Washington Filled With the Sound of Taxes: A Musical Review of 2017

by Michelle DeLappe

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Supplemented by a suggested soundtrack, this edition of Skookum Tax News summarizes wide-ranging state and local tax developments in Washington state in 2017. The developments include legislative efforts to fund education, the battle over taxes in Seattle, and dismay over retroactive taxes upheld. The article expresses hope for new opportunities in 2018 and beyond.

As we reflect on 2017, humming "should auld acquaintance be forgot," let's take a spin through the year's Washington tax developments with musical accompaniment.

'Low Budget' (The Kinks)

Efforts to 'Fully Fund' Education

Two major tax developments emerged from the 2017 legislative session: the Marketplace Fairness Act and property tax levy reform. Both were attempts to satisfy the state supreme court's order that the Legislature provide full and sufficient funding for public education from "regular and dependable state, not local, revenue sources."[1] This column recently discussed the Marketplace Fairness Act and other efforts to expand nexus,[2] while property tax levy reform[3] — commonly known as the "levy swap" — is the most complex and least understood 2017 tax development.

The levy reform is to fund teacher salaries with state — not local — levies, and 2018 property tax bills across the state will reflect higher tax rates. That is because the state will receive additional state property tax and will suspend one of the limits on state property tax increases. The Department of Revenue estimates an increase of 6 to 8 percent (assuming all else remains equal), but depending on the levy code area, the increase could be more or less than that.

Beyond 2018, the change is less predictable because of the phasing in of new limits on school district property taxes — with the state predicting a net decrease in some areas starting with 2019 property tax bills and a net increase in others. Though many thought that there would be decreases in rural areas and increases in areas with high property values, actual results are less predictable.[4]

In reviewing the Legislature's efforts, the state supreme court decided in November to continue holding the Legislature in contempt and to require lawmakers to bridge the short-term $1 billion funding gap during the 2018 regular session. The court recognized that when fully implemented, the new legislation would satisfy its requirements. But it faulted legislators for failing to meet the court's September 1, 2018, deadline to implement the teacher salary model because the levy reform

[1] *See* the Washington Supreme Court's October 6, 2016, order at p. 2, in the court's ongoing retained jurisdiction to monitor legislative funding for education under *McCleary v. State*, 173 Wash. 2d 477 (2012).

[2] Michelle DeLappe, "Washington's Ever-Expanding Definition of Tax Nexus," *State Tax Notes*, Oct. 16, 2017, p. 225.

[3] Laws of 2017, 3rd Spec. Sess., ch. 13.

[4] *See* Office of Superintendent of Public Instruction, "EHB 2242 Enrichment Levy and State School's Tax Analysis."

takes several years to phase in. So lawmakers have their work cut out for them going into 2018.

At the same time, the Legislature experienced a tectonic shift in the November elections. Voters in the state's 45th Legislative District elected Democrat Manka Dhingra to replace the late Republican Sen. Andy Hill, thus handing Democrats the Senate majority. With control of both houses and the governor's mansion for the first time since 2012, Democrats will likely seriously consider tax reform.

'Town Without Pity' (Gene Pitney)

Lots of New Taxes in Seattle

In 2017 Seattle probably broke a record in creating three new taxes: a sweetened beverage tax in June, an income tax in July, and a flat tax on short-term rentals in November. The City Council seriously considered a fourth new tax proposal — an employee hour tax on businesses grossing more than $5 million per year — but narrowly voted against it (for now).

Four lawsuits challenging the legality of the new income tax have been quickly making their way through the courts. The Economic Opportunity Institute even joined as an additional defendant on its own request. (The institute has worked for years to establish an income tax in the state and played a major role in persuading Seattle's leaders to adopt the tax.) In November the superior court heard cross motions for summary judgment in all four cases in a consolidated three-hour hearing. The court issued a 27-page decision in the taxpayers' favor.

