

# HOUSE BILL REPORT

## ESHB 2658

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### As Passed House:

February 19, 2002

**Title:** An act relating to changing requirements regarding state and local tax to provide for municipal business and occupation tax uniformity.

**Brief Description:** Changing requirements regarding state and local tax to provide for municipal business and occupation tax uniformity.

**Sponsors:** By House Committee on Finance (originally sponsored by Representatives Gombosky, Dunshee, Romero, Reardon, Berkey, Upthegrove, Edwards, Chase, Kenney, Linville, McIntire and Conway; by request of Governor Locke).

### Brief History:

#### Committee Activity:

Finance: 1/31/02, 2/11/02 [DPS].

#### Floor Activity:

Passed House: 2/19/02, 51-46.

### Brief Summary of Engrossed Substitute Bill

- Requires the Association of Washington Cities to adopt a model ordinance on municipal business and occupation taxes to address issues of uniformity and multiple taxation between municipal codes.
- Requires cities that impose business and occupations taxes to comply with all requirements of the bill by December 31, 2003, or lose the authority to impose the tax.
- Requires the model ordinance to be amended by January 1, 2005 to include provisions for the apportionment of business income.
- Prohibits cities from taxing the creation of intellectual property in general.

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### HOUSE COMMITTEE ON FINANCE

**Majority Report:** The substitute bill be substituted therefor and the substitute bill do pass. Signed by 6 members: Representatives Gombosky, Chair; Berkey, Vice Chair; Conway, Morris, Santos and Veloria.

**Minority Report:** Do not pass. Signed by 5 members: Representatives Cairnes, Ranking Minority Member; Nixon, Orcutt, Roach and Van Luven.

**Staff:** Mark Matteson (786-7145).

**Background:**

*City Business and Occupation Taxes*

Thirty-seven cities impose business and occupation (B&O) taxes. City (or municipal) B&O taxes are imposed on the gross receipts of activities conducted by businesses located within cities without any deduction for the costs of doing business, or for income that is derived by activity conducted in non-taxing jurisdictions. The Legislature has limited city B&O taxes on retail sales to a maximum of 0.2 percent, but higher rates are possible if voter-approved or in effect prior to January 1, 1982. Cities first imposing a B&O tax after April 22, 1983, and cities increasing tax rates must have a referendum procedure.

A business operating in more than one city may owe gross receipt taxes to multiple cities. Although cities are not required to coordinate their taxes, some cities have enacted provisions designed to prevent multiple taxation of the same activity. Typically, these cities allow a deduction from taxable gross receipts for income derived from activities that are taxed by another city.

Each city's municipal business code contains a number of terms and definitions, some of which are unique to that city's code. Each city determines the reporting periods for taxpayers to remit B&O taxes, the time period over which tax liabilities or refunds may be assessed, penalties, and interest rates for late payment or refunds. Each city also determines the minimum level of business activity that would make a business subject to its tax.

For several years, the business community has expressed concerns about city B&O taxes. Major concerns include the lack of uniformity among municipal tax systems and the multiple taxation of the same income by two or more cities. Legislation addressing these concerns has been introduced in recent years and supported by the business community. Representatives from cities have, in turn, expressed concern that such legislation would entail a significant loss of local autonomy and flexibility needed to address unique local circumstances.

In May 2001 the Governor directed the director of the Department of Revenue to convene a working group of city and business representatives to develop a solution regarding the municipal taxation issues. The working group's discussions were in large part centered on a model municipal B&O tax ordinance that had been developed by the Municipal Research and Services Center for the Association of Washington Cities in early 2001 to address some of the business community's concerns. The department was to submit a

report by October 15, 2001, of the recommended solution of the working group or, if the group could not reach consensus on a recommendation, of the department's recommendations. While consensus was reached on some issues, there was not agreement in total.

### *State Business and Occupation Tax*

The state's major business tax is the B&O tax. This tax is imposed on the gross receipts of business activities conducted within the state. Deductions for the costs of doing business are not allowed. The tax classifies businesses into categories and applies tax rates to these categories. The state B&O tax provides for many exemptions, deductions, and tax credits.

The department assesses interest and penalties to taxpayers who are late in paying the state excise taxes. The department also refunds overpayments of tax, with interest. In the case of assessments, the interest is calculated on the late amount, beginning with the last day of the calendar year in which the tax was first late. In the case of refunds, interest is calculated on the amount owed, beginning with the time that the overpayment was initially made.

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### **Summary of Engrossed Substitute Bill:**

The Association of Washington Cities (AWC) is required to adopt a model ordinance that will provide a more uniform system of municipal business and occupation (B&O) taxes. The intent of the model ordinance, in addition, is to eliminate multiple taxation of business income while continuing to allow some local control and flexibility to municipal governments. The model ordinance is to consider business taxes only, and not taxes on utility businesses.

