

Could You Have A Check In The Mail?

A Two-Part Series on Understanding How Washington State's Excise Tax Rules Impact Water & Sewer Utilities

By: Chris Gonzalez

Is your utility taking full advantage of the deductions and exemptions specified in the Revised Code of Washington (RCW) and the Washington Administrative Code (WAC)? A number of cities, towns, and special purpose districts have received refund checks from the Washington State Department of Revenue ranging in size from \$20,000 to over \$600,000.

Given the number of tax rules (and changes to those tax rules) applicable to water and sewer utilities in the State of Washington, it is relatively easy to miss out on potential deductions granted by the RCW and the WAC. This article explains those deductions and can help you determine if your utility might benefit from a refund audit.

Excise Tax

The RCW levies excise taxes on public service businesses engaging in enterprise activities (such as the provision of utility services) in Washington State. A portion of the funds generated from these taxes ends up in the Public Works Trust Fund (PWTF), which offers low-cost loans to utilities to fund capital improve-

ments. Because the excise tax rules have changed over the years, it is prudent for utilities to confirm that they are in compliance with current regulations and are taking full advantage of the deductions and exemptions specified in the RCW and the Washington Administrative Code (WAC).

RCW 82.16.020 imposes public utility taxes on revenues derived from the distribution of water and the collection of sewage, among other activities. The current rates applicable to water and sewer utilities are 5.029% (water distribution) and 3.852% (sewage collection). Per RCW 82.04.290, related business activities are taxed at the "Service & Other Activities" rate – this rate most recently changed in July 1998, dropping from 1.75% to 1.5%.

Water Utilities

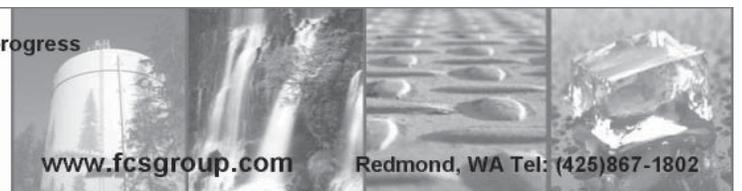
Generally speaking, amounts received for services incidental to the public utility activity (in this case water distribution) are subject to the 5.029% Water Distribution Tax. This includes rate revenue and many other charges imposed on existing customers (on/off fees, meter reading fees, etc.), but excludes late fees and other penalties for non-payment. However, Section 4 of WAC 458-20-179 states that these types of charges are subject to the Business & Occupation (B&O) Tax if the services are performed for new customers prior to receipt of regular utility service. Late fees and penalties for non-payment are also subject to the B&O Tax.

These taxes generally apply to "gross revenues," but the RCW and WAC provide a number of offsetting deductions and exemptions that can reduce your utility's tax liability. Examples provided by WAC 458-20-179 include:

- LID and ULID assessments, including related interest and penalties.
- Amounts generated directly from local taxes levied to support utilities. WAC 458-20-179 (9a) specifically excludes from this deduction service charges which are spread on property tax rolls and collected as taxes.
- Revenue from wholesale sales (sales for resale within this state) of water, electricity, and natural gas – note that this deduction only applies to the seller of the commodity.
- Amounts actually paid by a taxpayer to another entity taxable under Chapter 82.16 of the RCW for services jointly furnished by both – for example, utilities may deduct amounts that they pay to a regional facility or entity for wastewater treatment services. Note that this deduction only applies to the purchase of services and does not include the purchase of commodities (in other words, a utility making payments to another utility for wholesale water service cannot deduct those payments be-

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cause the water received is a commodity and not a service).

- Amounts derived from the distribution of water through an irrigation system, solely for irrigation purposes. The irrigation can be either agricultural or non-agricultural (such as landscaping) in nature.
- Amounts derived from the distribution of water by a nonprofit water association, which are used for capital improvements by that association.
- Cash discounts actually taken by customers, credit losses actually sustained by the taxpayer, and amounts received from insurance companies in payment of losses if included in the gross revenue reported.

Engrossed Substitute House Bill 1832 added a section to RCW 82.16 that allowed water utilities to deduct 75 percent of the expenditures that they incurred funding conservation programs and related efforts to improve consumers' efficiency of water use. The provisions of ESHB 1832 expired on June 30, 2003 – to date, no legislation has been passed to reinstate the deduction for conservation expenditures. This could represent a tax liability for your utility if it has continued to take this deduction beyond June 2003.

Sewer Utilities

The excise tax rules applicable to sewer utilities are quite similar to those established for water utilities, except that the 3.852% Sewer Collection Tax is the relevant public utility tax. Note that this tax only applies to revenues obtained for the collection of sewage – Section 2 of WAC 458-20-251 states that "collection" does not include the transfer, treatment, or disposal of sewage. Section 4 of WAC 458-20-251 classifies these activities as "related business activities" that are subject to the 1.5% B&O tax.

