

City B&O Tax Model Ordinance Update

A summary of City B&O tax
authority & required updates to
the model ordinance

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Association of Washington Cities

Overview

- B&O Tax Legal Authority
- Overview of Model Ordinance History
- Requirement for the 38 B&O Tax Cities to Adopt Allocation & Apportionment Provisions by January 1, 2008

Legal authority for City B&O tax

- Washington State Constitution, Article XI, Section 12, allows the Legislature to vest in municipalities the power to assess and collect taxes for municipal purposes.
- Legislature has authorized cities and towns to license businesses “for purposes of regulation and revenue” or words to that effect:
 - ◆ RCW 35.22.570 & 280(32) - First class cities
 - ◆ RCW 35.23.440(8) - Second class cities
 - ◆ RCW 35.27.370(9) - Towns
 - ◆ RCW 35A.82.020 - Code cities

Traditional forms of city business tax & license fees

- Taxes based on gross receipts or gross income
 - ◆ Business and occupation (B&O) tax (general business activities)
 - ✦ 38 of Washington's 281 cities impose a city B&O tax on general business activities. (All B&O tax cities are located in western Washington.)
 - ◆ Public utility tax (certain public service businesses)
 - ✦ Over 200 cities impose a public utility tax on certain public service businesses (including the 38 with a city B&O tax).
- Business license fees
 - ◆ flat business license fees
 - ◆ based on the number of employees, type of business, square footage, or some combination thereof.
 - ✦ Approximately 188 cities require a local business license (including the 38 with a city B&O tax).

City B&O tax limitations

- State law does not restrict the manner in which city B&O tax revenues may be used.
 - ◆ Most cities and towns use these revenues for general fund purposes.
- City B&O taxes are subject to a maximum rate of 0.002 (or 0.2%) unless the city or town levied a higher rate on January 1, 1982 (RCW 35.21.710). The voters may approve a higher rate (RCW 35.21.711).
 - ◆ On average, the tax rates are below 0.2% for all business classifications, with the exception of service businesses.
 - ◆ The average tax rates for major business classifications in 2007 are as follows:
 - ◆ Manufacturing – 0.157%
 - ◆ Retailing – 0.166%
 - ◆ Service – 0.207%
 - ◆ Wholesale 0.158%
- City B&O taxes on retail sales of tangible personal property must be at a uniform rate, and competitive telephone services must be taxed at this same rate (RCW 35.21.710).
- After April 22, 1983, any new or increased city B&O taxes are subject to a referendum procedure (RCW 35.21.706).

Role of B&O Taxes in City's Revenue Structure

- More stable source of income from the commercial sector than sources such as sales taxes.
- Enables cities to provide additional levels of services and infrastructure to support industries.
- On average, provides 12% of a B&O tax city's operating revenue.

Model Ordinance History

EHB 2030 (2003) – RCW 35.102

- Cities had been working for several years prior to the adoption of EHB 2030 to draft a model ordinance to address allegations regarding multiple taxation associated with the B&O tax, while also making the tax easier to administer, more understandable, and more consistent.
- Cities voluntarily began the B&O Tax Model Ordinance project in the spring of 2000, when neither a 1999 Task Force involving legislators, businesses, and cities, nor a legislative process in 2000, resulted in a solution.

Model Ordinance History

EHB 2030 (2003) – RCW 35.102

- In the 2003 session, the Legislature passed EHB 2030 (Chapter 79, Laws of 2003), the city B&O legislation, which required the 39 cities with local B&O taxes to
 - ◆ Implement a modified version of the city B&O tax model ordinance with certain mandatory provisions by December 31, 2004.
 - \$20,000 minimum threshold
 - Specific definitions
 - Penalty and interest provisions
 - Payment periods
 - ◆ Ensure that double taxation could not occur by implementing mandatory credits in the city model ordinance; and
 - ◆ Adopt an allocation and apportionment method that would allow businesses to allocate a portion of its income to a jurisdiction effective January 1, 2008. RCW 35.102.130

Model Ordinance History

EHB 2030 (2003) – RCW 35.102

- Cities were supportive of the first two provisions of the legislation
- A number of cities had already adopted an earlier version of a model ordinance developed by cities prior to the 2003 Legislative session.
- Cities never supported the apportionment provision and have never believed that the formula included in the final bill would work.

