Streamlined Sales Tax Mitigation
Advisory Committee Meeting Minutes
January 8, 2009

Attendees:
Lorrie Brown, Office of Financial Management
Cliff Craig, City of Puyallup
Sheila Gall, Association of Washington Cities
Shawn Hunstock, City of Tukwila
Bob Jean, City of University Place
Jim Justin, Association of Washington Cities
Neil Kruse, City of Kirkland
Danielle Larson, City of Tacoma
Glen Lee, City of Seattle
Lucy Liu, City of Bellevue
Bob Nachlinger, City of Kent
Rick Peterson, House Finance Committee
Gary Prince, King County Department of Transportation

Department of Revenue Staff - Matthew Bryan, Kim Davis, Joyce Fouts, Miki Gearhart, Mike Gowrylow, Don Gutmann, Jim Harden, Tim Jennrich, Tiffany Johnson, Diane Mielke, Greg Potegal, Janetta Taylor, Valerie Torres

First Mitigation Distribution

Don Gutmann: We sent the first payment information out on December 12. We have responded to numerous questions.

Accessing the data

Kim Davis: Some jurisdictions had trouble opening the files in secure messaging. We are working with our I.S. people to identify the problem and correct it.

Common questions

We have a handout with some of the questions that we have answered regularly. This handout will help us so we are consistent with our answers.

Jim Harden: One request we got was from somebody other than the contact person in an office who wanted their own password. Jurisdictions can share the password but only with people who have a signed secrecy clause.

Kim Davis: We still have to educate people that our information is confidential and can’t be shared with others.

Matthew Bryan: Some jurisdictions were not able to read the data files, and it seems as if the problem is fixed. The common questions that we have gotten have been simple technical questions about how we got the numbers.

Don Gutmann: We have been asked why these numbers aren't the same as the ones in the original study. The study was done quite a while ago and the economy has changed since then.

Jim Justin: Have any of the negatively-impacted cities challenged the amounts that they have received?

Don Gutmann: No -- we haven't had any.

Lucy Liu: We are not very satisfied with our amount. Ours is out of whack. We were estimated to have a $2 million loss and we ended up with a $28,000 gain.

Shawn Hunstock: We have the same thing for Tukwila. I contacted the stores and they say that isn't happening. They are not actually making the deliveries.

Lorrie Brown: Is your mitigation too high, then, because their deliveries are overstated?

Kim Davis: If a business with multiple stores opens another store, that will impact the mitigation. One of the things we are asking is that the local jurisdictions need to look at their detail and look at their top businesses. We have had other jurisdictions outside of the committee that have contacted us also. So we hope you can get the message to other cities as well to look at the detail.

<u>Internet summary files</u>

Matthew Bryan: Four jurisdictions did not get a payment but also did not appear in the gainer file. Their businesses had an outset of goods, but there was a compensating offset. We could show that as a zero.

Jim Justin: Why can't you list the offset?

Matthew Bryan: There is a disclosure problem for most of them.

Don Gutmann: My proposed solution is to show them under gainers with a zero impact. That way they will show up in the summary files.

<u>$25 payment threshold</u>

Kim Davis: We do have the $25 payment threshold. No one was impacted by that this quarter, but there were several that were close.

Issue Papers

Issue Paper 01-05 – NAICS – Computer Equipment

Valerie Torres: We have many businesses in the computer equipment NAICS that deliver and also install the equipment. Prior to destination sourcing, the installations were coded to the location of the installation, so the return was half origin-based and half destination-based. When comparing sales patterns in cities before and after the change to destination-based sourcing, these businesses might make the results inaccurate or misleading.

Don Gutmann: These amounts can be large and very infrequent. We are showing gains or losses that are not truly gains or losses.

Valerie Torres: They might affect one quarter and disappear.

Kim Davis: We haven't made an adjustment for these, but we will in the second payment.

