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Seattle Payroll Tax: Update and Frequently Asked Questions

The Seattle City Council passed a bill creating a new payroll tax on persons engaged in business in Seattle. While the ordinance has not yet been signed by the mayor (as of publication), the tax was passed by the council on July 6, 2020, by a veto-proof majority (7-2) and is expected to become law effective January 1, 2021.[1]

Although passed under cover of the COVID-19 crisis, the payroll tax is the product of long-standing efforts by many activists and council members to secure additional, "progressive" revenue sources from Seattle's large businesses. The city's effort to make the tax "progressive" has created a complicated tax with significant ambiguities that will need to be addressed by rulemaking, litigation, or legislative clarification.

Who Is Subject to the Seattle Payroll Tax?

The payroll tax generally applies to "every person engaging in business within Seattle," including nonprofits.[2] However, the combination of exemptions and the rate structure limit the payroll tax to businesses that (1) have more than \$7 million[3] in payroll expenses in Seattle and (2) pay at least one employee in Seattle more than \$150,000 in annual compensation.[4]

The payroll tax also specifically exempts grocery businesses, insurance businesses, certain motor vehicle fuel businesses, and certain liquor businesses.[5] In addition, certain nonprofit healthcare entities are exempt from payroll tax on employees making less than \$400,000 for the first three years of the tax.[6]

The payroll tax is imposed on the business and is not a tax on the employee.[7] Businesses are prohibited from deducting the tax from employees' compensation.[8]

How Is the Seattle Payroll Tax Computed?

The Seattle payroll tax is measured by "the payroll expense of the business" times a rate that varies based on the business's total Seattle payroll expenses and the compensation paid in Seattle to each employee whose annual compensation is \$150,000 or more:[9]

	Total Seattle payroll < \$100 million	Total Seattle payroll ? \$100 million and < \$1 billion	Total Seattle payroll > \$1 billion
Seattle employee compensation ? \$150,000 and < \$400,000	0.7%	0.7%	1.4%

Seattle employee compensation ? \$400,000	1.7%	1.9%	2.4%
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Who Is an "Employee"?

"Employee" is defined broadly as "any individual who performs work, labor, or personal services of any nature for compensation." [10] Thus, individual independent contractors that are hired to perform services are "employees" for purposes of the payroll tax. Temporary or contracted workers are employees of the business for which they are providing service even if the workers are employed by an employment agency. [11]

The definition of "employee" also specifically includes individuals who are partners in partnerships, members of limited liability companies, shareholders of S corporations, or other owners of pass-through entities. [12]

What Is "Compensation"?

The payroll tax is measured by "payroll expense." [13] "Payroll expense" is "compensation paid in Seattle to employees." [14] "Compensation" is broadly defined to include "remuneration," "net distributions," and "incentive payments" paid for "services rendered or work performed."

For traditional employees, compensation includes salary, hourly wages, commissions, bonuses, paid time off, separation/severance pay, equity compensation, and any other compensation paid for service. Although the definition is unclear, "compensation" probably excludes employer-provided retirement, disability, medical, dental, and similar employee benefits. [15]

For partners and other owners of pass-through entities, "compensation" generally includes distributions of net income. [16] Compensation does not include distributions in excess of the individual's share of the pass-through entity's net income. Likewise, the undistributed income of the pass-through entity is not compensation. Finally, distributions to a pass-through owner are not "compensation" if the distributions are "not earned for services rendered or worked performed." [17] For example, distributions of net income from an investment partnership would generally not be "compensation" to the partner.

What Payroll Expense or Compensation Is "Paid in Seattle"?

The greatest uncertainties in the payroll tax ordinance relate to the sourcing and apportionment of payroll expense. Compensation is "paid in Seattle" and, thus, part of the Seattle payroll tax base if:

1. The employee is primarily assigned within Seattle;
2. The employee is not primarily assigned to any place of business for the tax period and the employee performs 50% or more of their service for the tax period in Seattle; or
3. The employee is not primarily assigned to any place of business for the tax period, the employee does not perform 50% or more of their service in any city, and the employee resides in Seattle. [18]

This waterfall test for allocating compensation places great importance on whether an employee is "primarily assigned" to a place of business and, if so, where. If the employee is primarily assigned to a place of business, all

of the compensation paid to the employee is assigned to that location and there is no need to look at where the employee performed her services or the employee's residency.

