



# POLICY BRIEF

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## The need for sales tax reform in Washington State

*Streamlining Washington's costly and complex sales tax system would increase fairness, promote voluntary compliance, and free small business owners to create jobs, services and economic growth.*

Mark Harmsworth,  
Director, Center for Small Business

October 2021

### Key Findings

1. The Streamlined Sales and Use Tax collection process is burdensome on small business.
2. Adding a sales tax threshold and providing an option under that threshold to collect sales tax based on a flat rate destination sales tax will simplify tax collection and reduce tax filing for small business.
3. A flat rate destination sales tax for small business will not affect total state sales tax revenue.
4. A flat rate destination sales tax, apportioned to the destination, will not significantly affect local sales tax revenues paid to municipalities.
5. A flat rate destination sales tax will not jeopardize state certification in the Streamlined Sales and Use Tax agreement.



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## Introduction

Most states collect sales taxes. There are only five states that do not collect a sales tax at the state level; Alaska, Delaware, Montana, New Hampshire, and Oregon.<sup>1</sup> The sales tax rates imposed by the other 45 states vary from the lowest, at 4% for Alabama, to the highest, 7.5% for California.<sup>2</sup>

Washington's sales tax rate is 6.5%, but local district, county and city sales taxes can push the rate people actually pay to over 10%. For example, the city of Lynnwood has a sales tax rate of 10.5% and is ranked 34th highest in the United States.<sup>3</sup> The sales tax in Seattle is 10.25%.

Over the last several decades, the collection of sales taxes by state governments has become increasingly complex with the popularity of out of state mail order businesses, the expansion of local municipal sales tax authority and the explosion of online internet sales.

In 1999, the National Governors Association (NGA) and the National Conference of State Legislatures (NCSL), frustrated by the inability to collect sales tax from sales made to their residents in other states, created the Streamlined Sales and Use Tax Agreement (SSUTA).<sup>4</sup> The agreement requires the 24 member states to calculate sales tax rates based on the shipping destination and for businesses to collect the tax for remittance.

The result over time, however, is that the combination of local municipal tax rates, sales tax exemptions and interstate tax collection rules, has made the sales tax processes overly complex. In the effort to collect more sales tax revenue and to standardize the tax collection process, the SSUTA has created a costly administrative process and a time-consuming effort for business and consumers.

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1 "The 5 U.S. States Without a Statewide Sales Tax," by Tonya Moreno, CPA, March 12, 2021, at <https://www.thebalance.com/states-without-a-sales-tax-3193305>.

2 "2020 Tax-Rates.org – Sales Tax Rates by State," accessed August 10, 2021, at <http://www.tax-rates.org/taxtables/sales-tax-by-state>.

3 "What cities have the highest sales tax?" by the Sales Tax Handbook, accessed August 10, 2021, at <https://www.salestaxhandbook.com/highest-salestax-cities>.

4 "Streamlined Sales Tax Governing Board Library," accessed August 10, 2021, at <https://www.streamlinedsalestax.org/library/Index?SelectedDocumentType=Agreement+Documents>.

## Key U.S. Supreme Court ruling

On June 21, 2018, the United States Supreme Court ruled in favor of the State of South Dakota in the case *South Dakota v. Wayfair, Inc.* The ruling removed the need for a physical presence in a state when conducting business to determine whether a seller is required to collect sales tax.<sup>5</sup> This permitted state officials, including those in states that were not members of the SSUTA, to require sellers in other states to collect sales tax based on the buyer's state sale tax rate, irrespective of the seller location, and negated some of the original reason the SSUTA was created back in 1999.

Currently, there are no federal laws passed by congress governing sales tax collection across state lines, though there are several proposals that have been introduced including Senate Bill 698 and House Bill 2775.<sup>67</sup>

The State of Washington is a certified member of SSUTA and applies the SSUTA (sometimes referred to as Destination Sales Tax) rules within state borders to municipalities and political jurisdictions, requiring sales tax to be collected at the location of the sale or service.<sup>8</sup>

This calculation and collection of destination sales tax raises no revenue but creates a significant amount of work for all businesses but proportionately negatively affects small business the most.

## Management of the SSUTA agreement

The SSUTA is an agreement between member states that does not supersede state law.<sup>9</sup> It requires member states to follow a set of 22 general principles to maintain membership (or Certificate of Compliance) in the SSUTA. It is possible for a state to leave SSUTA, but so far no state has decided to leave.

The SSUTA is maintained by a governing body, led by an Executive Director and a board consisting of up to four delegates from each of the representative states. For Washington State, the delegates are typically appointed employees from within the executive branch of state government. Each of the member states has one vote.

While SSUTA was created primarily to address interstate sales tax collection, the agreement requires member states to follow similar rules within political

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5 “South Dakota v. Wayfair, Inc.,” accessed on August 10, 2021, at [https://www.supremecourt.gov/opinions/17pdf/17-494\\_j4el.pdf](https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf).

