Department of Revenue
Washington State

2005-2012
Legacy and Lessons Learned

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Introduction

As the state's principal tax collection agency, the Washington State Department of Revenue collects more than 90 percent of state tax revenues plus local sales tax, for a total of $17.6 billion in Fiscal Year (FY) 2012.

No one likes paying taxes, but maintaining a stable, reliable tax system requires that all businesses and residents pay their fair share of them. As the state's primary tax collection agency, the Department's mission is to administer the tax system equitably and advocate sound tax policy. While this might seem like a simple task, it is not.

Washington's tax system is principled on the Revenue Act of 1935, making it unique as a tax system because it does not rely on an income tax. Instead, Washington's tax system relies primarily on the retail sales tax along with an activity-based business and occupation tax on gross receipts. It also includes a variety of other taxes including property tax and the real estate excise tax. The unique nature of the business and occupation tax coupled with more than 75 years of changes in the way businesses operate along with changes in Washington's tax laws have made the system complex and difficult to administer.

Given the complexity of the tax system and the natural tensions between businesses and individuals that must pay taxes and the state agency charged with collecting them, it is remarkable that registered businesses consistently have paid 97 to 98 percent of taxes due, based on an analysis of audits. While impressive, that figure doesn't include the underground economy of businesses that fail to register and pay taxes, or some out-of-state companies that may not be registered because they don't understand Washington's tax system. The high compliance rate reflects the extensive efforts the Department makes to educate taxpayers, and the agency consistently gets high marks for customer service from businesses.

This report outlines the efforts the Department has made during the past eight years, a period of strong economic growth and then economic downturn following the mortgage crisis. During this period, the Department addressed challenges needed to maintain the integrity of the tax system during a period of budget cuts and tough times for businesses. The goal was to manage the tax system fairly and efficiently through good times and bad. It also has worked hard to propose legislation to reflect the changing economy, a gradual shift to services over manufacturing of goods, and technological advances such as the Internet and the delivery of products electronically rather than in tangible form.

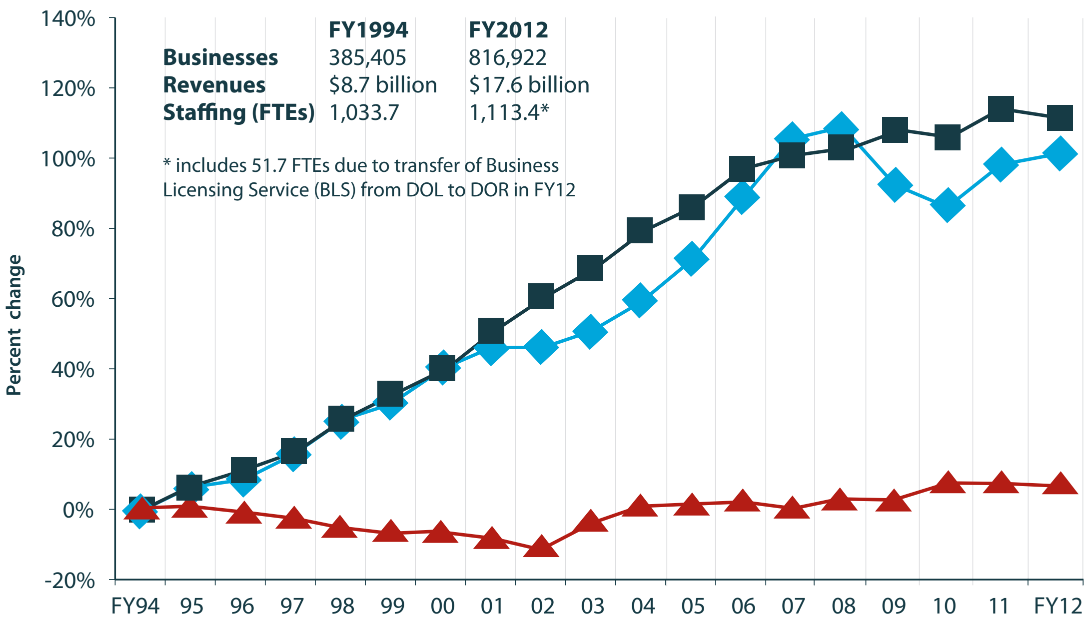
Pre-recession challenges and accomplishments

Managing during the growth years

The Washington economy was in the midst of a sharp upturn in 2005 after several years of slow growth. State tax revenues climbed from $12.2 billion in FY2003 to $13.9 billion in FY2005 before accelerating to $15.5 billion in FY2006, $16.9 billion in FY2007 and peaking at $17.0 billion in FY2008. The state responded to these strong revenues by investing in the future through targeted tax incentives. It sought to build upon the state's core industrial strengths such as aerospace. Aerospace incentives were enacted in 2003 to encourage the development and manufacture of a new commercial airliner in Washington, and they were expanded in 2005 to benefit a broader range of aerospace suppliers.

One challenge over time was a steady increase in the size of the Washington economy without a commensurate increase in agency staffing. The number of registered businesses more than doubled over the past 18 years with a corresponding increase in revenue collections, yet staffing remained nearly flat. The minimal increase in staffing has been achieved primarily through the Department's use of technology to promote correct and timely reporting along with payment of taxes. For example, electronic filing has largely replaced paper returns that were cumbersome to handle and had high error rates. Use of the data warehouse has enabled the Department to effectively identify compliance problem areas and prioritize its education and outreach, tax discovery and audit efforts.

Registered businesses, revenues more than double over the past 18 years while DOR staffing up slightly



	FY1994	FY2012
Businesses	385,405	816,922
Revenues	$8.7 billion	$17.6 billion
Staffing (FTEs)	1,033.7	1,113.4*

* includes 51.7 FTEs due to transfer of Business Licensing Service (BLS) from DOL to DOR in FY12

- Registered businesses **+112%**
- State and local revenue collections **+102.7%**
- DOR staffing **+7.7%** (**+2.7%** without BLS transfer)

The Department has invested in technology to transform business processes in order to meet the increased accountability and performance expectations of citizens. Additionally, the Department has engaged in continuous quality improvement efforts to increase the efficiency of its operations. It has conducted self assessments using the Baldrige Criteria, conducted GMAP sessions and most recently identified process improvements through LEAN principles. These types of activities have provided opportunities to improve overall tax administration and make our tax system more responsive to the changing needs of taxpayers.

