

ENGROSSED HOUSE BILL 2030 STUDY PROGRESS REPORT

Background

In 2003, the Legislature enacted Engrossed House Bill 2030 (EHB 2030), which provides for a more uniform system of municipal business and occupation (B&O) taxes. It directs the Association of Washington Cities (AWC), with input from the business community, to adopt a Model Ordinance to serve as a foundation for municipal ordinances that impose a B&O tax. The Model Ordinance must contain certain mandatory provisions, such as uniform definitions and administrative provisions, a system of credits developed to address multiple taxation of gross income, and a system to allocate and apportion gross income among cities. Cities are authorized to deviate from the non mandatory provisions of the Model Ordinance. Cities imposing B&O taxes must comply with all requirements of EHB 2030 by December 31, 2004.

The legislation directed the Department to conduct two studies. The first study is entitled the "Baseline Study," which is due to the Governor and the Legislature by December 31, 2004. The second study is entitled the "Allocation and Apportionment Study," which is due to the Governor and the Legislature by November 30, 2005. The Department is required to provide progress reports of the Allocation and Apportionment Study to the fiscal committees of the Legislature on November 30, 2003 and November 30, 2004. A timeline of the various deadlines contained within EHB 2030 are contained in the appendix of this report.

Advisory Committee

The legislation also directed the Department to use, and regularly consult with, an advisory committee while conducting the studies. This advisory committee was to be composed of an equal representation from interested business representatives and from representatives of cities imposing local B&O taxes. In 2001, the Governor directed the Department to convene a Municipal Tax Work Group composed of business and local government representatives to explore alternatives to simplify local B&O taxes. The Department invited the Municipal Tax Work Group members to serve on this advisory committee because the members are knowledgeable and interested in the subject matter. Additionally, their representation met the requirements of EHB 2030. The majority of the Municipal Tax Work Group accepted the invitation. A few new local government appointments were required to replace members who were leaving elected office or appointed positions.

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The Department held its first meeting with the advisory committee on September 30, 2003. A discussion of that meeting comprises the majority of this report. The Department sought input from the committee members on their understanding and expectations of the studies' content. The committee discussed the deadlines for the studies, and the difficulties the deadlines posed. The data available to conduct the studies was discussed and the advisory committee's assistance in supplementing the data was requested.

Status of Model Ordinance

The Department asked the AWC to provide an update on the status of the Model Ordinance. Both studies are critically dependent upon the adoption of the Model Ordinance at the earliest date.

In 2002, the AWC and its members developed a Model Ordinance with input from local chambers of commerce, business associations, and individual businesses. Many cities, including the five largest cities that impose a B&O tax (Seattle, Everett, Tacoma, Bellevue and Bellingham) have already enacted the 2002 Model Ordinance. Jim Justin, AWC Assistant Director for Intergovernmental Relations, reported that AWC revised its 2002 Model Ordinance to conform to EHB 2030. It was being circulated among AWC members for their input. Mr. Justin also asked the business representatives of the advisory committee for their input.

There was general agreement from the business representatives that they would provide input to AWC and the Department on the draft Model Ordinance by November 1, 2003. The Department sent an electronic version of the Model Ordinance to the entire advisory committee following the meeting. Neither AWC nor the Department received any input on the draft Model Ordinance from the advisory committee. However, the Association of Washington Business requested additional time to submit their comments.

In order to perform the studies by the due dates specified in the legislation, the Department needs a complete and final Model Ordinance by June 1, 2004. If the Model Ordinance is provided by an earlier date, the Department can provide a more detailed analysis in the studies. If the Model Ordinance is provided at a later date, the quality of the studies may be unavoidably compromised.

Baseline Study

The legislation provides that the Department shall report by December 31, 2004, to the Governor and the fiscal committees of the Legislature on the definitions used in the proposed Model Ordinance. The report is to detail the status of the definitions, noting any deviations from the

definitions in chapter 82.04 RCW and the reason for such deviation. The legislation also requires the report to estimate the fiscal impact on taxpayers of any deviations from the definitions under chapter 82.04 RCW.

The bulk of the Baseline Study is examining the effects of 13 definitions that cities are to develop in the Model Ordinance using chapter 82.04 RCW as a baseline. Those definitions are:

1. Eligible gross receipts tax
2. Extracting
3. Manufacturing (software development may not be defined as a manufacturing activity)
4. Retailing
5. Retail sales
6. Services (the term “services” excludes retail or wholesale services)
7. Wholesale sales
8. Wholesaling
9. To manufacture
10. Commercial and industrial use
11. Engaging in business
12. Person
13. Any tax classifications in addition to those enumerated in subsection (1) of this section that are included in the Model Ordinance must be uniform among all cities

Issues for Consideration

- Who are “taxpayers” for purposes of the study?

The advisory committee agreed that “taxpayers” means only those taxpayers within the 37 jurisdictions currently imposing a local B&O tax. For the report, the taxpayers will be sorted by classification, industry, and size.

- What does “fiscal impact” mean for purposes of the study?

The advisory committee discussed the proper measure of the fiscal impact and asked the following questions: Should the fiscal impact be measured in the aggregate by simply comparing the differences between the Model Ordinance to the state B&O tax definitions? Or, in contrast, should the fiscal impact be measured by comparing the differences between state B&O tax definitions and those adopted at the local level?