6 “S. 698 – Marketplace Fairness Act of 2015,” accessed August 10, 2021, at <https://www.congress.gov/bill/114th-congress/senate-bill/698>.

7 “H.R.2775 - Remote Transactions Parity Act of 2015,” accessed August 10, 2021, at <https://www.congress.gov/bill/114th-congress/house-bill/2775>.

8 “Sales and Use Taxes in Washington State,” by the Municipal Research and Services Center, accessed August 10, 2021, at <https://mrsc.org/Home/Explore-Topics/Finance/Revenues/Sales-and-Use-Taxes.aspx>.

9 “Streamlined Sales Tax Governing Board Library,” accessed August 10, 2021, at [https://www.streamlinedsalestax.org/docs/default-source/guides/state-guide-to-streamlined-sales-tax-project.pdf?sfvrsn=53d3448f\\_4](https://www.streamlinedsalestax.org/docs/default-source/guides/state-guide-to-streamlined-sales-tax-project.pdf?sfvrsn=53d3448f_4).

subdivisions inside state borders which has led Washington to create a destination based sales tax.

## **Washington imposes thousands of sales tax rates**

Washington state law allows municipalities and political jurisdictions to assess sales taxes on activities within their jurisdictional boundaries, independent of sales taxes assessed by the state. This creates differing sales tax rates based on where business activity occurs. There are thousands of sales tax rates, based on location, in Washington. The connection between the business activity and location is referred to as economic nexus.

For a consumer, much of the complexity of the sales tax rate calculation is invisible. The sales tax rate applied to a product or service is applied as an aggregate total of the local and state sales taxes and is not easily calculated at the point of sale. This is illustrated by the fact that the Washington Department of Revenue (DOR) has actually designed a phone app and website to help with the calculation of local and state sale tax rates.<sup>10</sup>

The government sales tax app is used by sellers; most consumers have no idea how much in sales tax they pay.

For a service business attempting to assess the correct sales tax rate for its services, the problem is compounded by the definition of a service and whether sales tax needs to be assessed. A service provider must determine, for each location a service is provided, if the service is subject to sales tax and then calculate the rate for that location. The tax collection reporting to DOR, completed monthly or quarterly, takes a considerable amount of time to complete and to calculate the sales tax that needs to be remitted by location.

Prior to the implementation of Destination Sales taxes in Washington, a business applied a sales tax rate based on the location where the business was registered, irrespective of the location a product or service was delivered.

Retail products and services tax collection are simpler given the fixed location of most businesses, but the underlying issue remains. A fixed location, such as a retail store has one rate to apply to local sales, at the store location. For a mobile retailer or a retailer that ships products to different locations, the calculation of the local sales tax is based on the destination and is a laborious and time-consuming effort.

Larger companies that provide products and services in multiple locations are forced to hire staff and build or buy accounting systems at significant cost to handle the complexity of tracking each sale location, rate and collected sales tax. The additional cost of staff and accounting systems raises no money for the government and provides no services to the customer.

For small businesses and individual business owners, operating in multiple locations, the reporting requirement and collection of the sales tax based on location requires a significant amount of work.

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10 “Tax Rate Lookup App,” by the Washington State Department of Revenue, accessed August 10, 2021, at <https://dor.wa.gov/taxes-rates/sales-and-use-tax-rates/mobile-apps>.

Hiring staff or buying accounting systems is not an economically viable solution. The reporting requirement is made worse if services are billed on an hourly basis, and a determination must be made whether a specific hour of work was subject to sales tax.

Additionally, Washington State requires that if a service is subject to sales tax, all services performed at that location at the same time are also subject to sales tax, regardless of whether the service actually qualifies as a sales taxable service or not.<sup>11</sup>

With the advent of cloud technologies that are remotely hosted, it is quite possible for a service to be provided to a customer where the service provider, customer and cloud hosted server are all in separate physical locations.

Consider the following business situation. If a technical software company provides a customer with a regular software patch, sales tax must be collected, but it's not clear whether this is still the case if the software patch is applied remotely.

If the work is performed remotely, sales taxes may not apply, since there is no nexus with the customer's physical location. If the work is performed on a cloud-hosting server, the applicable sales tax rate at the server's physical location does not have a physical nexus with the service provider either. In many cases, the provider may not even know where the cloud server is located. In fact, the relevant data center could be located outside the United States. Additionally, if a software change is not considered regular, it is not subject to sales tax.

To make the sales tax calculation more even complex, if the service provider provides a regular patch plus some custom changes at the same time, sales tax is collected on both. If the work for the custom changes is performed at a different time, only one activity is subject to sales tax and not the other. There may be several (based on state and local taxes) different sales taxes rates that a business owner may have to consider when calculating the taxes to be applied to the transaction, or possibly none at all.

Apply this single example to 50 customers in 30 different locations and the reporting requirement for one service company increases exponentially in complexity. A small business that bills hourly, must record each hour, by location and type of work, and then bill the customer based on the activity and send the calculated sales tax money to the state. The remittance to the state is not based on the customer, but on location, so additional work is required to summarize the tax amounts into separate jurisdictions.

