SEATTLE CITY COUNCIL
CENTRAL STAFF

April 17, 2020

M E M O R A N D U M

To: Select Budget Committee
From: Tom Mikesell, Analyst and Dan Eder, Deputy Director
Subject: Payroll Expense Tax Package - Tax and Interfund Loan

On Wednesday, April 22, 2020 the Select Budget Committee (Select Committee) will begin discussions on the proposed Payroll Expense Tax package (aka Tax on Corporate Payroll). This tax package includes three separate, but interconnected bills:

1. CB 119772 – Tax
2. CB 119773 – Interfund Loan (IFL)
3. CB 119774 – Spending Plan and Emergency Appropriations

This memo describes CB 119772 (Tax Bill) and CB 119773 (IFL Bill). In short, the tax bill would impose a new payroll expense tax annually on businesses with payrolls in excess of $7 million to generate $500 million in tax revenue annually. The IFL bill would approve loans to support emergency appropriations in 2020. Combined, these two bills provide the financing mechanism for the spending proposal included in Spending Plan bill CB 119774 to fund emergency cash assistance to low-income households impacted by COVID-19, acquisition and development of social housing, and housing-related strategies identified in Seattle's Green New Deal (GND) Resolution 31895.

CB 119772: Tax Bill

A. Revenue Amount

Raises $500 million annually (plus inflation beginning in 2022). Given a June 2020 effective date (described later in *Section D. Who Pays the Tax?*) tax revenues owed for 2020 (June through December) would be approximately $286.4 million. The 2020 tax payment, however, would not be due until February 1, 2022.

B. Tax Structure

Imposes a tax on non-exempt business payroll expenses with a Seattle nexus in excess of $7 million annually. Employers not exempted (discussed in *Section C. Exemptions*) would pay 1.3 percent times the total payroll paid to all employees for work performed in Seattle, as described below.

1. *Business Payroll Expense Calculation*
   As described in *Section C. Exemptions* of this memo, the tax would apply to business payroll expenses above a $7 million threshold for each individual business. The calculation of payrolls against that threshold bears further explanation given alternate approaches to business structures and employment in the 'gig economy'. For example:

a. *Independent Contractors*
When calculating total annual payroll, the bill would require a business to include their payments to all independent contractors that provide work for that business. An exception would be made for independent contractors whose compensation is already included in another business' payroll calculation.

b. *Integrated Enterprises*
In some instances, an organization that informally operates and advertises as a single business can be a collection of related, but independently licensed businesses. For example, a restaurant management company can provide management and operational oversight to an array of smaller independent restaurant and catering businesses. This bill would treat each individual restaurant, and the management company itself, as discrete, independent businesses when determining if their payrolls exceed the $7 million threshold.

c. *Franchise Businesses*
Similarly, for the purpose of determining total payroll, the bill treats individual franchises of a larger corporation as discrete businesses. For example, the payroll at an individual McDonalds franchise, which holds a business license with the City, will be tested against the $7 million threshold, rather than the payrolls at all McDonalds restaurants in Seattle being aggregated and tested against the $7 million threshold.

2. *Type of Compensation Included in Determining Payroll Expense*
The bill includes the following types of compensation in determining payroll expense:

> All forms of remuneration defined in RCW 50A.05.010, "net distributions, or incentive payments, including guaranteed payments, whether based on profit or otherwise, earned for services rendered or work performed, whether paid directly or through an agent, and whether in cash or in property or the right to receive property."

The definition of compensation does not include payments to a pass-through entity that are not earned for services rendered, including return of capital, investment income, or other income from passive activities.

3. *Allocation of Payroll in Seattle*
A final element of determining the tax base requires assigning payroll attributable to work in Seattle. The approach is the same framework used in proportionally allocating liability for the City's existing Business License Tax (Business and Occupation or B&O tax) for businesses that operate both inside and outside the city limits. Specifically, the bill would include a three-part test of whether to include the payroll expense for an employee. The tax would apply to a payroll expense for an employee in one or more of the following circumstances:

- Employee is primarily assigned to Seattle;
- Employee performs 50 percent or more of their work in Seattle; or

- Employee resides in Seattle and does not perform 50 percent or more of their work in a single city.

This is similar to the allocation framework used in HB 2948, a bill that was introduced during the 2020 regular session of the State Legislature and that would have granted authority for a county payroll tax.