Strategic Business Plan guides vision, mission, and goals

Critical to identifying opportunities for improvement and managing change is to formulate a plan that relies on clear guiding goals and principles. The Department has a mature and well-developed strategic planning process that sets direction, establishes priorities, prompts innovation, and provides accountability. The plan which is updated annually has both a long-term and short-term horizon and establishes alignment with the agency vision, mission, and goals. The goals identified in the agency's July 2012 through June 2017 Strategic Business Plan include:

- Make conducting business with the Department clear, simple and efficient
- Develop, retain and value a high quality, diverse workforce
- Promote correct and timely reporting and payment of taxes
- Promote fairness and consistency in the development and application of tax law
- Promote efficiency and protect the agency's integrity

The plan also outlines key strategies that must directly support the agency's goals. Strategies are monitored throughout the year and as a result the Department has been able to target its resources, increase productivity, address customer needs, and operate within budget constraints.

Involving stakeholders

Maintaining a high level of voluntary compliance by taxpayers is heavily dependent on understanding problems of business and equitable administration of tax laws. Even well intentioned tax legislation can have unintended consequences. To prevent such missteps, the Department works closely with the Governor's Office, legislators, tax professionals and business associations on proposed tax legislation. It seeks to ensure that new tax laws are administrable, and it provides the Legislature with estimates of the fiscal impacts of legislation. Laws have to be interpreted through the development of rules (Washington Administrative Code) and the Department seeks input from affected parties in the drafting and enactment of rules. The Department regularly meets with business associations to address issues and provide updates on agency operations.

The Whatcom County/British Columbia sales tax failure to communicate

A prime example of what can go wrong when stakeholders aren't consulted occurred when the Canadian province of British Columbia switched from its provincial sales tax and federal goods and services tax to a harmonized sales tax (HST) on July 1, 2010. Despite the name, an HST functions as a value-added tax, not a sales tax. That meant that according to past Department interpretations, residents from British Columbia would be eligible to purchase products in Washington without paying sales tax under a 1965 law that granted sales tax exemptions to residents from any state, territory or province with either no sales tax or one with a rate under 3 percent. The Department had years earlier determined that residents from several other Canadian provinces with an HST qualified for the exemption, but none of them shared a border with Washington.

What the Department failed to do was inform local governments in Whatcom County that residents of British Columbia would no longer be paying state or local sales tax on purchases of products to be taken back to the province. That had a significant negative impact on local tax revenues, and both Whatcom County and Bellingham promptly sued to block the Department from advising retailers that they had the option of providing the exemption. A judge granted an injunction pending judicial review of the Department's interpretation, but as oftentimes happens in cases like this, resolution of the issue was postponed until the 2011 Legislature was given an opportunity to amend the law so provinces with a value-added tax did not qualify. That resolved the issue to everybody's relief except possibly British Columbia residents and some retailers who saw the opportunity for higher sales. As it turns out, British Columbia residents disliked the HST and voted in 2011 to go back to a provincial sales tax system.

This example reinforces the fact that communication with stakeholders is critical for the Department in maintaining its credibility as an organization that values input from those impacted and is sensitive to minimizing the regulatory burden on businesses.

Debt collection management seen as a model for other agencies

A key component of equitable tax administration and maintaining an effective tax collection system is to efficiently pursue taxes owed by businesses. In that respect, the Department does an excellent job of managing state debt collections, according to a 2008 study by the State Auditor's Office (SAO).

Examples of best practices cited in the report include the Department's Initial Contact Team that uses autodialing technology to contact taxpayers who fall behind on their tax obligations, and data sharing with the Department of Labor and Industries and the Employment Security Department to help all three agencies coordinate their collection efforts.

The SAO audit noted that 76 percent of the $3.3 billion in debts it tracked fell within the Department's responsibility and it was an "excellent performer" in pursuing successful collection of those unpaid taxes. The audit also highlighted the Department's commitment to streamline debt collection operations and its use of "excellent performance measures" to gauge the effectiveness of its debt collection efforts.

The Department typically puts into deferred collection status an amount equivalent to less than 0.2 percent of its overall collections. These uncollected taxes generally stem from bankruptcies and other instances where businesses no longer have attachable assets. Even then, the Department continues to seek to collect those taxes if assets become available, such as through a lien on a property that may eventually be sold. Only after 12 years does it finally write off the taxes as uncollectible.

Reducing the underground economy

The underground economy was perceived as a growing problem even before the economy soured. Avoiding taxes may help some businesses get by, but it is at the expense of honest registered businesses that collect and pay all taxes due. Compliant businesses complain about this unfair competition and want the state to do more about it.

To address this issue, the Department worked with other agencies to develop an unregistered business study in 2007 to gauge for the first time ever the size of the underground economy. The results were used to target future education and enforcement efforts.

Suspectfraud.com

One offshoot of the underground economy study was the creation of a website to assist consumers in checking out businesses before they commit their hard-earned dollars —and to report businesses that may be operating without the proper licenses. The Department reviews these complaints to identify businesses that may be operating without a business license or underreporting their gross income.

The Department, in cooperation with Labor and Industries, Employment Security, and Washington State Patrol set up a central website, suspectfraud.wa.gov, to provide links to consumer fraud services. The agencies join together to share data and also participate in a media campaign during consumer protection month.

Visitors also can verify the legitimacy of charity fundraisers, and report fraud involving a variety of industries, such as banks, child support, insurance, unemployment and workers' compensation, vehicle titles, and medical services. Links also are provided to assist fraud victims.

Deterring tax evasion

While the vast majority of registered businesses pay nearly all taxes due, some businesses cannot resist the temptation to improve their competitiveness or bottom lines through tax evasion. Most commonly, businesses will collect but not remit sales tax collected from their customers, providing them with a boost in revenues even though it is a felony to divert sales tax trust funds. To deter such behavior and protect consumers, the Department works with a unit of the Attorney General's Office to file criminal charges against businesses that engage in tax evasion. Most common are businesses who understate the amount of taxable business they do. For example, one Everett drywall installer was convicted of only reporting one-half of 1 percent of his business, stealing more than $950,000 in sales tax in the process. Sometimes individuals will be prosecuted too, such as the Tacoma businessman who falsified the paperwork on a yacht he had built to substantially understate its taxable value. Other cases involved businesses that were not registered at all, and were either not collecting sales tax on their activities or collecting and keeping it. In all cases, the Department seeks media coverage of the prosecutions to help deter tax evasion.