Model Ordinance History

EHB 2030 (2003) – RCW 35.102

- Impacts of Allocation and Apportionment
 - ◆ A 2005 Department of Revenue study concluded that cities will lose approximately \$23.3 million due to apportionment, based on 2004 revenues.
 - ◆ Projected for inflation, this impact could be approximately \$30 million in 2008.

Model Ordinance History

EHB 2030 (2003) – RCW 35.102

- The Department of Revenue also clarified in its 2005 report that the apportionment provisions are mandatory for all businesses that engage in business in multiple jurisdictions.
- Some businesses have already expressed concern with the increased complexity of implementing apportionment.
 - ◆ In the 2006 session, the newspaper and publishing industry secured passage of SHB 2033 a bill that specifically exempted them from complying with the apportionment provisions.
 - ◆ The Washington Realtors have recently also expressed concerns regarding the service apportionment formula.
- In the 2007 session, a bill to clarify the statute and use MTC three-factor apportionment method did not pass (SHB 2368)

Model Ordinance: 9 changes

- Over the last year, the model ordinance has been updated to comply with the allocation and apportionment provisions required in the law and in response to comments from the business community.
- Nine changes:
 - ◆ **Allocation & Apportionment (.077)**: Addition of a new section adopting allocation and apportionment as provided in RCW 35.102.130, effective January 1, 2008.
 - ◆ **Exception for Newspapers (.078)**: Inclusion of an exemption from apportionment for the newspaper and publishing industry, as provided by RCW 35.102.150.
 - ◆ **State Penalties & Interest (administrative provisions .021 & .090)**: Changes to the administrative provisions to reflect changes made in 2006 to state penalty and interest provisions in RCW 82.32.050. Clarifies use of city code for interest for tax periods prior to December 31, 2004.
 - ◆ **Exemption for Professional Employer Services (.100(6))**: Addition of an exemption identical to RCW 82.04.540(2) for professional employer services to comply with RCW 35.102.160
 - ◆ **Repealed RCW References (.030 “Sale at retail”(9) & .090(3)(b))**: Deletion of reference to a repealed RCW related to environmental remediation in the definition of sale at retail in 0.30 and booth renter in the employee exemption in .090(3).
 - ◆ **References to Telephone Business & extended warranties (.030 “Sale at retail” (3)(f) & (4) and (1)(f) & (7); “Sale at wholesale”)**: Updates references from network telephone service to anticipate changes due to telecommunications provisions of SSB 5089 that will take effect July 1, 2008. Updated to include extended warranties.
 - ◆ **Definition of Delivery (.030)**: Adds definition of delivery for apportionment of retail and wholesale sales.
 - ◆ **Updates to Multiple Taxation Provisions (.075)**: Harmonizes provisions with allocation and apportionment provisions after January 1, 2008.
 - ◆ **Clarification of Engaging in Business (.030 “Engaging in business”)**: Clarifies common carrier exception to engaging in business to exclude de minimis activities from activities creating nexus.

RCW 35.102.130

Allocation and apportionment requirements

- Required to be adopted with January 1, 2008 effective date by all 39 B&O tax cities.
 - ◆ RCW 35.102.040(1)(c): “Any amendment to a mandatory provision of the model ordinance must be adopted with the ***same effective date by all cities.***”

RCW 35.102.130

Allocation and apportionment requirements

■ Allocation

- ◆ All income other than those taxed as service and royalties will be allocated to the location where the activity takes place.
 - Sales of tangible personal property (Retail Sales/Wholesale Sales): the activity takes place where delivery to the buyer occurs
 - Manufacturing/Extracting/Retail Services: allocated to the location where the activity takes place
- ◆ Royalties from the granting of intangible rights: allocated to the commercial domicile of the taxpayer