Lucy Liu: This is a huge number for us. I am presuming for the first payment it was recognized as a gain for us. If there are any businesses that reported incorrectly, that could have a huge impact for us.

Don Gutmann: If there are reporting errors, we will take care of those through the distribution process.

Jim Justin: Aren't we truing up reporting errors in future periods?

Don Gutmann: We will correct the errors and go forward.

Valerie Torres: Pretty much every single jurisdiction will have one company in this NAICS. Our proposed solution is that we will review all of the companies that are wholesalers of computer equipment and also the ones in computer manufacturing and determine whether or not in the base year they were doing installations. We have already looked at most of them. Stores that sell computers would be removed and taken out of the calculation completely.

Cliff Craig: I have a suggestion. Since you will be doing a survey of the companies anyway, you could look at the historical data to see what percentage of sales were installations and base the payment by first allocating the fixed dollars and allocate the rest based on what the percentages are. They would be installations historically or currently they would be installations and deliveries.

Lorrie Brown: Maybe you can come up with a percent for the delivered part versus the storefront part. Use that percent instead of pulling them out 100 percent.

Don Gutmann: My fear is that there may not be any relationship.

Neil Kruse: These could be very volatile. The stakes are very large.

Kim Davis: These businesses were doing destination-based sourcing even before the start of destination-based sales tax. It is not a change due to sourcing which is what we should be mitigating.

Lorrie Brown: But if you pull it all out you are going to understate mitigation in cases where it is just a computer being installed.

Lucy Liu: How are you determining if it is an installation or a storefront?

Don Gutmann: Just by the pure volume of sales you can see it is a storefront because it is the same volume month after month. If there is any question, we will have TAA contact them.

Jim Justin: Lorrie, what is your concern if we yank it all out?

Lorrie Brown: That it would be overstated. But it might not be a concern.

Don Gutmann: We simply cannot do it for the second payment. With the session we do not have time to do a detailed survey. We propose that we take them out of the data for the next payment and we will revisit it this summer when we do the true-up.

Cliff Craig: If we allocate the first dollars based on the historical locations of the storefronts and then allocate the rest based on the current delivery percentages, it would probably be close enough.

Kim Davis: It is not the Circuit Cities and Best Buys that are creating the problems.

Don Gutmann: It is the IBMs and similar firms that are creating the problem.

Lorrie Brown: I think Cliff is saying in the base period you take out deliveries and the rest are storefront sales.

Don Gutmann: I think it would work in one NAICS but not in the other.

Janetta Taylor: The only way you can get the information is to call every business and ask them.

Neil Kruse: That kind of argues to pulling them out because we are pulling out the construction activity. These firms are generally in a wholesale NAICS.

Rick Peterson: You can tell which ones are the construction types because they show up for a couple of months and then don’t show up again.

Valerie Torres: There are over a thousand businesses. We have looked at the wholesale firms but we haven’t looked at the Best Buy and Circuit City firms.

Neil Kruse: We have some wholesalers in our jurisdiction that are volatile all the time.

Don Gutmann: I want to go ahead with my proposal which is for the second and third payments we will remove the obvious wholesalers that we have identified and then we will look at this issue again when we do the true-up.

Jim Justin: I am fine with that. Can you tell me how many quarters we are using before we true up?

Don Gutmann: Six quarters.

Shawn Hunstock: I am assuming the wholesalers were not included in the mitigation payment?

Valerie Torres: They were in the first payment. This was not discovered until after the first payment was made.

Don Gutmann: And they will not be in the second payment.

<u>Issue Paper 06-04 – Existing business opens a new storefront or closes an existing storefront</u>

Bob Jean: These changes are all unrelated to sourcing – they are regular business decisions.

Valerie Torres: These are about businesses that have multiple storefronts and are filing one return with the Department of Revenue. A new or closed storefront affects the percentages for everyone. It looks like a gain where it is opened but it might look like a loss in other locations. For the mitigation calculation we look at the total sales for July, August, and September 2007. We use those percentages to determine what their origin-based sales would have been, and we subtract that from their actual 2008 sales.