The business activities subject to sales tax need to be better defined, but still, the underlying problem of the amount of work required to track these events and when and where the work was performed, does not change.

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<sup>11</sup> "Sale at Retail," RCW 82.04.050, accessed August 10, 2021, at <https://app.leg.wa.gov/rcw/default.aspx?cite=82.04.050>.

## Policy recommendation

Simplification of sales tax collection by small businesses is badly needed. The complexity lawmakers have imposed provides no benefit to the public, and directly punishes business owners who create jobs, services, and economic growth.

The following reform would solve many of the harmful effects lawmakers no impose on the public.

Businesses with less than \$25,000 in annual sales tax collections should be required to pay a flat sales rate for all services and products that are subject to sales tax. The flat rate would be based on the state sales tax rate plus the average of the municipal tax rates from the entire state. The business would be required to report the municipal locations where products and services are provided. The state would then apportion the sales taxes collected under the flat rate to municipalities provided by these businesses, based on the local, municipal tax rates.

Filing under the existing sales tax structure should also remain as an option for small businesses who are under the threshold.

As an example, a business providing services in Seattle, Everett and Spokane collecting sales taxes on \$50,000 in sales annually based on a flat sales tax rate of 9.5% (a state rate of 6.5% plus an assumed averaged statewide municipal rate of 3%), would generate \$3,250 in sales tax revenue for the state and \$1,500 in sales tax revenue for the municipal distribution. The municipalities would be paid amounts at the state the local sales tax rates that have been imposed under statute. In this example Seattle would receive \$582 (3.7%), Everett \$524 (3.33%) and Spokane \$394 (2.5%).<sup>12</sup>

Assuming the sales volume were split evenly between Seattle, Everett, and Spokane, the same \$50,000 in sales, under current law would generate \$3,250 (6.5%) in sales tax for the state and for the municipalities a total of \$1584. Seattle would receive \$617 (3.7%), Everett \$550 (3.33%) and Spokane \$417 (2.5%).<sup>13</sup>

A \$25,000 sales tax threshold would result in no change in collected sales tax for the state and only minor differences to municipalities. In our example, there is only an \$84 difference in annual tax revenue split between the three municipalities, for an average of just \$28 for each city per year.

Given the total number of small businesses paying sales taxes, a change to a flat rate tax would sometimes generate slightly less revenue for a municipality, and sometimes more. Given the lower overall sales taxes typically paid by small business, municipalities would see a negligible impact on general sales tax revenue. Some municipalities would actually see an increase in revenue, depending on the final rate adopted as the statewide average sales tax rate.

Additionally, a small business owner would be free to use the time and money saved from filing complex tax reports to generate additional business income,

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<sup>12</sup> "Tax Rate Lookup Tables," by the Washington State Department of Revenue, accessed August 10, 2021, at <https://webgis.dor.wa.gov/taxratelookup/SalesTax.aspx>.

<sup>13</sup> Ibid.

jobs and sales. The result would be increased economic activity and higher state and local sales tax revenues. It would also make the tax system fairer, save on enforcement costs and would increase voluntary compliance.

Charging a flat rate to small business but continuing to use the municipal sales tax rate for payments to the municipalities, does not violate the SSUTA rules and arguably increases compliance with the SSUTA requirement to simplify tax remittances and returns.

Small business, however, would see a significant reduction in the amount of complexity, cost and effort required to remit the correct sales tax amounts to the state. A small business should be able to continue to use the existing destination sales tax system if the business owner so chooses.

## **Conclusion**

Simplification of sales tax collection from small business is needed. It has never been overhauled and state lawmakers have not enacted a sales tax cut in living memory, they have only added to the cost and complexity of the system.

The current sales tax collection system, implemented by Washington State, modeled on the SSUTA is overly complex and needs to be simplified for small businesses that spend a larger portion of their revenue on sales tax calculation and preparation compared to a larger business.

Thresholds for sales tax dispersal should be implemented as an option for businesses that are under either defined sales tax amounts or business activity levels.

Small business owners, with the reduction in the amount of complexity and effort required to remit the correct sales tax amounts, would then be free to create more jobs and products and services and, significantly, generate more overall sales tax revenue for the state, counties, and cities.



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### About the Author

Mark Harmsworth joined WPC in 2019 and became WPC's Center for Small Business Director in January 2020. He was elected in 2014 to the Washington State House of Representatives where he served two terms. His focus was on transportation and technology, including serving as the ranking member on the House Transportation Committee.

Prior to the legislature, Mark served two terms on the Mill Creek City Council and was elected Mayor Pro-Tem in his last year.

He recently finish serving as a Director on the Everett Community College Foundation Board and currently serves as a Director on the Boys and Girls Club of Snohomish County.

Mark works in the technology industry and is an owner of a small business after completing a long career at Microsoft and Amazon.

Mark and his family live in Mill Creek, Washington.