Improving the business climate

The Department has undertaken several initiatives to improve the business climate over the past eight years. This includes examining how it can help small businesses survive, streamlining business transactions with government, and enhancing the business licensing system.

Helping small businesses survive

Under the best of circumstances, building and growing a business is challenging. Washington has one of the highest rates of new business formation, in part due to the ease of obtaining a business license. But it also has one of the highest rates of new business failures. At the direction of the Governor's Office, and in cooperation with several other state agencies, the Department produced a Small Business Survival report in 2007. The study found that 93 percent of active registered businesses are small businesses defined as those with 20 or fewer employees and less than $3 million annual gross income. It identified measures the state could do to increase the survival rate of small businesses. The Department prepared more guides to help businesses plan for keeping on top of tax and other regulatory requirements and is a member of the Governor's Office of Regulatory Assistance's Small Business Liaison Program.

Seeking tax simplification

Businesses complained about the regulatory burdens on them during a series of meetings Governor Gregoire held around the state in 2010. The Governor directed the Department to research ways it could help small businesses by reducing the complexity of the state's tax system. As the result of extensive stakeholder feedback from businesses and cities, the Department issued recommendations to the Governor. From the majority of comments and concerns, the Department concluded that the greatest tax complexity problems faced by Washington's small businesses related to:

- Reporting business and occupation (B&O) tax
- Reporting retail sales tax
- Understanding the reporting and licensing requirements of multiple agencies
- Understanding tax administration processes

During the 2012 session, the Governor's Office proposed tax simplification legislation that would have resulted in businesses filing a single tax return using the Department's electronic filing system. The intent of the legislation if passed would have been to increase uniformity between state and city B&O taxes and required the Department to collect all local B&O taxes. While the business community and many smaller cities supported this proposal, it was opposed by Seattle and four other large cities that indicated they plan on creating a city portal that would allow businesses to file local tax returns in one place. The Governor maintained that creating a single state/local portal was simpler for businesses than requiring them to use both state and local portals. The Association of Washington Business, which is a strong proponent of tax simplification, has indicated that it will urge legislators to pass legislation that addresses local B&O administration during the 2013 session.

Streamlining business transactions with government

Businesses have told the state that they want a single web-based, one-stop shop where they can sign in one time and conduct all their state business, including licensing, permitting and the payment of all taxes, fees and premiums to multiple state agencies. The Department and several other state agencies are working with the Office of the Chief Information Officer (OCIO), to develop a single portal through which businesses can interact with state government. Pursuant to Executive Order 12-01: Regulatory Reform and Assistance to Help Small Businesses Succeed and Grow, the OCIO produced a report in November 2012 that identified how such a system could be deployed, resources permitting. This multi-biennial, phased approach would first integrate state systems such as those operated by Revenue, Licensing, Employment Security, and Labor and Industries. Ultimately, more local jurisdiction business licensing and taxation functions could be added so businesses could deal with all state and local governments in a single place. The Department has been asked to lead this effort.

Improving business licensing

Legislature in 2011 transferred the state's Master License Service from the Department of Licensing to the Department of Revenue. The transfer takes advantage of the Department's strong relationships with business associations and local governments and aligns business licensing processes with the Department's existing systems, allowing it to improve services through a new Business Licensing Service (BLS). The transfer allows the Department to modernize the service to make it more responsive to the needs of the business community.

The number of businesses renewing their business licenses online rose from 31 percent in July 2011 to 53 percent by March 2012 after the Department implemented several improvements to the system. Those improvements include creating simple web addresses for corporate renewals and business license renewals. BLS offers more than 200 endorsements from 10 state agencies and 70 licenses from 54 cities.

Adding partners to BLS simplifies licensing for Washington businesses. BLS has added 10 cities and one sub-agency partner since July 2011; 25 percent of the 212 Washington cities that license businesses are now part of BLS, covering 30 percent of state businesses. At least 10 other cities have expressed interest or are in discussions with the Department about their participation and outreach is ongoing.

The Department is also working closely with the Office of the Secretary of State (SOS) to ensure we are leveraging resources. This may include developing a shared database so businesses can go to one place to register their business with BLS and their legal entity with the SOS.

While an improvement over earlier systems, the technology underlying the BLS system needs to upgraded, and the Department is working with a consultant on a replacement study and anticipates issuing a request for proposals to replace the current system starting in early 2013. The new system should be more flexible and scalable – enabling the Department to keep pace with partners' demands for a user-friendly, efficient system that provides easy access to reports to use for planning and recording trends.

Providing better taxpayer education and assistance

A key aspect of business growth is understanding the impact of taxes on business activities. While it is the obligation of businesses to understand and comply with state tax laws, the Department seized an opportunity to make tax information more readily available over the Internet and improve the clarity of all its communications. The Department has a solid education and outreach program committed to providing taxpayers with the information they need to understand and meet their tax reporting responsibilities. This is done through numerous channels from face-to-face taxpayer assistance, workshops, online services, and a centralized help desk.

Plain Talk

The Department was one of the first agencies to adopt and implement plain talk techniques to its communications with taxpayers and the public. Standard notices to businesses were reviewed to improve their clarity. Providing clearer instructions to taxpayers has helped maintain a high level of voluntary compliance and has reduced the number of calls from taxpayers seeking clarification.

Web-based taxpayer support and training

Washington also is a leader among state revenue departments in deploying web-based taxpayer support and training, including video tutorials. The website offers numerous tools to assist businesses – from an online address/map look up tool to an ability to file and pay their taxes. The Department conducts website usability testing of online applications with volunteer businesses during the design phase to address the needs of the end-user.