Janetta Taylor: You would know if a store was opened or closed if the business reports on a separate tax return.

Don Gutmann: The good news is that we are looking at the 12 monthly tax returns for these firms. We can look at the firm and all of its location codes. The value of sales is pretty similar for all 12 months. But for this location code, the amount has gone up significantly – you can tell it is a new storefront.

Valerie Torres: For the big businesses we identified new locations and closed locations for the top 250 retailers. We took those locations out or put them in to correct for the opened and closed storefronts. These businesses were part of the calculation this last time. If they didn't have data for both years, we took them out.

Kim Davis: You certainly can send us information on opened and closed businesses by e-mail, but please do not send the entire file back to us by e-mail because that is confidential information. You can send us the name and registration number but take the tax information off. It is fine to start with our file but remove the tax detail.

Bob Nachlinger: A problem that we have had with some of our data is changes in UBI numbers. I have identified four or five where the UBI number is closed, and I know they opened another UBI but I can't find it.

Don Gutmann: That is the predecessor-successor issue.

Neil Kruse: This is a problem with car dealers.

Bob Nachlinger: Can you provide us a crosswalk where we could see the new UBI?

Janetta Taylor: We can't because we don't program that information in the system. You just need to send us the closed numbers and we can look them up.

Valerie Torres: So the proposed solution to this was that the Department will identify new store openings and closings for the top 250 retailers and will adjust the taxpayer data before the mitigation calculation is made.

Don Gutmann: Again, this is something we can probably broaden. The problem is when the firm has multiple storefronts in the same location code.

Jim Justin: What if the cities want to go to a threshold larger than the top 250 firms?

Lorrie Brown: If cities sent you lists of openings and closings, can you do it or do you need to wait until true-up?

Don Gutmann: It depends. We might not be able to get them all done by the second payment.

Janetta Taylor: TAA can help with that.

<u>Issue Paper 08-04 – Regional Transit Authority (RTA) Tax – Sales Tax</u>

Valerie Torres: These next two issues are related to the Regional Transit Authority and how we adjusted their payment. There was a change in the way they report to the Department of Revenue on January 1, 2008, so we only have one number before January 1, 2008, and after January 1 the information is broken down by location code.

Gary Prince: If the RTA boundary would change, that would change this.

Kim Davis: These two papers on the RTA are to make the process as transparent as possible.

<u>Issue Paper 08-05 – Regional Transit Authority (RTA) Tax – Rental Car Tax</u>

Valerie Torres: Issue Paper 08-05 is basically the same but refers to the RTA rental car tax. We use the same formula but we use line 82 instead of line 45. That is the only difference.

The King County food and beverage tax is kind of the same issue. We found that King County food and beverage has an area with a bunch of location codes. They didn't change their reporting but it is very difficult for us to see the deliveries. Just for King County food and beverage we selected the codes that do catering. That was an identifiable set of businesses for us because they're all in the same NAICS code.

Don Gutmann: This change is truly due to sourcing. That is why we picked caterers. We are talking about a relatively small tax and a small amount, but we needed to find a way to have confidence in the number.

Valerie Torres: We are still looking for possible solutions for the true-up period. We would like to use the same process for the next two payments.

<u>Other discussion</u>

Jim Justin: I want to hear Lucy's other issue.

Lucy Liu: We are going to be recognizing a general increase by construction taxpayers. It impacts some of the technology codes if they are putting equipment into a new building. We know we want that recognized because it is a one-time gain spread over this period of time that we are looking at. I hope we can identify them and factor that in.

Neil Kruse: Along with that we see some services NAICS.

Don Gutmann: They would have to be in our mitigated NAICS.

Neil Kruse: Some are miscoded.

Don Gutmann: That is something cities need to let us know about.

Lucy Liu: What I am worried about is as these purchases are being made, we are going to see a spike. It is not so much a change in sourcing – it is the timing and it is not repetitive.