RCW 35.102.130

Allocation and apportionment requirements

■ Apportionment

- ◆ Services and Other: apportioned to a city by multiplying apportionable income by a fraction, the numerator of which is the payroll factor plus the service-income factor and the denominator of which is two –

$$\text{Apportionable Services Income} \times \frac{(\text{Payroll Factor} + \text{Service-Income Factor})}{2}$$

- Allocation and apportionment of income to “non-taxing” jurisdictions

Allocation and apportionment of retail & wholesale income (.077)

- Retail & Wholesale 35.102.130(1)(a):
 - ◆ (a) In the case of sales of tangible personal property, the activity takes place where *delivery to the buyer occurs*.
 - ◆ Similar to SSB 5089 Streamlined Sales Tax destination-based sourcing
 - Potential confusion to businesses due to different effective dates
 - January 1, 2008 for local B&O taxes
 - July 1, 2008 for retail sales tax

Allocation and apportionment of services income (.077)

■ Services and Other:

◆ Services Income =

$$\text{Total Services Income} \times \frac{(\text{Payroll Factor} + \text{Service-Income Factor})}{2}$$

◆ Total Services Income: in-state, nationwide, or worldwide – will depend on accounting practices and nature of individual company

◆ Payroll Factor = $\frac{\text{Total Compensation in City}}{\text{Total Compensation Everywhere}}$

◆ Service Income = $\frac{\text{Service Income in City}}{\text{Service Income Everywhere}}$

Allocation and apportionment of services income (.077)

■ Payroll Factor

◆ Payroll Factor =
$$\frac{\text{Total Compensation in City}}{\text{Total Compensation Everywhere}}$$

- ◆ (a) The payroll factor is a fraction, the numerator of which is the total amount paid in the city during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the tax period. Compensation is paid in the city if:
 - (i) The individual is *primarily assigned* within the city;
 - (ii) The individual is not primarily assigned to any place of business for the tax period and the employee performs *fifty percent or more* of his or her service for the tax period in the city; or
 - (iii) The individual is not primarily assigned to any place of business for the tax period, the individual does not perform fifty percent or more of his or her service in any city, and the *employee resides in the city*.
- ◆ **Question:** “Primarily assigned” is defined as the business location of the taxpayer where the individual performs his or her duties. What is meant by “business location of the taxpayer?” This must be a place of business, store, or office.
- ◆ **Note:** If the business has no employees, then there is no payroll factor. If there are no employees within the city but there are employees elsewhere, then the payroll factor is zero.

Allocation and apportionment of services income (.077)

■ Service-Income Factor

- ◆ Service Income =
$$\frac{\text{Service Income in City}}{\text{Service Income Everywhere}}$$
- ◆ (b) The service income factor is a fraction, the numerator of which is the total service income of the taxpayer in the city during the tax period, and the denominator of which is the total service income of the taxpayer everywhere during the tax period. Service income is in the city if:
 - (i) The **customer location** is in the city; or
 - (ii) The income-producing activity is performed in more than one location and a **greater proportion of the service-income-producing activity is performed in the city** than in any other location, based on costs of performance, and the taxpayer is not taxable at the customer location; or
 - (iii) The **service-income-producing activity is performed within the city**, and the taxpayer is not taxable in the customer location.
- ◆ **Question:** “Customer location” is defined as the city or unincorporated area of a county where the “majority of the contacts” between the taxpayer and the customer takes place. The term “majority of the contacts” is not a commonly used term in other tax apportionment methods.

Examples

Examples	Current Law	Post-Allocation & Apportionment Changes
Manufacturing:		
A firm manufactures goods in City A and sells goods those same goods wholesale in City B.	100% to City A, the manufacturing city, under multiple activities rules.	100% to City A under multiple activities rules – no change in allocation: allocated to “where the manufacturing activity takes place.”
Retail/Wholesale Sales:		
A firm ships via common carrier from its warehouse in City A to a homeowner in City B. The firm has no physical presence in City B, such as salespeople calling on homeowners or other customers.	City A would tax the activity since City B has no taxing nexus.	Under RCW 35.102.130(1)(a), the “activity” takes place in City B. City A cannot tax the sale. City B would only be able to tax if the firm had nexus in the city
Same fact pattern, but the firm has a physical presence, in City B, such as a store or salespersons visiting customers.	City B would tax the activity.	Under RCW 35.102.130(1)(a), the “activity” takes place in City B. Because the firm has taxable nexus in City B, City B would be allocated the revenue from this delivery. City A can not tax.