The decision adopted the taxpayers' statutory arguments and declined to consider the state constitutional issues. In a nutshell, the taxpayers argued that:

- The city must have express legislative authority to create the tax, which it lacks.
- The tax violates the statutory prohibition against net income tax.
- The graduated tax on income (with a 0 percent tax rate on income under $250,000 (single) or $500,000 (married filing jointly) and a 2.25 percent tax rate on income above those amounts) is unconstitutional as a nonuniform tax on property under a long line of Washington Supreme Court precedents interpreting the state constitution's broad definition of property. (The constitution defines property to "include everything, whether tangible or intangible, subject to ownership.")[5]

The city's arguments, in brief, are that:

- The tax is actually an excise tax on the privilege of living in Seattle and the benefits the city provides that separate us from "the savage state of nature," or a *sui generis* tax.
- The city enjoys a legislative grant of plenary authority to impose such taxes.
- Though "netting occurs" in many instances in order to determine total income on a federal tax return, a tax on total income is not a prohibited tax on net income.
- Precedent should not be followed or should be overruled because a tax on income is not on property but rather on an "earned expectancy."

The city has vowed to appeal. The case may go to the court of appeals or may receive direct review before the state supreme court given the issue's importance and urgency created by the city's accelerated timeline for the new tax's effective date. Though the first returns would not be due until April 15, 2019, if a higher court reverses the superior court, the tax would apply to income received by Seattle individual residents and nongrantor trusts starting January 1, 2018.

Another new Seattle tax established in 2015 received the state supreme court's approval in 2017.[6] The "firearms and ammunition tax" imposed on retailers a tax of $25 per firearm sold and 2 to 5 cents on every round of ammunition sold. The National Rifle Association and others challenged the ordinance as a disguised regulatory fee and a violation of state statute barring local gun regulations, but the court disagreed. As the sole dissenting justice pointed out, the analysis of the fee-versus-tax issue relied on case law involving property taxation and is not entirely suited to this different type of tax.

But given Seattle's ongoing creation of various taxes, the argument that the tax was outside the

[5] Washington Const., Art. VII, section 1.

[6] *Watson v. City of Seattle*, 189 Wash.2d 149 (2017).

city's taxing authority is of particular interest. Under the state constitution, cities derive their power to tax from the Legislature, and only cities and counties have the ability — when so authorized — to levy local taxes. By statute, Seattle can tax local businesses as part of its power to issue licenses.[7] The court reasoned that the flat taxes at issue were a type of excise tax on the business of making retail sales of firearms and ammunition, and were permitted under the city's licensing power. According to the court, it did not violate statutory uniformity requirements for local gross receipts taxes because it was a different type of tax, measured on a per-unit basis instead of by gross receipts, and without any effect on retailers' gross receipts tax rate regardless of the effect on the retailers' overall tax burden.[8]

At least one taxpayer prevailed against Seattle in 2017. In *City of Seattle v. T-Mobile West Corporation*,[9] T-Mobile successfully fended off a Seattle business licensing tax assessment of $498,000 on international cell phone roaming charges the company had received from customers. The court of appeals held that the state had not authorized cities to tax revenue derived from international roaming charges.

'(I Can't Get No) Satisfaction' (The Rolling Stones)

Retroactivity Upheld Again

May 22 was a sad day for champions of due process in state taxation because the U.S. Supreme Court denied review of two of the most flagrant examples of retroactive taxes in recent memory: one Washington case[10] and a group of Michigan cases.[11]

To briefly summarize the Washington case, in 1983 the Legislature adopted an exemption from business and occupation (B&O) tax for out-of-state companies selling consumer products and limiting their in-state presence to sales solicitations by separate representatives. Dot Foods structured its sales to fit the exemption and obtained a ruling from the DOR that it qualified. The department later reversed course and assessed B&O tax on Dot Foods for 2000 to 2006. In 2009 the Washington Supreme Court held that the plain language of the exemption applied to Dot Foods.[12] Pending that decision, Dot Foods had another case challenging assessments for later years.

After the 2009 decision, rather than settle the later years, the DOR asked the Legislature to change the law. The Legislature, motivated to prevent revenue losses, obliged the DOR by amending the exemption retroactive to 1983, except it would not apply to Dot Foods for the specific years at issue in the 2009 decision. Dot Foods's challenge of those later assessments reached the state supreme court.

The court disagreed with Dot Foods and affirmed the later assessments. The court concluded that the state's need for revenue was a legitimate legislative purpose. The court also reasoned that the statute of limitations would limit the retroactive effect to a reasonable period — less than the eight-year retroactivity period that the same court had recently upheld in an estate tax case.[13] Based in part on those two decisions, the Council On State Taxation has given Washington a C-, one of its lowest grades, for tax appeals and procedural requirements; the scorecard said that Washington "has produced two of the most egregious retroactive tax changes in the nation, reversing the results in two Washington Supreme Court decisions, with the retroactive changes subsequently upheld by the same court."[14]

It is difficult to say whether Washington's or Michigan's legislature acted worse. On the one hand, Michigan applied its retroactive elimination of the alternative apportionment election under the Multistate Tax Compact back seven years — not as far back as 1983. On the other, unlike Washington, Michigan applied its

[7] Wash. Rev. Code 35.22.280(32).