In the development of the model ordinance, the AWC must include a public involvement process and must solicit input from stakeholders, including the business community. The Municipal Research and Services Center (MRSC) must post a copy of the model ordinance on its web site and make hard copies of the ordinance available upon request. Cities that impose B&O taxes must make electronic or hard copies of their ordinances available upon request. The AWC may amend the model ordinance to comply with state law, but is restricted from otherwise amending the definitions and classifications in the ordinance more frequently than every four years. Any city that imposes a B&O tax must comply with provisions of the bill by the end of calendar year 2003.

The model ordinance must include a number of mandatory provisions: a system of credits that prevent multiple taxation of the same income; a gross receipts threshold for small businesses; tax reporting frequency requirements; provisions for penalties and interest; claim and refund provisions; and certain definitions, to be based on comparable

definitions within the state B&O statutes. Deviations from the state B&O definitions must be noted in the model ordinance.

With the exception of the system of credits to prevent the multiple taxation of business income, cities are allowed to continue to adopt their own provisions for tax exemptions, credits, deductions, and other preferences, as well as tax classifications and tax rates. With respect to any nonmandatory provisions of the model ordinance, cities that deviate must make a description of the deviations available.

In order to provide for the prevention of multiple taxation, the model ordinance must include a system of credits. A credit must be allowed against:

- Retail or wholesale taxes due on sales of products for any manufacturing or extracting taxes paid on the same products;
- Manufacturing taxes on the value of products for any extracting taxes paid on the same products; and
- Retail or whole taxes due on the sales of publications for any printing or publishing taxes paid on the same publications.

The model ordinance must include provisions for credits that will prevent the multiple taxation of business service income and income of any other classifications of businesses.

The model ordinance must also include provisions concerning a de minimus business activity threshold. Under these provisions a city may only tax a business that has earned gross receipts in excess of a specified level. This minimum level must be at least \$20,000, but may be higher. Cities with de minimus activity thresholds that were higher than \$20,000 as of January 1, 2002, may not reduce their thresholds.

The model ordinance must include provisions that cities with B&O taxes must allow for monthly, quarterly, or annual reporting of taxes. A city may require monthly reporting only in the case where the taxpayer also reports the state B&O taxes on a monthly basis.

The model ordinance must also provide that, with respect to assessments for underpaid tax and to refunds, cities must calculate interest in the same manner that the Department of Revenue (DOR) does for state excise taxes.

The model ordinance is to provide for uniform penalties, modeled on the DOR administrative code, as follows:

<u>Activity</u>	<u>Penalty</u>
Delinquent filing of taxes	10 or 20 percent, depending on the tardiness
Delinquent tax assessment payments	10 percent of additional tax due

Warrants	5 percent of tax due
Disregard of specific written instruction	10 percent of additional tax due
Intent to evade	50 percent of the additional tax due

The aggregate penalties that may be imposed for late filings, late payments on assessments, and on warrants is 35 percent of the tax due. Penalties may not be issued for both intent to evade and disregard of written instruction.

The model ordinance must also provide for limitations on the length of the claim periods upon which assessments can be made or upon which refunds can be requested; these are also modeled upon DOR administrative code. With respect to assessments, claims may not be made more than four years after the applicable tax year, unless the taxpayer is unregistered or is fraudulent, in which case there is no limitation. With respect to refunds, refunds may not be granted for claim periods more than four years before the refund application was made. Waivers of the time period limitations for both assessments and refunds may be made by mutual consent of the city and the taxpayer.

The model ordinance must also include definitions for a number of terms. These include:

- Eligible gross receipts tax,
- Extracting,
- Manufacturing (which may not include software development as an activity),
- Nexus (which must be based on United States commerce clause standards),
- Retailing,
- Retail sale,
- Services (excluding retail and wholesale services),
- Wholesale sale, and
- Wholesaling.

The model ordinance must use as a baseline the definitions for the same terms in the state B&O statutes, and any deviation from the state definitions must be noted in the ordinance.

The DOR must continue to work with the AWC and the business community on the issues of apportionment and taxable income, and on the issue of the application of B&O taxes to the creation of intellectual property. The working group must report to the Governor and the Legislature by the beginning of the 2003 session. Notwithstanding the conclusions of the working group, cities that impose B&O taxes must adopt ordinances by January 1, 2005, that provide for the apportionment and allocation of business income. Moreover, cities are preempted as of July 1, 2003, from imposing a gross receipts tax on intellectual property creating activities, including research, development, authorship, creation, or other inventive activity, as of the effective date of the act, unless a city imposed such a tax as of January 1, 2002. In the latter case, a city is prohibited from imposing such a tax as of January 1, 2004.

