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Finance Committee

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HB 2030

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

**Sponsors:** Representatives Kessler, Cairnes, Talcott, McDonald, Schindler, Shabro, Pearson and Holmquist; by request of Governor Locke.

**Brief Summary of 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, 2004, or lose the authority to impose the tax.
- Requires that by calendar 2008, cities that impose business and occupation taxes must allow businesses to apportion income from non-service activities based on location and from service activities based on a formula with payroll and service income factors.

**Hearing Date:** 2/28/03

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

**Background:**

City 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. The Legislature limited city B&O taxes on retail sales to a maximum of 0.2 percent in 1982, but higher rates are possible if approved by the voters in the city, or if a higher rate was in effect prior to January 1, 1982. Cities imposing a B&O tax for the first time after April 22, 1983, and cities increasing tax rates, must have a referendum procedure. Thirty-seven cities impose B&O taxes.

City B&O taxes, like the state B&O tax, include certain terms and definitions that provide the structure for the tax base and rate classifications. Common classifications include manufacturing, wholesaling, retailing, and services. Like the state B&O tax, city B&O taxes

include provisions concerning 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. City B&O taxes may also provide exemptions from tax for a particular business activity.

A city with a B&O tax imposes the tax on a business if the city determines that there is nexus. Nexus has been interpreted to mean that the business has some sort of physical presence inside the city and that some portion of the business' activity (e.g., relating to a sales transaction) occurs within the jurisdiction. Cities have held that physical presence may be established a number of ways, such as by the rental of office space or through a salesperson who operates within the jurisdiction. Cities have held that sufficient activity for nexus purposes is also evidenced in various ways, from the signing of a contract with the jurisdiction, to the loading of items from a warehouse (even though the sale may not originate or be consummated in the city), to the occurrence of an actual sales transaction within the jurisdiction's boundaries. The court has upheld broad interpretations of nexus with respect to tax rationale.

If nexus is established, the city may assert B&O tax on the entire value of the transaction or particular activity involved. Thus, for example, in the case where items are loaded for delivery from a warehouse in a city with a B&O tax, the city could impose tax on 100 percent of the income derived from the associated sale, irrespective of whether the sales transaction or delivery occurs within the city's boundaries. Because of the broad interpretation of nexus, two cities may simultaneously impose tax on income from the same sale or activity. Unless the cities' tax ordinances allow a credit for city B&O tax paid elsewhere on the same activity, the business may be subject to multiple taxation on income derived from a single activity.

In several state court cases, including *Dravo Corp. v. City of Tacoma* and *City of Seattle v. Paschen Contractors*, the court has upheld a city's imposition of its tax on an activity in which at least part of the value of the product or service that is taxed is derived outside jurisdictional boundaries. The court has provided, in part, that as long as a "reasonable relationship" exists between the tax imposed by the city and the benefits conferred upon the taxpayer by the city, due process is not violated and the tax is legitimate.

Apportionment. Generally, cities with B&O taxes in Washington State have not permitted businesses in the past to apportion income for taxation purposes. Apportionment refers to an approach under tax law whereby a multi-jurisdiction business is allowed to apportion, or divide, its taxable income among the jurisdictions in which it does business. Most apportionment laws involve use of a formula, in which the division of a business' income between jurisdictions is based on factors relating to sales income, property value, and/or payroll amounts. The effect is that a jurisdiction could only impose tax on a portion of the total income earned.

Recent developments concerning city B&O taxes. 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; potential multiple taxation of the same income by two or more cities; and the interpretation of nexus that permits cities to capture income from taxable activity conducted outside jurisdictional boundaries. 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, as well as a significant loss of revenue.

In response to concerns, the Association of Washington Cities (AWC) developed a model municipal B&O tax ordinance in early 2001. The model ordinance provides a basis for the use of uniform terminology, definitions, administrative provisions, rate classification structure, and exemption structure. As of the end of calendar 2002, a number of cities with B&O taxes have updated their ordinances to reflect the model ordinance that was available at that time.

