

DRAFT

What Incremental Changes Can be Made to the Current Tax Structure to Keep it Viable?

There are a number of issues facing the state that should be addressed if the current tax structure and its administrative mechanisms are to remain adequate to carry us into the foreseeable future. There are four areas that the Department believes are essential to address if we, and other state and local administrative agencies, are to continue the trend of collecting more revenue, from more taxpayers, with the same or a reduced level of staffing. These areas are certainly not the only ones that should occupy our attention, but are the ones that we feel should be tackled first.

The four areas are:

1. streamlining administration of state and local sales/use taxes
2. simplification of individual tax sources, either by replacing complex ones with less complex ones, or making existing sources easier to understand
3. improving fairness by adopting a better method for apportioning service income of businesses who operate in Washington and other states
4. increase the uniformity of application of locally imposed gross receipts business taxes to make it easier for businesses to conduct business throughout the state and eliminate the prospect of being taxed on more than 100% of their income

Streamlining Administration of Sales/Use Taxes

Washington relies on the sales/use tax to a greater degree than any other state. The administrative mechanisms of this vital source need to keep pace with how modern business operates. There is general agreement amongst the states that: a) current sales/use tax systems are not equipped to address the needs of existing and new electronic economies, b) tax systems need to become more simple, c) tax systems need to increase uniformity while maintaining individual state flexibility, and d) the burden of tax compliance on taxpayers needs to be reduced.

Our state, through the Department, has been a very active participant in a project initiated by the National Conference of State Legislatures and the National Governor's Association. The Department has not been a voting member in this effort, however, because of the requirement that such designation be made through legislative action. The goal of this effort is to improve sales and use tax administrative systems for all sellers and for all types of commerce through:

- one registration and one return per taxpayer for multiple states
- uniformity in state and local tax bases
- uniform definition of terms
- uniform sourcing rules for all transactions

DRAFT

- simplified tax returns
- protection of consumer privacy
- Simplification of state and local tax rates
- Simplified administration of exemptions

Our state needs to continue this effort, along with other states, so that an agreement can be reached and signed to accomplish these goals. The Department has introduced legislation in the 2002 session that designates the agency as the state's representative in this effort and requires that we enter into such an agreement, subject to certain conditions. Signing an agreement with other states will not result in any change to the tax statutes. That must be done by the Legislature in each state.

Tax Simplification

Our state has adopted a number of taxes that are not mainstream, utilize specific/unique tax bases, apply to targeted types of transactions or activities, and whose receipts are in most cases earmarked to provide direct support to desirable programs. In many cases these earmarked taxes are the only source of funds for the programs. Administration of these taxes is complex, and relatively costly for taxpayers and administering agencies. Most of these sources are used to generate funds for environmental programs, such as the litter tax, hazardous substance tax, oil spill tax, wood stove fee, and petroleum products tax.

Some of the common problems that have arisen are:

- the taxes are complex, unique, and hard for agencies to explain (educate) and for taxpayers to understand
- voluntary compliance levels are often much lower than for more mainstream taxes
- collections are often erratic, not reliable, and very difficult to predict with a reasonable degree of certainty
- when collections are less than expected (budgeted for) programs suffer because cuts have to be made

The general solution to these problems is to make these taxes less complex, more mainstream, and more predictable/stable. This may involve trying to simplify the existing sources, and/or replace these sources with more broad-based, stable ones that recognize the propriety of funding the programs from a wider segment of the economy. The Department has prepared a report, which will be supplied to the Committee, discussing these issues and possible alternative funding mechanisms.

Apportionment

All states have to deal with the issue of how to determine what portion of the income generated by businesses operating in their state and other states they should subject to tax in their state. Most states have corporate and individual income taxes. Essentially all of

DRAFT

them use some variation of a formula that consists of the portion of sales, property, and payroll in their state versus all states in which these firms operate.

In Washington the issue concerns fair apportionment of income generated by service firms located in our state when part of the service is performed at out-of-state locations. Washington law for more than 30 years has specified two methods for apportionment, one for the income of financial institutions, and a second for other service income. For financial businesses, the law requires that they are to apportion income pursuant to rules promulgated by the Department consistent with uniform rules for apportionment developed by the states. The Department has promulgated such rules incorporating the standard three-factor formula applicable throughout the country. For other kinds of service business, the law requires taxpayers to apportion based on separate accounting of the activity inside and outside Washington or, where such accounting cannot be accurately made, to use the cost of doing business in Washington versus the cost of doing business everywhere.

The inform to apportion service income for non-financial businesses is often difficult to generate, is not a fair representation of the amount of activity in Washington, and is information of no use to the business other than to comply with Washington's B&O tax law. The separate accounting/cost method of apportionment is antiquated, distinctly out of step with what other states use and what records business normally maintain, is more costly for taxpayers than it needs to be, and discriminates against firms whose headquarters are in Washington.

The general solution to these problems is to adopt an apportionment system for non-financial businesses that is more mainstream, more in line with other states, and one that results in a more realistic representation of the amount of activity that takes place in our state.

Local B&O Tax Uniformity

Cities (but not counties) are authorized to impose a variety of fees and taxes on the privilege of doing business. They have also been given a considerable degree of latitude (local control) to define the nature of the activities subject to the tax. For those cities who employ the gross receipts form of business tax, which is conceptually the same as the state B&O tax, there is no requirement that the definition of a given activity be the same or bear any relationship to the definition used for state B&O tax purposes. For example, some cities may define an activity as a retail sale while another may define the same activity as a service, each subject to different tax rates.

Another area that lacks uniform treatment is the apportionment of income from activities that are performed in more than one entity. The general rule is that such income is not apportioned, but allocated entirely to one jurisdiction or another. If all of the activity takes place in one city, that city is allocated all of the income, provided the business has nexus in that city. If a business has no nexus in the city where the activity takes place, or that city has no gross receipts B&O tax, the service income is taxable by the city where

DRAFT

the customer is located. If not taxed there, then the income is taxable in the city where the service provider is located. Apart from these general approaches in some cases businesses may enter into discussions with an individual city or cities to arrive at a method for apportionment of income.

The business community has in recent years been increasingly vocal about the negative effect of local B&O tax laws on the business climate. For businesses that operate in more than one city the task of keeping up with varying definitions for the same or like activities can be difficult. The effective lack of any apportionment for service income means that very few cities are taxing such income in relation to the actual amount of activity taking place in their jurisdiction. The combined effect of non-uniform definitions and the lack of apportionment can result in the same income being taxed by more than one city.

The Governor and the business community have both introduced measures for consideration by the 2002 Legislature that deal with these issues.