Multilingual efforts

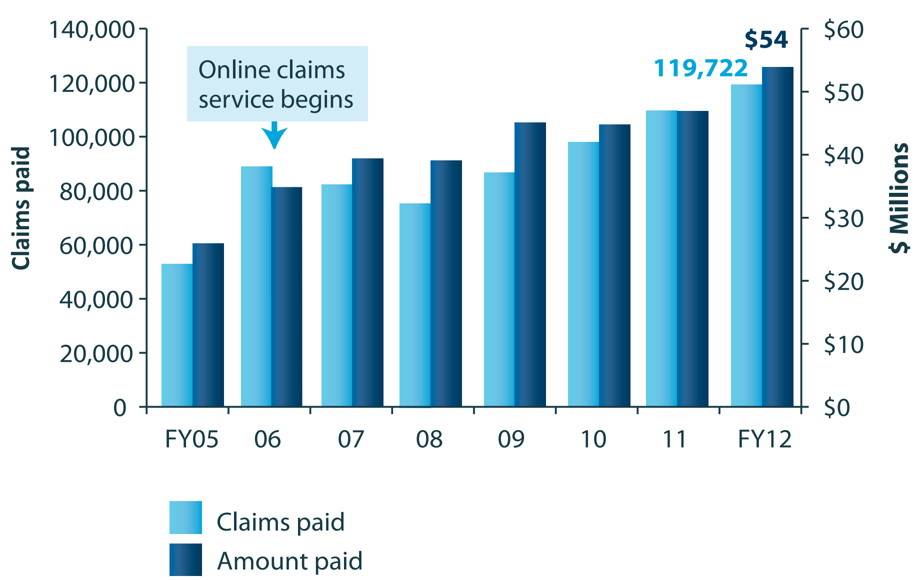
Washington's ethnic diversity continued to increase over the years, with some minority groups having a tradition of running their own businesses. The Department embarked on an effort to convert many of its publications into a variety of languages to assist non-English speaking business owners and continues to expand outreach services and advertising in languages other than English. This includes Spanish, Russian, Chinese, Korean, Tagalog and Vietnamese. Speakers of other languages can be accommodated upon request.

Targeted, data driven educational and enforcement efforts increase effectiveness

During the early 2000s, the Department increasingly used data analysis to identify compliance issues. The Department can audit only two or three percent of the state's 480,000 active registered businesses every year. Using data to drive decisions has helped the agency target its audit and educational efforts to problem industries and reduce audits of areas where past audits indicate a high level of voluntary compliance. The result is a greater return on audits and improved compliance among industries.

The Department relies heavily on education to maintain a high voluntary compliance rate. For example, the Department mailed letters to businesses that had not reported use tax on out-of-state retail purchases over the past few years. The letters remind the businesses of their obligation to pay use tax equivalent to the sales tax where the product was being used – for example copiers or dental equipment. The result was a large number of businesses voluntarily reporting use tax on their next returns. The program has been recognized nationally as a best practice, noting it as a cost-effective way to promote voluntary compliance that helps taxpayers understand their obligations. Targeted education efforts resulted in increasing voluntary collections by $3.4 million in FY2012.

Unclaimed property claims and amounts paid



Playing supervisory role over property tax system

The Department plays a statutory role in overseeing the work of county assessors to ensure fair and equitable administration of property taxes across the state. Typically, it addresses inequities and inconsistencies in local property taxation by reviewing the work of assessors and providing advisory services. This includes assisting counties in correctly setting levies, current use assessment, and most recently conversion to annual revaluation cycles.

The Department's key role in providing guidance and occasionally direction to counties, as well as the implementation of state legislation affecting property taxes, has immersed it in several controversial issues over the years. Most of the issues involve perceived lack of staffing in county assessor offices, and the resulting inability of some counties to revalue existing property and add new construction to the tax rolls in a timely manner. The Department also has been involved in ensuring that counties properly administer current use programs that reduce property taxes which has generated considerable media coverage.

Online applications help increase unclaimed property reported, claimed by rightful owners

The Department operates a self-funded unclaimed property program that seeks to reunite claimants to unclaimed assets such as uncashed paychecks, stocks and bonds, life insurance proceeds, bank accounts, security deposits, escrow proceeds and the contents of abandoned safe deposit boxes. Most states operate such programs, which require businesses to report assets after an extended period of no contact with the owners. The agency has heavily promoted the program in the media, resulting in repeated coverage, particularly on television.

As a result of deploying an online reporting system and online claims system, the amount of claims paid and the number of businesses reporting unclaimed property has continually increased. The Department returned a record $54 million to a record 119,772 claimants in FY2012, and tripled the number of businesses reporting unclaimed property since 2004.

The recession stresses tax system

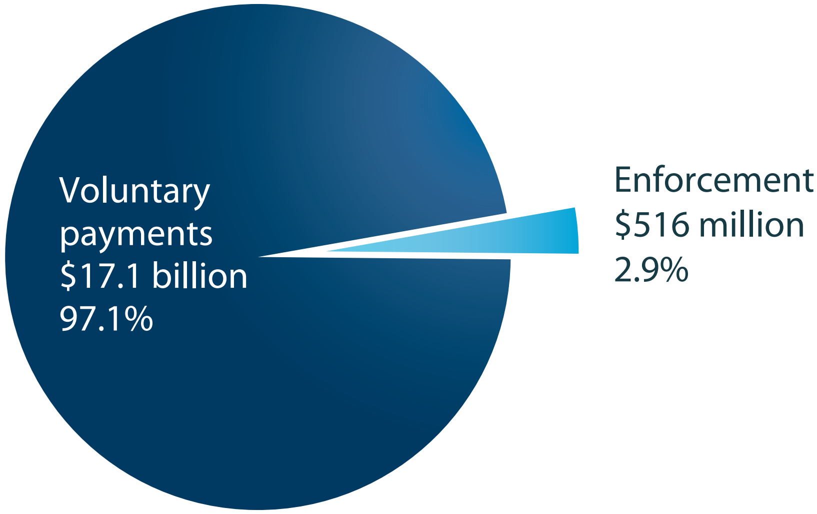
The Department's work became more complicated after the mortgage crisis hit. Construction virtually halted, home foreclosures soared, consumer sentiment soured and discretionary purchasing plummeted. State tax revenues dropped to $15.6 billion in FY2009 and $15.2 billion in FY2010 before recovering to $16.0 billion in FY2011. Legislators, the media and progressive think tanks began taking a hard look at whether some of the state's 640 tax exemptions were justified.

The economic shock of the mortgage crisis also hit businesses hard. Some struggled to pay their bills, and some got behind on their tax obligations. The Department was faced with the challenge of collecting taxes due but not forcing companies out of business due to overdue taxes. The Department was caught between its tax collection mandate and a perceived need to keep businesses in business wherever possible. In some cases, businesses that had collected retail sales tax from customers spent it paying bills rather than remitting it to the state as required. The Department had to collect these taxes, preferably by getting businesses to agree to pay their back taxes over time while not falling further behind.