C. Exemptions

Some businesses based on size and type would be exempted, as follows:

1. *Businesses Generally Not Subject to the Tax*
   The bill would exempt businesses with annual payrolls less than $7 million in 2020 and 2021. Beginning on January 2022, the exemption threshold grows with the rate of inflation. The exemption threshold (like the measure of the tax itself) is based on payroll expenses for work attributable to a business licensed in the City of Seattle. As an illustrative example, a hypothetical business has a worldwide payroll of $10 million in 2019 of which $5 million is for Seattle-based employees. This business would be exempt from paying the proposed tax because its annual Seattle-based payroll expense amount is less than the $7 million exemption threshold.

2. *Other Exemptions*
   The bill would exempt the following businesses irrespective of size of payroll expense:

   a. Non-profit organizations
   b. Educational employers
   c. Grocery stores
   d. Local government employers
   e. Those entities for which the City does not have authority to tax, specifically:

      i. federal government and its subsidiaries,
      ii. state government and its subsidiaries,
      iii. insurance businesses and their agents (SMC 5.45.090),
      iv. businesses that only sell, manufacture, or distribute motor vehicle fuel (RCW 82.38.080), and
      v. businesses that only sell or distribute liquor (RCW 66.08.120).

   Based on summaries of 2018 State Employment Security Department employment data provided by the King County Office of Financial Analysis to Seattle's City Budget Office, approximately 800 businesses would be required to pay the tax after accounting for all exemptions. This represents two percent of the 39,600 firms represented in the 2018 data.

D. Who pays the tax?

The tax must be paid by the employer and cannot be deducted from employee compensation.

E. Effective and Due Dates

To generate revenue to meet the needs from the COVID-19 civil emergency, the proposed tax would be imposed effective June 1, 2020. While the tax would take effect on June 1, 2020, tax payments for 2020 and 2021 would be due with the final tax payment for 2021 (the earliest we expect that Department of Finance and Administrative Services can both complete rulemaking and stand up the administrative infrastructure needed to accept tax payments).

F. Emergency Clause

The new tax revenue from this bill is generated to respond to public needs resulting from the COVID-19 and homelessness civil emergencies. The tax legislation therefore includes an emergency provision and would have an immediate effective date if passed by a three-quarters of Councilmembers and signed by the Mayor.

CB 119773: IFL Bill

The IFL bill would authorize interfund loans supporting the emergency 2020 appropriations addressed in the separate Spending Plan and Emergency Appropriations bill (CB 119774).

An interfund loan is the practice of one City fund borrowing from a different City "source" fund; the source fund has a cash balance that will be needed to meet future obligations, but the cash balance is temporarily used for other short-term spending priorities.

The IFL bill would authorize multiple City funds to make interfund loans to the General Fund (GF). The GF would repay the source funds the borrowed amounts plus interest in 2021 using the payroll expense tax revenues as described in the Spending bill.

A. Cumulative Loan Amount

The IFL bill would authorize the GF to borrow up to $200 million from a to-be-determined combination of general government source funds.

The bill identifies six potential funds that would loan cash to the GF to support the emergency 2020 appropriations. These funds were selected based on Central Staff's evaluation of year-end fund balances and a determination that the six funds would each likely be able to support a loan of up to $50 million without significantly affecting the City's ability to support projects and programs that were authorized in the 2020 Adopted Budget and the 2020-2025 Capital Improvement Program.

There is some uncertainty about how much cash is actually available in each fund and what impacts (if any) of the interfund loans would have on projects and programs. Authorizing a loan of up to $50 million from each of the six funds is intended to provide the Executive with flexibility to address this uncertainty. The cumulative loan amount from the six sources (listed below) cannot exceed $200 million.

1. Low Income Housing Fund
2. Housing Incentive Fund
3. Families Education and Preschool Promise Levy Fund
4. Move Seattle Levy Fund
5. Seattle Parks District Fund
6. 2019 Library Levy Fund

B. <u>Minimizing Impacts</u>

The bill would request that the Executive minimize or eliminate impacts on the City's other planned uses of cash in each of the six potential source funds during the period of the IFL.

The bill would also require that the Executive provide a report three weeks about how this goal will be accomplished within the flexibility provided.

C. <u>Emergency Clause</u>

The interfund loans are proposed to respond to the COVID-19 civil emergency. The IFL legislation therefore includes an emergency provision and would have an immediate effective date if passed by a three-quarters of the Councilmembers and signed by the Mayor.

cc: Kirstan Arestad, Executive Director