Examples (cont)

Examples	Current Law	Post-Allocation & Apportionment Changes
Services:		
<p>An accounting firm located in City A conducts the annual tax audit for a business in City B. To complete this particular audit, it assigns staff to work at the customer's location for several weeks. Assume that the payroll factor allocates the revenue from this customer to City A. Since the majority of contacts occur in City B, the service income factor allocates the revenue to City B. Taxpayer has nexus in City B due to physical presence.</p>	<p>City A can tax 100% of revenue unless City B is a gross receipt B&O tax city and the majority of the service is conducted in City B, and then City B gets 100% of revenue.</p>	<p>City A would receive 50% and City B would receive 50%.</p> <p>City A = service income X (payroll factor (=1) + service income factor (=0)) / 2 = service income X (1 + 0) / 2 =service income X ½</p> <p>City B = service income x (payroll factor + service factor/2) = service income x (0 + 1) /2 = service income x ½</p>

Examples (cont)

Examples	Current Law	Post-Allocation & Apportionment Changes
<p>A City C (a non-B&O tax city) engineering firm has multiple customers in City A. They do not come into City A to meet with their clients, but conduct their business over the phone and through emails and meet at various construction sites south of City A. They advertise and send mailers and bids to City A construction firms.</p>	<p>No nexus, no activity, and no tax.</p>	<p>No nexus, apportionment would not apply to activities in City A.</p>
<p>Same facts, but they also meet in City A with one of their customers but none of the others. City C has all of the payroll costs and City A's customer represents 40% of the service income.</p>	<p>100% of the revenue attributable to customers or activities in City A to City A</p>	<p>All of payroll allocated to City C and 40% of services income to City A. 20% apportioned via service income formula to City A.</p> <p>City A = service income X (payroll factor + service income factor) / 2 = service income X (0 + 4/10) / 2 =service income X 1/5</p>

Other Changes

- **Exception for Newspapers (.078):** Inclusion of an exemption from apportionment for the newspaper and publishing industry, as provided by RCW 35.102.150.
 - ◆ Allocated to principal place from which the taxpayer's business is directed or managed
- **State Penalties & Interest (administrative provisions .021 & .090):** Changes to the administrative provisions to reflect changes made in 2006 to state penalty and interest provisions in RCW 82.32.050.
 - ◆ RCW adopted by reference avoid future revisions to model ordinance if state makes additional changes to these provisions.

Other Changes (cont)

- **Exemption for Professional Employer Services (.100(6)):** Addition of an exemption identical to RCW 82.04.540(2) for professional employer services to comply with RCW 35.102.160
 - ◆ Applies in rare cases to exempt wages paid by the professional employer services firm to the worker from calculation of gross revenues
- **Repealed RCW Reference**
 - ◆ **(.030 “Sale at retail”(9)):** Deletion of reference to a repealed RCW related to environmental remediation in the definition of sale at retail.
 - ◆ **(.100 “booth renter):** Deletion of repealed RCW reference. State law still refers to deleted reference.

Other Changes (cont)

◆ Definitions Updates

- **References to Telephone Business (.030 “Sale at retail” (3)(f) & (4); “Sale at wholesale”):** Updates references from network telephone service to telephone business to anticipate movement of RCW references for telecommunications provisions in the streamlined sales tax legislation, SSB 5089, which will take effect July 1, 2008.
 - **Definition of Delivery (.030):** Adds definition of delivery for apportionment of retail and wholesale sales to place of delivery under .077.
 - **Clarification of Engaging in Business (.030 “Engaging in business”):** Clarifies common carrier exception to engaging in business to exclude de minimus activities from activities creating nexus.
- ## ◆ Updates to Multiple Taxation Provisions (.075):
- Harmonizes provisions with allocation and apportionment provisions after January 1, 2008.