Maintaining a high compliance rate amid economic downturn

The sharp economic downturn that began in 2008 posed new challenges for the Department. It needed to increase its efficiency while maintaining the high compliance rate among registered businesses, reducing the size of the underground economy, and helping small businesses stay in business. In addition, work with the Governor's Office and Legislature to review tax incentives on the books, and do it all amid budget cutbacks.

Voluntary vs. enforcement
State and local collections FY12



Revenue enhancement packages outlined

Whenever an economic downturn occurs, the executive and legislative branches of government begin looking for ways to raise new revenue. Most often the first step is to increase enforcement presence to ensure all businesses are paying the taxes they already should be paying. The Legislature in the past has added enforcement FTEs, primarily auditors and revenue agents, to the Department's work force to generate a given amount of revenue that wasn't being collected due to non-compliance. This approach, however, can reach the point of diminishing returns due to the already high compliance rate among registered businesses in Washington.

The Department plays a crucial role in identifying methods to manage the ongoing budget shortfall by repealing or narrowing of exemptions, deductions, and credits, increasing existing taxes, and instituting administrative reforms. In 2011, the Department developed a list of 180 revenue options for Governor Gregoire's review. The proposals took into consideration administrative and legal issues, costs and revenue impacts. The Department was instrumental in helping the Governor develop guiding principles to help shape recommended revenue options and assisted her in selecting proposals that could be presented to Washington's citizens and the Legislature as a 2011 2nd Special Session revenue package.

Resale certificate abuse curtailed

One may wonder how a mini-mart owner can buy tires for his personal car without paying the sales tax the rest of us pay. It used to be pretty easy if he claimed to be buying the tires for resale using the Department's former resale certificate process. Retailers do have a legitimate reason to not pay sales tax on items they buy from wholesalers or other retailers that they intend to resell to the final consumer, who then pays the tax. But many exploited that self-issued certificate to buy personal items. Some people took out business licenses simply so they could issue themselves a resale certification and buy products for their own use without paying sales tax. Resale certificate abuse was costing state and local governments $100 million a year and it was difficult for the Department to enforce. A more closely controlled system was needed.

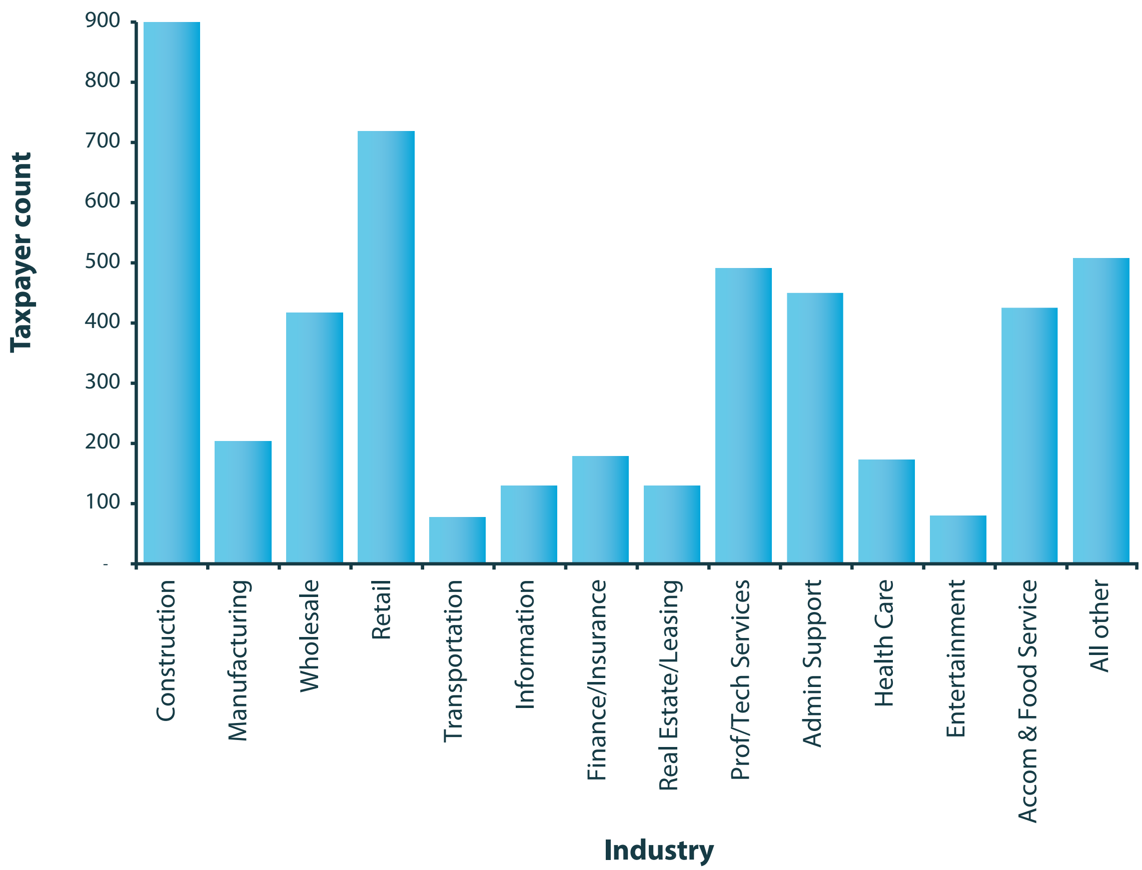
In 2009, the Department implemented legislation to improve sales tax compliance with better controls by replacing self-issued resale certificates with a Department-issued reseller permit. The change went smoothly and only businesses with a legitimate need for reseller permits got them. The level of abuse has dropped sharply. The implementation of the reseller permit system earned the Department the Federation of Tax Administrators (FTA) 2010 outstanding compliance award, adding to more than a dozen previous awards the agency has received in the past decade.

Amnesty provides partial solution to budget

Although the Department had never before proposed an amnesty program, it was one way of both generating tax dollars during a state budget crisis and giving taxpayers a way to get a fresh start. The time-limited amnesty program was authorized by the Legislature in 2010 at the request of Governor Gregoire. The amnesty program that took place in early 2011 allowed qualifying taxpayers to pay back taxes on certain taxes without the penalties and interest that otherwise applied. More than 5,095 businesses paid $345.8 million in state and local taxes. Penalties and interest waived totaled $91 million. The program received an award from the Federation of Tax Administrators (FTA) in 2012. Even though other states have implemented amnesty programs, FTA judges said it named the agency co-winner of its Taxpayer Service and Education award in recognition of how it launched the three-month amnesty period only seven weeks after the Washington State Legislature authorized it in a one-day special session.

