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Policy Brief

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Seattle's Payroll Expense Tax is Highly Concentrated and Shaping Up to Be a Volatile Revenue Source

Briefly

The City of Seattle adopted the payroll expense tax (PET) in July 2020. The rate of the tax varies from 0.7%–2.4% depending on the total payroll expense of a business and the amount of an employee's compensation.

The PET is the city's fourth-largest tax source, behind property, business and occupation, and retail sales taxes. In 2021, the first year of collections, PET revenues totaled $295.4 million (about the same amount as the retail sales tax). PET revenues declined to $253.1 million in 2022, which is a 14.3% reduction from 2021 and 9.5% below what was assumed for 2022 in the city's current budget. The city's April 2023 revenue forecast estimates that PET revenues will be $263.3 million in 2023 and $279.7 million in 2024. Although revenues are expected to grow in 2023 and 2024, the current estimates for those years are lower than what was assumed in the adopted budget.

City data show that a small number of taxpayers with the highest payroll expense pay the vast majority of the tax. In 2021, the 48 taxpayers with $100 million or more in payroll expense (9.9% of all taxpayers) were responsible for $245.0 million in revenues (83.4% of all PET revenues). Further, according to the city's Office of Economic and Revenue Forecasts (OERF), "The largest 10 taxpayers account for 70% of total revenue, and essentially all the revenue decline in 2022 is accounted for by these top 10 taxpayers."

Additionally, the largest taxpayers are concentrated in a few economic sectors. Together, the information, trade, and professional and business services sectors account for 55% of taxpayers and 85% of taxes paid. The information sector accounts for the largest share of taxes paid (38.6% in 2021 and 38.3% in 2022).

With a deep revenue decline in 2022, the PET is shaping up to be a volatile tax source. This should concern the city, as revenue volatility compromises budget sustainability. The OERF notes, "Revenues are generated from relatively few firms and depend on their individual financial performance." As they go, so go the PET revenues. Consequently, it would behoove the city to foster a business climate that—despite the PET—encourages businesses to grow in the city.

The City of Seattle adopted the payroll expense tax—a new tax on businesses—in July 2020 (Ordinance 126108, codified as Chapter 5.38 of the municipal code).

Enactment of the payroll expense tax followed the demise of a proposed head tax (which was approved by the City Council in 2018 and then repealed a month later), and it came amid expected revenue losses due to the COVID-19 pandemic. From the beginning, the payroll expense tax was to be used in 2021 to help replenish the city's emergency funds (which had been used for pandemic-related purposes), to continue city programs that might be cut given revenue shortfalls, and to extend funding for programs that were funded in a July 2020 COVID relief appropriations bill. Then, beginning in 2022, the revenues would be used for administration of the tax and new spending on housing and services, economic revitalization, Equitable Development Initiative projects, and Green New Deal projects.

The payroll expense tax (PET), which is effective through 2040, is on top of the city's business and occupation tax (businesses pay property, sales, and other taxes as well). Seattle is the only jurisdiction in Washington with such a tax. (The tax is written in law as the "payroll expense tax," but it is often referred to colloquially as the "JumpStart tax.")

How the Payroll Expense Tax Works

"Payroll expense" is defined as compensation paid *in Seattle* to employees. To calculate the amount of compensation paid in Seattle, businesses may annually choose one of two methods, and they must use the same method for all their employees. (They must make their choice on the first return filed for the year, which is due at the end of April.) The first method is based on the fraction of overall work time each employee actually spends inside Seattle's city limits. The second method is based on where each employee is primarily assigned to work.

As shown in the table below, the rate of the tax varies depending on the total payroll expense of a business and the amount of an employee's compensation. (The thresholds are indexed to inflation. For simplicity's sake, this brief refers to the original threshold levels, but the updated levels are noted in the table's footnotes.) For example, a company with total payroll expense of $200 million pays a PET rate of 0.7% on the compensation to an employee who makes $300,000 and a PET rate of 1.9% on the compensation to an employee who makes $500,000. For those same employees, a company with total payroll expense of $1.2 billion pays PET rates of 1.4% and 2.4%, respectively.

Companies are not subject to the PET if they pay no single employee at least $150,000 or if they have total payroll expense of less than $7 million. Some types of businesses are also exempt from the tax:

- Grocery businesses,
- Independent contractors (if their compensation is included as payroll expense of another business), and

Table: Payroll Expense Tax Rates

		Tax Rate on Payroll Expense of Employees with Annual Compensation of:	
		$150,000 to $400,000[d]	$400,000[e] or More
Company Payroll Expense	$7 million to $100 Million[a] (Category 1)	0.7%	1.7%
	$100 Million to $1 Billion[b] (Category 2)	0.7%	1.9%
	$1 Billion or More[c] (Category 3)	1.4%	2.4%

Note: The thresholds are adjusted for inflation annually.

a = $7,386,494 to $105,521,399 in 2022; $8,135,746 to $116,224,938 in 2023

b = $105,521,399 to $1,055,213,392 in 2022; $116,224,938 to $1,162,249,382 in 2023

c = $1,055,213,392 or more in 2022; $1,162,249,382 or more in 2023

d = $158,282 to $422,085 in 2022; $174,337 to $464,900 in 2023

e = $422,085 or more for 2022; $464,900 or more for 2023

- Businesses that cities are not allowed to tax (certain insurance businesses, certain motor vehicle fuel businesses, certain liquor businesses, and government agencies).