Jim Justin: We didn't think we could mitigate for that growth.

Don Gutmann: The elevator one is one that we should pursue because it could be like the computer equipment.

Neil Kruse: We don't want to be unfairly penalized for that.

Kim Davis: If you can see where they probably were doing destination sourcing prior to July, those things should still be brought to our attention because it might need to be taken out.

Some jurisdictions have had MacDonald's or Jack In The Box with a large gain for their area but they don't make deliveries. Other various retail stores are in the mitigated NAICS but probably don't make deliveries. So we need to rectify this issue also.

Don Gutmann: This also might be an issue with the opened and closed storefronts. This will be a problem for us if a MacDonald's or something similar opens or closes a storefront.

Glen Lee: We were wondering whether there could be some impact because of firms that are not coded correctly.

Don Gutmann: The Department has done a very large education effort. If you see something like that, contact Tiffany and she will contact the business.

Kim Davis: We could correct our data for the mitigation payment. On the businesses that we don't believe make deliveries, I don't know that all of them are due to a store opening or closing. We will have to do more looking into this.

Don Gutmann: How do we try to do a correction that we apply statewide? It will be really hard for us to apply anything on a statewide basis. That is one of our challenges. If we rely upon the cities we will correct it for the cities that contact us.

Janetta Taylor: Some of these businesses have launched Internet sales.

Lorrie Brown: But the base year is last year, so they are getting mitigated on sales last year.

Don Gutmann: If we can locate one franchise owner and he tells us that his stores don't do deliveries we might eliminate ten stores, but we won't get all of them across the state.

Bob Jean: The result is that some mitigation is being paid that shouldn't be paid?

Cliff Craig: We could identify them as a group based on the six-digit NAICS code.

Don Gutmann: That encompasses all types of restaurants including Pizza Hut that does deliveries.

Cliff Craig: You would probably have a smaller rate of error.

Lorrie Brown: I would see the error of including some MacDonald's that have opened and closed would be smaller than excluding the whole NAICS. Can you look at their web sites and they would list their new stores?

Valerie Torres: It may list the stores but we don't know the UBIs.

Cliff Craig: Most of the pizza delivery companies in Puyallup have the largest amount of their sales in Puyallup, so I wouldn't worry about it. Take the percentage of sales by the industry as a group.

Lorrie Brown: Why don't you look at the study and see what percentage comes from them?

Valerie Torres: Other businesses in there don’t make deliveries and the jurisdiction knows that they don’t make deliveries in its jurisdiction, but it is showing up in their mitigation.

Don Gutmann: This is a byproduct of the way we are doing the calculation.

Miki Gearhart: It is kind of a slippery slope – if you do this drastic change for this NAICS code, what is going to be the next one?

Neil Kruse: You are kind of getting into a materiality issue. In some jurisdictions it is a large issue but in others it is not.

Don Gutmann: So you’re comfortable with having each jurisdiction tell us?

Valerie Torres: If a jurisdiction tells us to eliminate one business we will eliminate it from all jurisdictions for that taxpayer.

Miki Gearhart: It is a matter of do you want to make exceptions for each thing that comes up? Where do you draw the line? What is material to one isn’t material to another.

Sheila Gall: The goal is to be as accurate as possible.

Miki Gearhart: Do we have the same problem in the other direction – that we are excluding businesses that are doing deliveries?

Don Gutmann: It’s possible.

Valerie Torres: You also have some firms that are so diversified in what they do. They can only have one NAICS code. So they might not be in an affected NAICS.

Lorrie Brown: But there are not very many NAICS that aren’t in there.

Bob Jean: If a city went to the extent of identifying a business that shouldn’t be on the list you’re putting the burden on the city to tell you, so how do you handle it?

Rick Peterson: You have to be a little bit careful because you would exclude the business from all the cities; you have to be really sure that it is not making deliveries.