Careful consideration must be given to the length of these types of programs so as to not significantly impact agency operations. Future amnesty programs should be carefully considered in regards to impact on future enforcement collections and maintaining levels of voluntary compliance.

Amnesty total count of taxpayers by industry



Electronic filing becomes mandatory

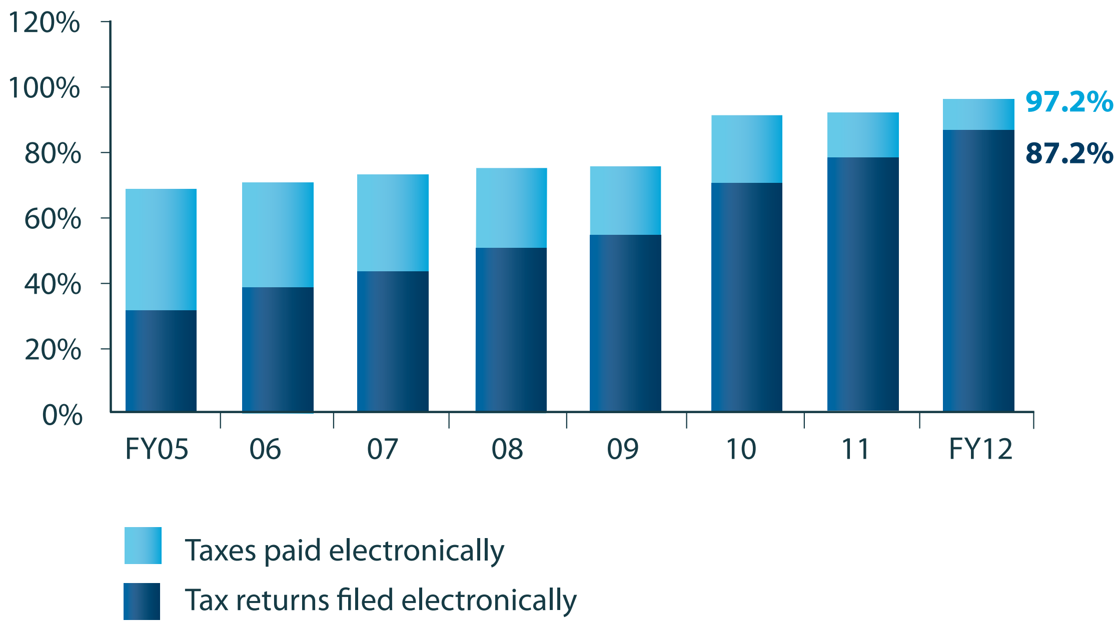
The Department began promoting electronic filing of excise tax returns in the late 1990s, and saw a steady increase in the number of businesses that voluntarily filed electronically versus paper. However, there reached a point where those that wanted to file online had done so, and the rest continued to file by paper. In addition, many who switched to electronic filing still paid their taxes by separate paper check. The Department needed to move to mandatory electronic filing to further reduce the handling of paperwork, the higher error rate associated with paper returns, and paper and printing costs.

In 2009, the Legislature granted the Department's request to require all monthly filers to file and pay their state taxes electronically, and in 2011, it extended that requirement to quarterly filers. The Department was able to grant exemptions to businesses for hardship reasons, such as not having computers or Internet connections. Annual filers are still allowed to file by paper since they only file once a year and pay relatively small amounts of tax.

E-file benefits taxpayers because they are less likely to make errors, saving them an estimated $1.3 million in penalties and interest in FY2012.

As other executive agencies consider mandatory filing, it is important to keep the program voluntary as long as possible to reach a tipping point where the majority of businesses were filing electronically if not paying electronically.

Electronic filing and payment rise



Budget cuts lead to printing and mailing fewer documents

One casualty of budget reductions has been printing and postage. In order to cut costs, the Department has curtailed most of the materials it formerly mailed to taxpayers or otherwise made available in paper form to the public, such as research reports. Instead, the materials are published in electronic form except when absolutely necessary, such as communication with stakeholders without Internet access. Otherwise, the Department communicates with taxpayers through email, secure messaging, listservs, E-file accounts and the media. As a result, it was able to reduce printing and postage expenditures by 43 percent between FY2007 and FY2012.

Employee turnover, retirements pose agency challenges

Prior to the recession, the Department struggled to hire and retain qualified employees, in particular examiners, auditors and information systems specialists. The Department frequently hired and trained new college graduates only to have them leave for better paying local government and private sector jobs in a few years. Recruitment and retention issues have meant the Department has had difficulty fully staffing positions necessary to ensure a high level of voluntary compliance through audits and other education and enforcement efforts. The economic downturn actually helped the Department attract and retain employees as private sector competition diminished; however turnover rates have increased as the economy has recovered.

Another challenge has been retirement of agency employees with the knowledge and expertise to train newer employees. This has created an experience gap between newer employees with less than seven years of employment and not-yet-retired senior employees with more than 18 years of experience. The Department's ability to attract and retain talented employees that possess the necessary knowledge, skills, and abilities directly impacts the core operations in support of the agency's mission. Based on recruitment, retention, and retirement data, the Department has increased its focus in succession planning, leadership competencies and training, knowledge management strategies, and diversity. Additional focus has been placed on recruitment and retention tools through the Department's Strategic Business Plan and Employee Satisfaction Survey priorities.

Offices closed and consolidated

In response to budget cutbacks, the Department has closed and consolidated three field offices over the past eight years. Most of these offices had been open to the public but it was costly to maintain them and the rise of the Internet as an information vehicle for taxpayers had reduced the need for in-person assistance. The Department still has 12 field offices throughout the state that provide customer services to taxpayers and stakeholders and is currently developing an agency plan for long-term service delivery. The plan will consider optimal geographic locations of field offices to best service the needs of taxpayers and provide opportunities for staff, while deploying resources efficiently and effectively.