The questions are relevant for two reasons. First, the effect of a deviation from state law could be eliminated through deductions, exemptions, and credits that cities are allowed under HB 2030 to adopt without limit. Second, the Model Ordinance may contain additional uniform tax classifications that cities must adopt. The fiscal impact of additional classifications will depend on the tax rate imposed at the local level.

For example, RCW 82.04.2403 exempts the cleaning of fish from the state definition of manufacturing. It is anticipated that the Model Ordinance will not require cities to exclude this

activity from the definition of manufacturing to accommodate the city of Westport, which taxes this activity. Some cities, however, may choose to continue to exempt this activity. Without examining the Model Ordinance as adopted at the local level, the fiscal impacts may be exaggerated.

The consensus of the advisory committee was that the fiscal impacts would be measured by the differences between the Model Ordinance and the state definitions on all taxpayers located in cities imposing a B&O tax. Caveats would be included when appropriate that the fiscal impact may be mitigated by rates, deductions, credits, or exemptions. If cities know the content of the ordinances they plan to adopt by June 1, 2004, the Department can analyze local impacts in those jurisdictions. However, cities have until December 31, 2004, to conform to EHB 2030, which is also the deadline for submitting the Baseline Study. Therefore, it is unlikely that local impacts will be included in the Baseline Study.

Allocation and Apportionment Study

The Department of Revenue is required to conduct a study of the net fiscal impacts of EHB 2030, with particular emphasis placed on the apportionment and allocation methods contained in the legislation. As part of its report, the Department will examine and recommend options to address any adverse revenue impacts to local jurisdictions.

EHB 2030 provides that gross income derived from all activities other than those taxed as service or royalties are allocated to the location where the activity takes place. In the case of sales of tangible personal property, the gross income is allocated to where delivery to the buyer occurs. Service income is apportioned through a two-factor formula using payroll and service income of the taxpayer.

Because of the complexity of the study, the Department requested the advisory committee to appoint individuals from business and cities to a technical advisory committee to work with the Department's Research Division. Those individuals are:

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Issues for Consideration

- Timeline of Study

The study committee has requested that the net fiscal impacts be estimated for each of the 37 cities currently imposing a local B&O tax. Fulfilling this request will be a challenge with the current timeline of EHB 2030. Adoption of the Model Ordinance at the local level is not required until December 31, 2004. The deadline to submit the study is November 30, 2004. Consequently, there will be little actual data on the effects of EHB 2030 available to use in the study.

- Available Data

Data to determine the effects of the allocation of income, other than services, is generally available. Retail sales are currently coded to a location on taxpayer returns, and thus, there is an accurate and available source of information to allocate retailing among jurisdictions. Additionally, the Department can use the results of the streamlined sales and use tax sourcing study to estimate the impacts of allocating the sale of tangible personal property to the point of delivery.

Data to determine the effects of the apportionment of service income is more difficult to obtain. The payroll factor of the formula can be estimated through the use of wage data collected by Employment Security. Wage data is collected by firm and can be located to a particular city. The payroll factor can be calculated for each firm by taking its wages within a city divided by its total wages.

However, the Department of Revenue does not currently have any access to a firm's service income earned within a particular city. The state B&O tax is a source of data only for a firm's statewide service activity. The advisory committee noted that businesses and cities have limited information on service income earned in each jurisdiction because the information is not currently relevant to completing a city tax return. The study committee has discussed various ways of obtaining a firm's service income earned within a particular city. These include surveying businesses, conducting information audits of selected firms, and modifying city B&O tax returns to collect the needed data. All of these methods will require additional resources and time that may not have been considered with the original legislation.

- Survey – Firm data on service income data by city could be collected through a survey mailed directly to representative sample of taxpayers for each city with a B&O tax. There is a concern whether a firm would have this data readily available to respond to a survey. Additionally, the Department learned through its recent streamlined sales and use tax sourcing survey that taxpayers feel they are being excessively surveyed. Thus, the response rate of such a survey is also a concern. Designing, mailing, and compiling the results of a survey will require additional resources. The Department generally contracts with the Washington State University Research Center to conduct its surveys at a cost of approximately \$50,000 per survey.
- Information Audits – The Department of Revenue could hire additional auditors to perform informational audits to collect the needed data. A representative sample of firms could be selected and the data could be obtained through the audits. This could be a very expensive technique and would require a significant amount of time to complete the audits. Taxpayers may also object to the time and expense they incur from such audits. Additional resources would be required from the Legislature to implement this option.
- Modify city B&O returns – Cities with a B&O tax could modify their returns to collect data directly from the taxpayer. This option places the administrative burden on the business taxpayer to report, and on the cities to collect and compile the information. As a result, cities will need time to modify their returns and to educate taxpayers. The Department would need data from the tax returns over a six to twelve-month period.

In the absence of additional resources, the Department proposes to use Washington input/output tables to estimate the impact of the new apportionment formula on service income at the city level. Input/output analysis could be used to estimate the amount of services purchased by households and businesses. Household purchases of services could be allocated to individual jurisdictions by its share of statewide household income. Input/output tables would give us information on the purchases of different type of services by industry sector. This could be allocated to different jurisdictions based on the number of employees for that particular industry. This means of estimating would not require additional resources for the Department of Revenue. However, the accuracy of the estimates may be less than that desired by the Legislature. Input/output data can provide only a gross estimate of the effects service apportionment. Surveys, informational audits, and return data could be used to verify certain key assumptions, and thus, improve the accuracy and quality of the study.