Consequently, sewer rate revenues should be split between collection and related business activities (transmission, treatment, and disposal). Because the sewer rates charged by a sewer utility are designed to recover the utility's operating expenses, it seems reasonable to assume that the revenue attributable to these other activities is approximately equal to the corresponding expenses and could be split proportionately based on those expenses. For example, treatment revenue should be roughly equal to the total treatment expense which, depending on the utility, could be either treatment plant operating costs or payments made to another agency for regional sewage treatment.

Of the "related business activities," treatment and effluent disposal revenues are generally the easiest to quantify, as the corresponding expenses (facility operations, payments to other agencies for jointly provided services) are directly measurable. Transmission expenses include both pumping expenses (which are directly measurable) and the share of pipe-related expenses allocatable to transmission mains – because the definition of a "transmission main" versus a "collection main" is debatable, transmission ex-

penses (and corresponding revenues) are generally harder to quantify.

There is no single obvious approach to determining the split between collection and transmission mains in a sewer system – consequently, a number of methods have been used to differentiate between collection and transmission mains. The guiding principle in establishing a definition of collection versus transmission is one of "substantive use" – does the pipe collect sewage from a local property (or set of properties), or does it transmit wastewater that has already been collected to treatment and disposal facilities? I will discuss the various approaches used to determine a split between collection and transmission in greater detail in a subsequent article.

Other Considerations

In addition to what has been mentioned above, there are several other common excise tax issues relevant to

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most water and sewer utilities:

- WAC 458-20-251 (2c) explicitly cites stormwater mitigation as a business activity related to a sewerage collection business, and indicates that stormwater utility charges are subject to the B&O tax. This also applies to cases in which a separate stormwater utility has been established, as it provides a service that is subject to taxation under RCW 82.04.290 as an enterprise activity that does not have a specific public utility tax imposed on it.
- WAC 458-20-179 (4) states that revenue derived from charges for services to new customers (prior to receipt of regular utility services) is subject to the B&O tax. This includes meter installation and connection charges (the latter of which has a variety of monikers such as general facilities charges and system development charges).
- WAC 458-20-189 (3a) indicates that municipal corporations are not subject to B&O tax on amounts derived from non-enterprise activities that are exclusively governmental, such as license, permit, and inspection fees.
- RCW 82.04.4291 provides a deduction for compensation received by a political subdivision from another political subdivision for services taxable under RCW 82.04.290 (the B&O Tax). A "political subdivision" would include any entity that qualifies as a "municipal corporation," but would also include special purpose districts, which are markedly absent from the definition of a "municipal corporation" provided in the RCW. Services subject to taxation under RCW 82.04.290 include sewer transmission and treatment, effluent disposal, or drainage. For example, a regional treatment provider (such as King County Metro or the LOTT Alliance) can deduct the payments that it receives from cities and districts for regional wastewater treatment services. Note that this deduction does not apply to revenue received from the State of Washington or its agencies and departments (WAC 458-20-251 (5)), nor does it apply to revenue received from federal governmental entities (WAC 458-20-190).
- Given all of the tax rules applicable to water and sewer utilities in the State of Washington, it is relatively easy to miss out on potential deductions granted by the RCW and the WAC – in particular, many utilities have not taken the advantage of the tax savings from splitting sewer utility revenues between collection and related business activities (transmission, treatment, and disposal). If your utility would like to claim a refund on any of the issues mentioned in this article, you may request a refund audit from the Department of Revenue. The ensuing audit will address most (if not all) of the issues mentioned here, considering both tax overpayments and tax liabilities (in case your utility has not paid taxes on stormwater or connection charge revenue, for example) in the final refund awarded.
- WAC 458-20-230 delineates the statute of limitations with regards to any potential refund audits. Generally speaking, an audit may consider tax overpayments made within four years after the close of the tax (calen-

dar) year in which the tax was incurred (for example, filing a refund request in 2008 will enable your utility to claim a refund on tax payments made from as far back as January 1, 2004).

This statute of limitations may be waived in writing - given that the audit process can take a long time for a number of reasons, it is prudent to waive the statute of limitations through a letter to the Department of Revenue.

A number of utilities have employed the services of a consultant for such audits – consultant services may range from preparing analytical materials in support of the refund request to working directly with a DOR auditor during the audit process. If your utility would like to use a consultant, you (or the consultant, with your authorization) will need to file a Confidential Tax Information Authorization Form with the Department of Revenue. This form can be found on the Department of Revenue's website (<http://dor.wa.gov>), and will allow the DOR auditor to share confidential information with the consultant.

An excise tax refund audit can benefit your utility in two ways – it can result in some extra cash for your utility, and it can provide a sound basis for future tax payments.

Chris Gonzalez is a senior analyst with FCS GROUP. He is skilled in utility rate studies, system development charges, specialized rate structures, and Washington State excise tax rules. He has a bachelor's degree in operations research and financial engineering and a certificate in engineering and management systems from Princeton University.

The second article in this series will follow in the January issue of Pipeline