Non-disclosed letter rulings victim of budget cutbacks

The Department provides guidance to taxpayers in a variety of ways, including the web, special notices and advisories, rulings and telephone assistance. It also provides 5,000 to 6,000 letter rulings annually to individual businesses upon request. Based on a description of planned business activity, the Department issues rulings, which are binding on the Department, on the taxability of specific activities. The rulings are highly fact-specific. Unlike some states, the Department does not charge for its rulings.

In the past, tax practitioners requested letter rulings on behalf of non-disclosed clients. In 2010, the Department discontinued providing such rulings due to the volume of requests it was receiving, budget constraints, and concerns about the anonymity of the businesses requesting them.

Publication of letter rulings and appeals determinations

The Department also has declined to publish its letter rulings due to resource concerns. Such rulings must be "sanitized" to remove names and proprietary or confidential tax information. This takes time and resources. Moreover, readers might be able to identify the requesting business by the nature of the activity described. The Department has been criticized by one tax trade publication and in-state business groups for not publishing its rulings or all of the decisions rendered by its appeals decisions. The Department's position is that rather than expend the resources to publish all rulings and appeals decisions, taxpayers are better served by having the Department issue guidance to taxpayers in the form of special notices, industry guides, excise tax advisories and other general tax education outreach. The Department continues to review its policies in this area.

Strengthening partnerships with local governments

The downturn also affected local governments, which are always concerned about the impact of legislation on their budgets. To communicate more effectively with these stakeholders, the Department engaged in a local government partnership effort to span the collective work of the many divisions at the Department, the 39 counties, and the hundreds of cities. Regular meetings are held with local government and a web portal has been created to communicate key issues of interest to local jurisdictions.

Adverse court decisions create challenges

If the economic downturn wasn't enough, several adverse Washington State Supreme Court decisions would have further reduced tax revenues had the Legislature not passed corrective legislation. The biggest dollar case involved a direct seller exemption intended to benefit out-of-state companies that supplied products to door-to-door salespeople. The court's 5-4 ruling in 2009 that Dot Foods didn't owe business and occupation tax on revenues it received from products sold to retail stores had a multi-million dollar negative impact on state revenues because many other businesses could claim the same exemption using the court's logic. The Legislature subsequently passed legislation that eliminated this "direct seller" exemption altogether.

Another case involved a company that claimed that it was eligible for a preferential B&O tax rate intended for meat packers because it put meat into the canned chili it manufactured. The Department disallowed the company's attempt to pay a lower tax rate as a meat processor, but that decision was appealed in court. The Washington State Supreme Court ruled in its 2005 Agrilink decision that the company qualified for the preferential rate. This meant that any other company that put any amount of meat into its products would also qualify, opening the gates to multiple refund requests from businesses. The logic behind the Agrilink decision also meant processors of fruit and vegetables were entitled to a preferential B&O tax rate. While the Department successfully sought legislation to restore the legislative intent of the meat packing rate in 2010, it was repealed by voters through Initiative 1107 later that year. That initiative also repealed a tax increase on carbonated beverages and extension of the sales tax to candy, gum and bottled water.

In 2005, the Washington State Supreme Court invalidated Washington's estate tax due to changes in the federal estate tax to which it was linked. The Department worked with the Governor's Office and Legislature to enact a standalone estate tax that applied to estates of more than $2 million (Chapter 516, Laws of 2005). The estate tax generated $121.5 million for the Education Legacy Trust Account in FY2012.

The Department has prevailed in a number of other significant cases, but challenges to the tax code – sometimes tried through the media first – continue to be a significant management issue.

Increasingly sophisticated tax avoidance, court challenges of a 1930s tax system

The current state tax system was created in the 1930s and is not functioning well in the borderless, Internet-based service economy of the 21st century. Tax practitioners developed theories to allow clients to claim favorable tax treatments that often were disallowed by the Department. Some disputes ended up in court. The Department frequently needed to turn to the Legislature to update tax laws in response to new challenges.

For example, businesses sometimes buy other businesses that own real estate. Prior law specified that whenever a business bought a controlling interest in another business, real estate excise tax was due on the value of any real estate involved. Businesses were able to exploit a loophole by structuring partial purchases of the business over an extended period of time, avoiding payment of real estate excise tax on property acquired. In response, the Department successfully sought legislation in 2010 that deterred this tax avoidance technique.

Representing state's interests in Congress

Seeking legislation to collect sales tax on online consumer purchases

The rise of the Internet added to the pressure on in-state merchants. An increasing number of consumers turned from traditional brick-and-mortar stores toward the Internet. These consumers were drawn by convenience and competitive prices, but also by the fact that these so-called remote sellers were not required to collect sales tax on their sales due to a 1992 U.S. Supreme Court decision. While consumers were liable for an equivalent use tax on their purchases, few paid it and enforcement was impractical. Although the Department audits businesses to ensure they pay use tax on out-of-state purchases, it lacks an effective enforcement mechanism for consumer purchases by individuals.

The result of sharp growth online sales has been erosion of the state's sales tax base, with Internet and mail order sales growing much faster than in-state sales. This erosion is of particular concern to Washington because the sales tax is by far its single largest source of tax revenue. Barring Congressional action to require collection of the tax, the Department estimates that Washington will lose more than $1 billion in state and local taxes to untaxed Internet and mail order commerce during the 2013-15 Biennium.

The Department has worked closely with the Governor's Office and the state's congressional delegation to convince Congress to pass legislation requiring out-of-state sellers to collect and remit sales tax. Repeated bills have been introduced over the years, but it appears that bi-partisan support is building in Congress, and legislation may be enacted by Congress in 2012 or early 2013. Washington has been a key player in the work of a consortium of states that have been working together to reduce the complexity of sales tax collection across multiple states and local jurisdictions. This led to the development of the Streamlined Sales and Use Tax Agreement (SSUTA) now adopted by 24 states, including Washington. The SSUTA would allow the state to almost immediately begin collecting sales tax from larger remote sellers, generating an estimated $558 million in state and local taxes during the 2013-15 biennium and $934 million in the 2015-2017 biennium.

Untaxed Remote Sales
Estimated Loss of State and Local Sales Tax

Opposing Business Activity Tax

The Department has been successful to date in working with the state's congressional delegation to thwart efforts in Congress to enact a business activity tax that would have severely limited the state's ability to require cross-border companies to pay business and occupation tax on gross income derived from Washington customers. This would have had a significant negative impact on tax collections, estimated at more than $1 billion, equal to over a quarter of all business and occupation tax collections, by FY2016.