The payroll tax ordinance defines "primarily assigned" as "the business location of the taxpayer where the employee performs their duties."^[19] Unfortunately, the definition is missing a quantitative component. Presumably, an employee is not "primarily assigned" to every business location where she performs her duties. We expect that "primary assigned" will be interpreted as the business location where an employee performs most of her duties or more of her duties than any other location. Because home offices are not typically a "business location of the taxpayer,"^[20] compensation paid to an employee that performs her duties at the taxpayer's business location in Seattle and at her home outside Seattle would likely be "primarily assigned" to Seattle even if most of the employee's service is outside Seattle.

Finally, the ordinance contains an "equitable" apportionment provision that allows the city to alter the general sourcing rules "[i]f payroll expense ... does not fairly represent the extent of the compensation paid by the taxpayer to its employees that is attributable to work performed or services rendered in Seattle." Thus, it may be possible for taxpayers to request (or be forced to accept) apportionment of payroll based on service days or hours if the normal all-or-nothing sourcing rules do not "fairly represent" the compensation "attributable to work performed or services rendered in Seattle."

When Is Seattle Payroll Tax Due?

The payroll tax is effective January 1, 2021.^[21] The payroll tax for 2021 will be due January 31, 2022.^[22] Payroll tax for subsequent periods will be paid on a quarterly basis by the end of the month following the close of each quarter. The tax sunsets December 31, 2040.^[23]

Additional Questions?

Please contact the authors with any additional questions.

Endnotes

[1] Council Bill No. 119810, § 13. Section 1 of the council bill creates a new chapter 5.38 of the Seattle Municipal Code. For convenience, all citations are to chapter 5.38 as it will be codified after it formally becomes an ordinance.

[2] SMC § 5.38.030(A).

[3] The exemption applies to any business having payroll expenses of less than \$7 million "in the most recent completed calendar year." SMC § 5.38.040(A)(1). Thus, a business with more than \$7 million in payroll during the current year would appear to be exempt if they had less than \$7 million in payroll during the prior calendar year. Conversely, a business that made more than \$7 million in the prior calendar year would generally be subject to tax even if their payroll for the current tax year is less than \$7 million.

[4] SMC § 5.38.030(B) and 5.38.040(A)(1).

[5] SMC § 5.38.040(A)(2) and (4).

[6] SMC § 5.38.045.

[7] SMC § 5.38.090.

[8] SMC § 5.38.030(C).

[9] SMC § 5.38.030(B).

[10] SMC § 5.38.020 (defining "employee").

[11] SMC § 5.38.050(D).

[12] SMC § 5.38.020 (defining "employee").

[13] SMC § 5.38.030(A).

[14] SMC § 5.38.020 (defining "payroll expense").

[15] See SMC § 5.28.20 (defining "renumeration" by reference to RCW 50A.05.010 (family and medical leave definitions)). Although the statutory definition of renumeration does not exclude employee-provided benefits, the Employment Security Department has interpreted the term to exclude payment made under various employee benefit plans. WAC 192-510-025.

[16] SMC § 5.38.020(defining "compensation" and "net distributions").

[17] SMC § 5.38.020 (defining "compensation").

[18] SMC § 5.38.020 (defining "payroll expense").

[19] SMC § 5.38.020 (defining "primarily assigned").

[20] See SMC § 5.30.040(D) (defining "office" and "place of business" as "a fixed location or permanent facility where the regular business of the [taxpayer] is conducted and which is either owned by the [taxpayer] or over which the [taxpayer] exercises legal dominion and control.").

[21] Council Bill No. 119810, § 13.

[22] SMC § 5.38.060.

[23] SMC § 5.38.120.

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