[8] Wash. Rev. Code 35.21.710.

[9] 199 Wash. App. 79 (2017), *review denied* (2017).

[10] *Dot Foods Inc. v. Department of Revenue*, 185 Wash. 2d 239 (2016), *cert. denied*, No. 16-308 (2017).

[11] *Sonoco Products Co. v. Department of Treasury*, 880 N.W.2d 521 (2016), *cert denied*, No. 16-687 (2017).

[12] *Dot Foods Inc. v. Department of Revenue*, 166 Wash. 2d 912 (2009).

[13] *In re Hambleton*, 181 Wash. 2d 802 (2014), *cert. denied*, No. 14-1436 (2015).

[14] COST, "The Best and Worst of State Tax Administration: COST Scorecard On Tax Appeals & Procedural Requirements" (December 2016).

retroactive change to reverse the victory of the very taxpayers that had prevailed in court for the very same years they had litigated.[15] In a SALT Academy Awards presentation at the COST annual meeting in October, *Dot Foods* beat the Michigan cases out for the dubious honor of winning the "Most Interesting Supreme Court Case," which perhaps settles the question of which case was worse.

'Keep It a Secret' (Jo Stafford, Bing Crosby, etc.)

What DOR Discloses or Publishes

The developments on disclosure include two sides of the same coin: confidentiality and transparency. On the confidentiality side, in recent years the DOR has been battling superior court and Board of Tax Appeals orders requiring it to disclose third-party confidential taxpayer information. These are situations in which, for example, one taxpayer conducts discovery that includes other taxpayers' information. In April the DOR issued an advisory explaining its policy and process when those situations arise.[16] In brief, the DOR will object and not voluntarily disclose third-party tax information, seek a protective order to prohibit discovery of that information, and oppose motions to compel its discovery. If ordered to disclose, the department will notify the nonparty taxpayer, redact information to protect the taxpayer's identity, and potentially consult with the nonparty taxpayer about the redactions.

On the transparency side, here is a progress report on the DOR's commitment to publishing rulings from its internal review process (formerly known as its appeals division). Criticism of the department for publishing very few of its determinations peaked in 2012.[17] Though the DOR bridled at the criticism,[18] it committed to dramatically increasing the number of published determinations. The table below shows the number of determinations the DOR has published each year since 2011. As of this writing, it is on track to publish more than 90 in 2017. Many of the determinations have been on substantive issues and provide valuable guidance on the DOR's position on a variety of subjects. Though the department has greatly increased the number of published determinations compared with earlier years, it is important that it continue to commit to that effort.

Year	Determinations Published
2011	15
2012	16
2013	53
2014	96
2015	100
2016	107
2017 (as of November 30)	90

'Get Up, Stand Up' (Bob Marley)

Civil Rights in Tax Assessments?

It isn't every day that a taxpayer uses federal civil rights claims to challenge tax assessments. A Washington trade association and several trucking carriers got surprising traction (pun intended) with this argument at the court of appeals, but the arguments failed at the supreme court.[19]

The plaintiffs brought claims against the state's Employment Security Department for violating their civil rights under federal law (section 1983) and interfering with their business expectancies by imposing unemployment tax assessments. The assessments resulted from the Employment Security Department's reclassifying independent contractors as carrier employees. The supreme court held dismissal of the claims was proper because state law provided an adequate remedy (to appeal the assessment or seek a refund), making civil rights claims unnecessary. Moreover, the Employment Security Act's remedies for appealing or correcting tax

[15] *IBM v. Department of Treasury*, 852 N.W.2d 865 (Mich. 2014).

[16] ETA 3201.2017.

[17] *See, e.g.*, Cara Griffith, "Washington State Falls Short on Transparency," *State Tax Notes*, June 18, 2012, p. 815.

[18] Brad Flaherty, "Washington DOR Responds to Transparency Article," *State Tax Notes*, July 2, 2012, p. 59.