Updating the tax code for the 21st century

In addition to the Internet onslaught, the state's 1930s-era tax code was under pressure from increasingly sophisticated tax avoidance schemes. Out-of-state companies increasingly were competing with in-state companies yet not paying taxes on the gross income they received from Washington customers. Changes needed to be made to make the system cope with changes in the economy and tax planning.

Defining Digital Goods

Digital goods were rapidly replacing tangible personal property, such as downloadable music supplanting compact disks sold in retail stores, but the state tax code provided little guidance in how these new forms of digital goods should be taxed.

In 2009, the Department created a comprehensive new tax structure for the growing economic area of digital goods, such as the transition of music in CD form to downloadable files, and the emergence of cloud computing. Washington became recognized as a national leader in this area and has provided guidance and examples for other states and Congress.

Economic nexus and apportionment reforms

In 2010, the Department urged Governor Gregoire to seek legislation that led to the adoption of reforms that leveled the playing field between in-state businesses and their out-of-state competitors. Banks and service businesses such as attorneys, architects and engineers were providing services to in-state customers but because of outmoded tax laws, they were not subject to the state business and occupation tax because they had no physical presence in the state. Thus, the out-of-state businesses were able to undercut in-state businesses that were paying state taxes. The Legislature created a definition of economic nexus that subjected these out-of-state companies to the same taxation as in-state companies. In addition, it revised the method for apportioning income for tax purposes for companies that do business in multiple states. This had the effect of reducing the Washington state tax liability of in-state service providers that served customers in other states.

Deterring abusive tax avoidance

Another element of the 2010 legislation was intended to deter businesses from avoiding state taxes through complicated schemes that frustrated the intent if not the letter of the law. Special legislation was needed to disallow transactions that served no other purpose than to reduce or eliminate tax liability. For example, businesses would create out-of-state subsidiaries whose sole purpose appeared to be to shift taxable gross income to lower-taxed states when in fact most of the actual work was being done in this state. While the legislation began the process of updating the tax code, the Department continues to work with the business community in developing rules that discourage abusive tax avoidance but allow businesses to conduct legitimate transactions without fear of having the Department later disallow them and impose back taxes and penalties.

Lack of prior stakeholder involvement due to the sudden emergence of this issue during a legislative session contributed to the business community's strong opposition to the original legislation. As a result, implementation has been slowed due to the need to provide significant stakeholder involvement prior to official rulemaking.

Although taxpayers have appreciated the opportunity to work with the Department, clear guidance and certainty for businesses in this area remain elusive. Washington's unique B&O tax structure creates unusual challenges for many businesses that may only be resolved through additional legislative changes.

Revenue alternatives explored

The Department also periodically produces lists of possible revenue raisers that if enacted could generate additional revenue. These include increases in existing tax rates, the elimination of exemptions, and closing loopholes that arise through creative interpretation of tax laws. This list is generally limited to changes that the Department considers to be administrable.

Although proposals to repeal exemptions and "loopholes" may appear attractive, they are not a viable solution to resolving large and sustained revenue shortfalls because they tend to lack political support. Increases to broad based existing taxes, such as the retail sales tax, represent the most viable method of raising large amounts of revenue.

While a published list of revenue alternatives and their estimated revenue impact provides transparency for legislators, legislative staff, media, and the public, care must be taken that such alternatives are fully vetted to ensure that the alternatives are practical. Targeted tax increases that visibly impact individual groups, such as taxes on candy, bottled water, or carbonated beverages, may create highly motivated opponents that have the resources to fund initiatives repealing such increases.

Taxation of business activity in Indian Country, including tribal-private partnerships

An emerging issue is economic development in Indian Country that involves private-tribal partnerships. The taxability of such enterprises requires the application of a complex federal balancing test, developed by the U.S. Supreme Court, that weighs the interests of the federal government and the tribe in the activity the state wishes to tax against the interests of state and local governments. This test is applied on a case-by-case basis, and there are no bright lines. In another area, the state has successfully negotiated tribal cigarette compacts with 24 Tribes, it to date has been unable to resolve a dispute with the Yakama Nation over the sale of cigarettes to non-members by smokeshops located on its reservation. While federal courts have upheld the state's right to impose state cigarette taxes on purchases by non-members, it is difficult for state officials to enforce this right, relying instead on federal authorities that have authority to enforce laws on Indian reservations.

Replacing legacy computer systems

The Department depends on legacy systems for its mission critical tax and business licensing processes. These systems are the backbone of daily operations. These systems have evolved over the years with regulatory and legislative changes. They have become more complex programmatically, are more difficult to maintain and developers with legacy programming skills are more difficult to recruit. For users of the system, the user-interface and workflows have become cumbersome and time-consuming to use.

Replacing these systems and migrating to modern technologies will reduce the agency's operational risks and provide more desirable features and ease of use than what is currently available. It also allows access to a larger workforce trained on new technologies as well as software products that only work with more modern systems.

The Department is working with an external consultant to complete feasibility studies and planning efforts for two legacy system replacements – one for the business licensing service systems and one for the core tax systems. These studies will be completed in late 2012 and early 2013.

It will be requesting funds to support the replacement project starting in the 2013-15 Biennium. This project is anticipated to take approximately six years to complete. To mitigate the project risks and improve the likelihood of success of a system replacement of this size and scope, the suite of legacy systems will be broken-down into smaller, well-defined functional areas that can be worked on and migrated incrementally, over time.

Funding Washington's future

Despite the continuing challenges outlined in this report, the Department is well positioned to continue its mission of funding Washington's future. It continues to implement new economic nexus laws governing B&O tax liability of out-of-state service firms, work with the Governor's Office and our state's congressional delegation to pass legislature requiring remote sellers to collect sales tax, and represent the state's interest in a series of court cases. Other issues include evolving interpretations of tax law as they apply in Indian Country, legislative review of the efficacy of tax exemptions and dealing with the underground economy. Overall, the agency has a good track record of defending the tax system, seeking corrective or clarifying legislation when necessary, and recommending updates to the tax code to respond to changes in the economy. The Department is proud of its accomplishments, the national recognition it receives as a leader among state revenue agencies, and its continuing use of technology and process improvements to achieve even greater administrative efficiencies.