bill may not impose a B&O tax.

The DOR 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 DOR must consult with an advisory committee that includes representatives from business and from cities that impose B&O taxes. The DOR 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 DOR must include options for mitigating any potential adverse revenue impacts to jurisdictions.

The DOR is also 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.

Votes on Final Passage:

House 73 25
Senate 32 17

Effective: July 27, 2003
January 1, 2008 (Section 13)