Additionally, for calendar years 2021, 2022, and 2023, non-profit healthcare entities may deduct the payroll expense of employees who earn $150,000 up to $400,000.

The tax is due quarterly (i.e., on the last day of the month following the end of the quarter). However, the tax due for 2021 was payable entirely in January 2022. Thus, there was no indication during 2021 about how well collections would match forecasts.

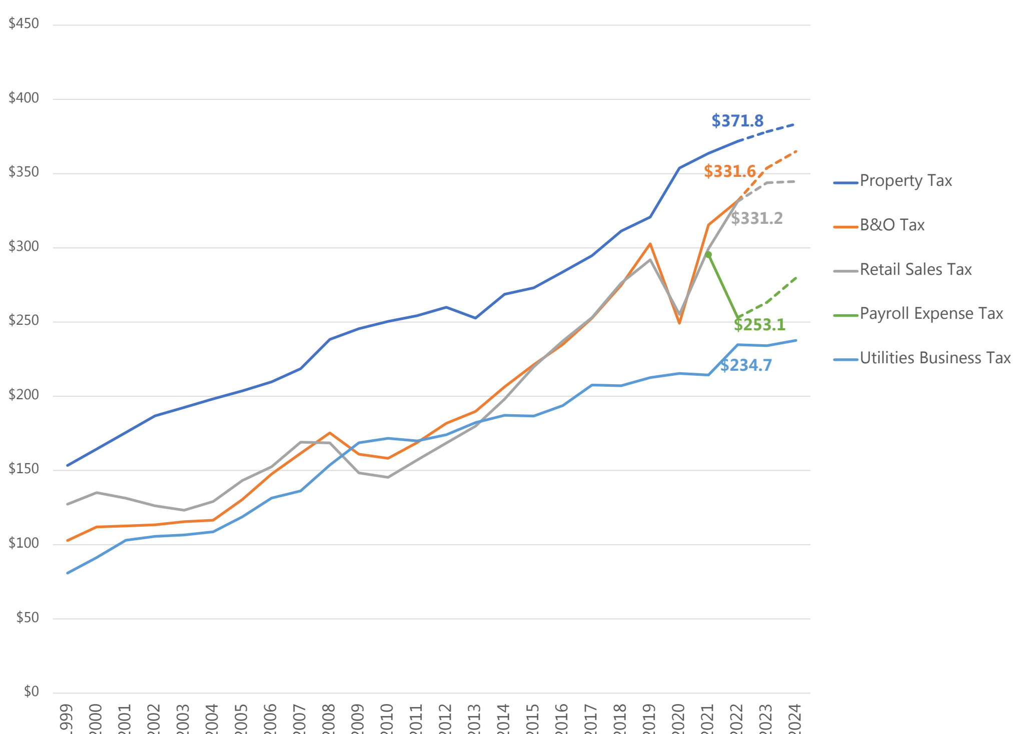
Originally, PET revenues were to be deposited in the city's general fund. In July 2021, the City Council created the "JumpStart Payroll Expense Tax Fund" (Ordinance 126393). As of Jan. 1, 2022, PET revenues go to this dedicated account instead of the general fund. (Revenues owed in 2021 must still be deposited in the general fund, regardless of when they are collected. Additionally, the city has approved transfers of some PET revenues to the general fund for 2022, 2023, and 2024.)

PET Revenues are Seattle's Fourth-Highest Tax Source

When the city's 2021 books were closed on March 1, 2022, PET revenue collections for 2021 totaled $248.2 million. However, revenues due on 2021 activity have continued to roll in, as businesses realize they are subject to the tax. Altogether (as of the April 2023 revenue forecast), 2021 PET collections total $295.4 million. (Of that, $47.1 million is booked in 2022 and was deposited in the general fund.)

The PET is the city's fourth-largest tax source, behind property, business and occupation, and retail sales taxes. Chart 1 (and the rest of this brief) uses the $295.4 million figure for 2021 to show the full magnitude of the tax in the year it was *owed* (rather than breaking it up to show when it was *collected*).