[19] *Wash. Trucking Associations v. Employment Sec. Department*, 192 Wash. App. 621 (2016), *reversed*, 188 Wash. 2d 198 (2017), *cert. denied*, No. 17-145 (2017).

assessments barred claims for tortious interference with business expectancies.

'Eye of the Tiger' (Survivor)

Cougar Den and Dreams of the Past

In 2017 the state supreme court struck down a Department of Licensing assessment of $3.6 million in taxes, penalties, and fees on wholesale fuel deliveries from Oregon to Cougar Den Inc., a gas station owned by a member of the Yakama Nation and located on the Yakama Indian Reservation in Washington.[20]

The court based its decision on the Yakama Nation Treaty of 1855. Under that treaty, the Confederated Tribes and Bands of the Yakama Nation have the right to free access from the reservation and to travel on all public highways to engage in trade. Accordingly, the tribes could import fuel without holding an importer's license and without paying fuel taxes — given that importing fuel without traveling on public highways would be impossible. The Department of Licensing has asked the U.S. Supreme Court for review. As of this writing, the last activity in the case was the Court's invitation to the solicitor general to file a brief on the United States' views in the case.

'Have a Heart' (Bonnie Raitt)

And I Should Pay and Pay

An unpublished 2017 appellate case is a grim reminder that companies with professional employee organizations or other coemployment arrangements need to carefully follow Washington's narrow exceptions to avoid paying multiple layers of B&O tax. In *Heartland Employment Services LLC v. Department of Revenue*,[21] Heartland provided personnel to client affiliates that operate nursing homes and assisted living centers. It also administered payroll and benefits. Each client affiliate paid Heartland the employee costs (wages, benefit costs, payroll taxes, etc.), plus enough to cover administrative expenses.

Heartland was not reporting any taxes to the DOR despite reporting millions in wages to the Employment Security Department. The department assessed B&O tax on the full amounts Heartland received, which effectively subjected the income used to pay employee costs to two layers of B&O tax: at the level of the client affiliate and at Heartland's level. Heartland argued that it qualified for the statutory deduction allowed for professional employer organizations (PEOs).[22] The court of appeals affirmed the assessment, however, because Heartland did not strictly comply with the requirements of the PEO deduction. The main flaw was the fact that employees received mixed and unclear messages about who employed them (based on the employee handbook, the letter sent to employees, and their paystubs). Without clear written notice to employees indicating which were subject to coemployment by Heartland and its client affiliate, Heartland was not entitled to the PEO deduction.

'I Hope' (Dixie Chicks)

A Wish for 2018

The gestalt of these 2017 developments is about increasing tax revenue — through everything from the state's expansion of nexus in 2017[23] to the aggressive new taxes in Seattle. That focus is reminiscent of the motto emblazoned at the bottom of every email from state revenue employees: "Working Together to Fund Washington's Future." While state and local governments clearly must adequately fund government functions, it should not come at the expense of due process through retroactive laws or by passing laws contrary to constitutional jurisprudence — such as with the Seattle income tax, the expansion of economic nexus contrary to *Quill*, or by ignoring dissociation contrary to *Norton*.

As we raise our glasses to "Auld Lang Syne," our main wish for 2018 and beyond is that next

[20] *Cougar Den Inc. v. Department of Licensing*, 188 Wash. 2d 55 (2017), *petition for cert. filed*, No. 16-1498 (2017).

[21] 198 Wash. App. 1065 (2017) (unpublished opinion).

[22] Wash. Rev. Code 82.04.540.

[23] *Supra* note 2.

year this column will be able to celebrate more developments in which the government and the governed work together to advance fairness in taxation. Examples of recent headway include the DOR's progress in publishing determinations in recent years and the simplification of tax incentive reporting enacted in 2017.[24] Upcoming opportunities include the task force working to simplify local B&O taxation[25] and ongoing efforts to create a tax court in Washington.[26] There is plenty of work ahead. ■

[24] Laws of 2017, ch. 135.

[25] Laws of 2017, ch. 209 (requiring submission of a report by October 31, 2018, from a task force comprised of municipal and business representatives).

[26] *See* DeLappe, "Giving Washington Taxpayers Their Day in Tax Court," *State Tax Notes*, Feb. 10, 2016, p. 265. In 2017 S.B. 5866, which would have established a tax court inspired by the goals of the American Bar Association's Model Act and modeled on the Oregon Tax Court, received strong bipartisan support in the Senate, but failed to emerge from difficult budgetary negotiations and never reached a vote in the House.