A city that fails to comply with the provisions of the bill by July 1, 2003, is prohibited from imposing a B&O tax.

The DOR administrative statutes are amended to make the calculation of interest on refunds, in terms of the period of time to which the interest would apply, consistent with the interest calculation used for assessments.

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**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date:** The bill contains several effective dates. Please refer to the bill.

**Testimony For:** Last spring, the Governor requested the Department of Revenue to convene a group of representatives from cities and from the business community, and appointed Joe Dear to lead the discussions. The group was instructed to address two principal concerns: the elimination of any double taxation on business income that may have been subject to more than one municipal B&O tax ordinance; and the establishment of clear definitions of nexus as to when business would be taxable by a jurisdiction.

There was not total agreement between the cities and business on all issues, and two in particular. The first concerned local control. Cities believed that a single uniform municipal code would be sufficient to address business concerns. Business thought that there should be a single municipal code as well, but that it should be substantially fashioned after the state B&O code. Cities disagreed, saying that, by tying local ordinances to the state code, there would ultimately be unintended consequences when state lawmakers changed the state code. An example that was given was the passage of the machinery and equipment exemption for manufacturers, in which little consideration was given to the impacts on local governments, but which had a rather sizeable revenue hit.

The second principal issue of dispute concerned apportionment of business income for the purposes of taxation. The problem is that there is no hard data on which to base discussions, and so the fiscal impact is uncertain. It seems that apportionment to the road may be the way to go, but there is a proviso in the bill that the group will continue to study the issue and report back to the next Legislature.

The AWC supports the bill by and large but has a few concerns. We have worked on a model ordinance to address the concerns of the business community. The model ordinance is structured to eliminate multiple taxation and provide uniformity. The development of the model ordinance was well along when the Governor called for the DOR to convene the most recent group effort. The DOR-coordinated effort has helped the development efforts. Under the original model ordinance, for instance, cities with

B&O taxes were encouraged to conform with the model, but were not required to do so. Under this bill, cities would be required to conform. The bill also includes a bright line test for nexus, based on a dollar amount, which is applied to all businesses, not just resident businesses. Both of these helped strengthen the model ordinance.

The AWC believes that this bill strikes the appropriate balance on uniformity and local control. There is one set of definitions, which is a scenario that is much better than current law, but does not tie the definitions to the state's, which we believe would be unacceptably prescriptive. With respect to apportionment, we believe this bill takes a sensible approach, calling for further study of the issue.

The B&O tax is a key source of revenue for some cities. Representatives of cities were involved in the municipal tax work group that met in the fall of 2001. Cities have acknowledged business concerns in the model ordinance. This is a concession on the part of cities, and will require a number of administrative changes. In some cases, the applicable ordinances will increase from just a few pages to about 50 pages. In addition, some cities are likely to lose revenues because of having to line up on definitions. Moreover, for some cities the small business nexus threshold will be higher. We think that the model ordinance required by the bill will address uniformity issues but allows for adequate local control.

Cities are unique, and small cities like Westport will have to put forth a large effort to comply with the provisions of this bill. But we have agreed to do so for the sake of uniformity.

(With concerns) The Washington Software Alliance supports the bill but seeks an amendment. We would like to have the bill preclude the taxation of intellectual property-creating activity. The bill does not currently do so. The B&O tax is a killer for high-growth start-up companies.

The small business community is overwhelmed by B&O taxes, but generally supports the bill. This bill represents substantial progress from the small business perspective. Owners are caught up with nexus issues and administrative complexity in respect to complying with B&O ordinances. Uniformity would help. We are looking for a definition of nexus that makes sense. We like the bill because the process allows for both big and small business input. We would like to see as many similar definitions as possible with respect to the state definitions. The small business threshold in the bill is a great step. We would like the effective dates of the bill moved up.

The city of Seattle supports the bill but would not support any amendment precluding taxation of software development. Seattle has a large software industry and has been in litigation with the industry concerning taxation under the municipal business tax ordinance. Under the Seattle ordinance, software development would be taxed under manufacturing classification, with a partial exemption for research and development.

While the state has chosen not to tax these activities, it should be up to the local jurisdiction as to whether these should be exempted or not.

**Testimony Against:** The business community feels the proposed bill does not go far enough. With certain changes to the bill, we could support it.

**Testified:** (In support) Terese Holm, city of Bellingham; Doug Miller, city of Tacoma; Bob Overstreet, city of Everett; Randy Lewis, city of Westport; Ron Rosenbloom, Association of Washington Cities; and Fred Kiga, Office of the Governor.

(With concerns) Julie Sexton, Department of Revenue; Lew McMurrin, WSA; Gary Smith, Independent Business Association; Carolyn Logue, National Federation of Independent Business; and Mel McDonald, city of Seattle.

(Opposed) Wes Uhlman, Association of Washington Business.