Don Gutmann: We would contact the business to make sure it is or isn’t making deliveries in all locations. Since it does impact more jurisdictions, we have to identify it.

Miki Gearhart: When you do something about that, will it affect the payments going forward?

Don Gutmann: Yes.

Glen Lee: Why can’t you audit them?

Don Gutmann: Because we don't have time to do it before the next payment. If it is a large enough taxpayer it will be audited within the next four years. We audit all large taxpayers on a four-year schedule. We are not going to audit based on whether they do deliveries or not.

Glen Lee: I would like you to audit businesses based on a big shift. So I think this is a good reason to audit them.

Cliff Craig: I am still missing the problem of identifying businesses by six-digit NAICS.

Don Gutmann: From what I am seeing this would not be a good method to use. So at least until the true-up period, we will agree to verify if the taxpayer is making deliveries and then we will do that on a case-by-case basis.

Bob Nachlinger: We knew these kinds of business activities were going to happen from day one.

Don Gutmann: So you would prefer that we just make the change for the one business that the jurisdiction brought forward?

Bob Nachlinger: I am not sure I want you to remove it at all.

Shawn Hunstock: I disagree.

Bob Nachlinger: In this case we are talking about no deliveries, no openings and closings.

Valerie Torres: It is not a change due to sourcing.

Lorrie Brown: This is a data issue and not an economic issue. It is because we have some changes in activity that are not due to deliveries.

Don Gutmann: Holding everything else constant, there shouldn't be a significant change that would show up. There must be something else going on like a new storefront to cause such a change. If we take that out, what else is going on?

Miki Gearhart: Isn't it also possible that they are reporting on a return and they are also reporting other things on the return?

Valerie Torres: They are not impacted by sourcing if they don't do deliveries. So why leave them in? If the company only makes deliveries out of location X and doesn't make deliveries out of ABC, we would take out A, B, and C.

Janetta Taylor: It is risky to take out a location because in the next period they might make a delivery.

Bob Nachlinger: Back to the trust but verify. If you find they are not doing deliveries, you take them out.

Lorrie Brown: When we did the sourcing study we did a very comprehensive survey, and there were hardly NAICS that did not do deliveries. Businesses do a variety of activities and a lot of them do remote sales.

Don Gutmann: This is something else I would like to report back to you about at our next meeting.

If we verify that a MacDonald's does not do any deliveries at any location and we remove it, we will keep a log of these.

Kim Davis: We do have a log already, so we have a way to easily go back and explain why we have done what we have done.

Miki Gearhart: Will the list of common questions be put on the Internet site instead of waiting until someone calls with a question?

Kim Davis: We can do that.

Questions From Cities

Sheila Gall: One business asked if the data they get could include a percentage of change.

Valerie Torres: We can't because of disclosure – they could back into the data.

Don Gutmann: I was extremely happy with how everything went with the first payment. The Governor put funds for mitigation in her budget. We updated the amounts based on what we saw in the first payment and the economic situation. It is $65 million for the two years and is fully funded in the Governor's budget. Now it goes to the Legislature.

The Impact of the Economy on SST Mitigation

Don Gutmann: We have included the December 10, 2008, Revenue Collection Report from the Economic and Revenue Forecast Council. The bad news continues.

Bob Nachlinger: The total dollars that are coming into the state are lower because there are shifts that we hadn't anticipated. Those of us that advocated for the system need to talk to our legislators and tell them that we are making it work.

Gary Prince: Will there be money left over?

Don Gutmann: If there is money left in the fund -- if no one takes it out -- it will stay in there until the next year.

Lorrie Brown: The types of things that are being delivered are being affected more by the economy than the economy as a whole. The amount of stuff delivered is a lot less, so there probably will be money left in the fund.

Don Gutmann: We are sending out the next mitigation payment on March 31.

Valerie Torres: The communication will come out a couple of weeks before the payment.

Don Gutmann: Our next meeting will be in May.

Minutes Submitted by Diane Mielke