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 municipal taxation issues concerning uniformity and multiple taxation. The working group's discussions were in large part centered on the model ordinance developed by AWC in early 2001. While consensus was reached on some issues, there was not agreement in total. Nonetheless, HB 2658 was submitted at the request of the governor in the 2002 session to address some of the agreement reached by the working group, and was passed by the House. The proposal was not supported by the Association of Washington Business, and alternative proposals concerning municipal business taxation were also introduced.

### **Summary of 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 form a model ordinance development committee. The development of the ordinance 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. In addition, the Department of Revenue and the Department of Licensing must post a copy of the ordinance on their web sites. Cities that impose B&O taxes must make 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 2004, except the apportionment provisions, for which compliance is required by 2008.

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 terms with definitions from the state B&O statutes or 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, or manufacturing taxes previously 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 a de minimus business activity threshold. A city may only tax a business that has earned gross receipts in excess of \$20,000 in the jurisdiction.

The model ordinance must provide 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. Payment is due at the same time that payment is required under state B&O statute.

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 must provide that penalties must be imposed according the state B&O statutory requirements concerning penalties.

The model ordinance must also provide that the limitations on the length of the claim periods upon which assessments can be made or upon which refunds can be requested must be the same as the state B&O statutory requirements concerning such limitations.

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

- business (with the same meaning as under the state B&O statutes);
- city;
- commercial and industrial use;
- business and occupation tax or gross receipts tax;
- eligible gross receipts tax;
- engaging in business;
- extracting;
- gross income of the business (with the same meaning as under the state B&O statutes);
- gross proceeds of sales (with the same meaning as under the state B&O statutes);
- to manufacture;
- manufacturing (which may not include software development as an activity);
- person;
- retailing;
- retail sale;
- services (excluding retail and wholesale services);
- value of products (with the same meaning as under the state B&O statutes);
- wholesale sale; and
- wholesaling.

For the terms that are not required to have meaning identical to those in the state B&O statutes, the model ordinance must use as a baseline the definitions for the same terms in the state statutes, and any deviation from the state definitions must be noted in the ordinance.

In addition to the provisions concerning the model ordinance, a requirement is imposed on all cities with gross receipts B&O taxes that, in order to impose the B&O tax on a business activity, there must be nexus. Nexus is defined to mean business activities that are sufficient to subject the business to the taxing jurisdiction of the city under interstate commerce standards.

All cities that impose gross receipts B&O taxes must allow for the apportionment of business income by January 1, 2008. For activities other than services or income from royalties, income is allocated based the location of the activity. In the case of a wholesale or retail sale, the location is based on the location of delivery to the buyer. If the location occurs in more than one jurisdiction, credit must be allowed for taxes paid on the same activity, or, in the case where not all the affected cities impose gross receipts taxes, an allocation system must be allowed. For income from royalties, income is allocated to the commercial domicile of the taxpayer. For income from services, income is apportioned to a city by multiplying total taxable income by the average of a payroll factor associated with a city and a service-income factor associated with a city. The payroll factor is equal to the ratio of the compensation paid in a city to the total compensation paid everywhere. The service income factor is equal to the ratio of all service income of the taxpayer in a city to total service income of the taxpayer everywhere.

The taxpayer may petition the taxing jurisdictions to allow for an alternative method of apportionment if it is believed that the prescribed apportionment approach does not fairly represent the taxpayer's business activity. Alternative approaches may be based on methods relating to separate accounting; to a single-factor; to the prescribed approach, with the addition of other factors; or to another approach as may be deemed to provide an equitable

allocation and apportionment of the taxpayer's income.

A city that fails to comply with the non-apportionment provisions of the bill by December 31, 2004, is prohibited from imposing a B&O tax.

The Department of Revenue is required to evaluate the terms with definitions in the model ordinance, and report to the governor and the legislature by the end of calendar 2004. The report must include the expected fiscal impact as the result of the adoption of the terms.

**Appropriation:** None.

**Fiscal Note:** Requested on February 19, 2003.

**Effective Date:** The bill takes effect 90 days after adjournment of session in which bill is passed, except for section 13, which is effective January 1, 2008.