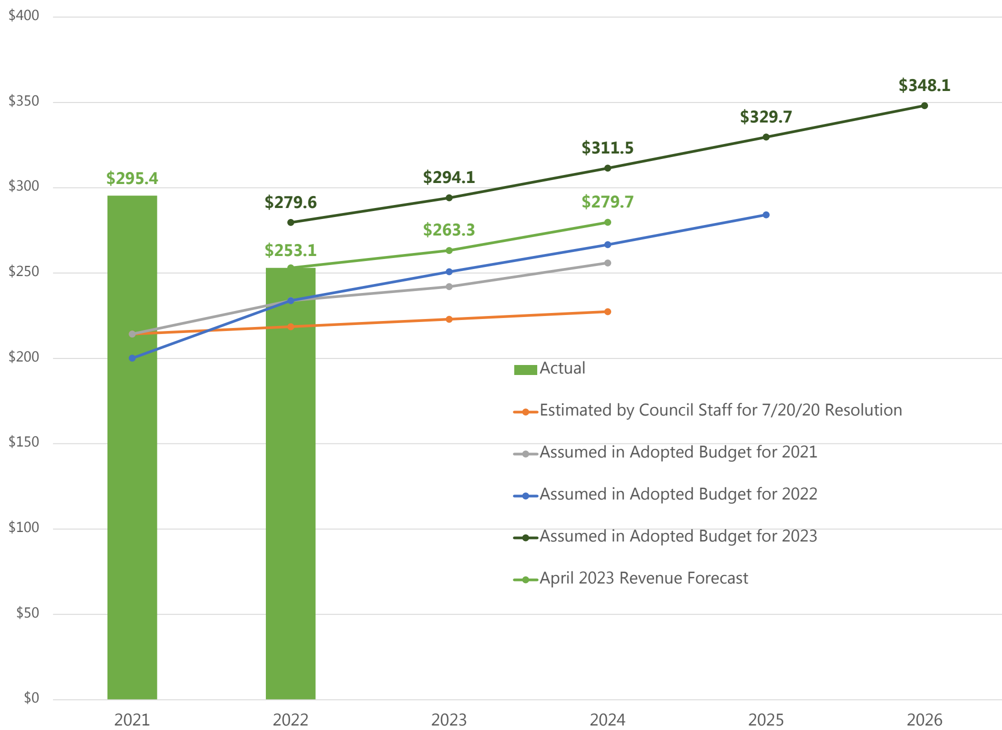
Chart 1: City of Seattle Tax Revenues (History and April 2023 Forecast, Dollars in Millions)



PET revenues in 2021 were almost equal to retail sales tax revenue for the city.

According to the city's April 2023 revenue forecast, PET revenues collected for 2022 total $253.1 million, a decline of 14.3% from 2021 (OERF 2023d). The 2022 collections figure is $26.6 million (9.5%) below what is assumed in the city's current budget. Note that the revenue amounts referenced in this report could go up or down as late collections come in and re-

Chart 2: Payroll Expense Tax Revenues (Dollars in Millions)



funds go out. However, as the City of Seattle's Office of Economic and Revenue Forecasts (OERF) notes in a March report, unlike last year, "There appear to be no significant payments outstanding at this point" (OERF 2023b).

The Current PET Forecast is Lower Than Budgeted

Chart 2 shows how the forecasts for PET revenues have changed over time. The numbers associated with the July 20, 2020 resolution refer to preliminary estimates made by Seattle City Council staff as the Council adopted a spending plan for the PET revenues. The initial estimate for 2021 revenues was $214 million. Council staff simply assumed a 2% annual inflation rate going forward, so they estimated that revenues would be $219 million in 2022.

New tax sources are especially difficult to forecast. As it turned out, the initial staff estimates and the forecasts assumed in the 2021 and 2022 budgets dramatically underestimated actual 2021 revenues. The November 2022 revenue forecast, which was assumed in the adopted 2023 budget, increased the PET revenue forecast accordingly. That turned out to be an overestimate given 2022 collections.

Now, the OERF's April 2023 revenue forecast estimates that PET revenues will be $263.3 million in 2023 and $279.7 million in 2024. Although revenues are expected to grow year-over-year (by 4.0% in 2023 and 6.3% in 2024), the current estimates for those years are lower than what was assumed in the adopted budget (by 10.5% in 2023 and 10.2% in 2024).

PET Revenues are Highly Concentrated on a Small Number of Firms and in the Information Sector

According to OERF data, there were 484 PET taxpayers in 2021 and 497 in 2022 (OERF 2023a, 2023c). In both years, the information, trade, and professional and business services sectors jointly accounted for 55% of taxpayers and 85% of taxes paid. Firms in the professional and business services sector made up the largest share of taxpayers (about 36% of the total). However, the sector responsible for the highest amount of revenues was information, which accounted for 38.6% of total revenues in 2021 and 38.3% of revenues in 2022. (The information sector accounted for just 9.7% of the number of taxpayers in 2021 and 8.5% in 2022.) (See Charts 3 and 4 on page 5.)

Chart 3: Number of Payroll Expense Taxpayers By Sector

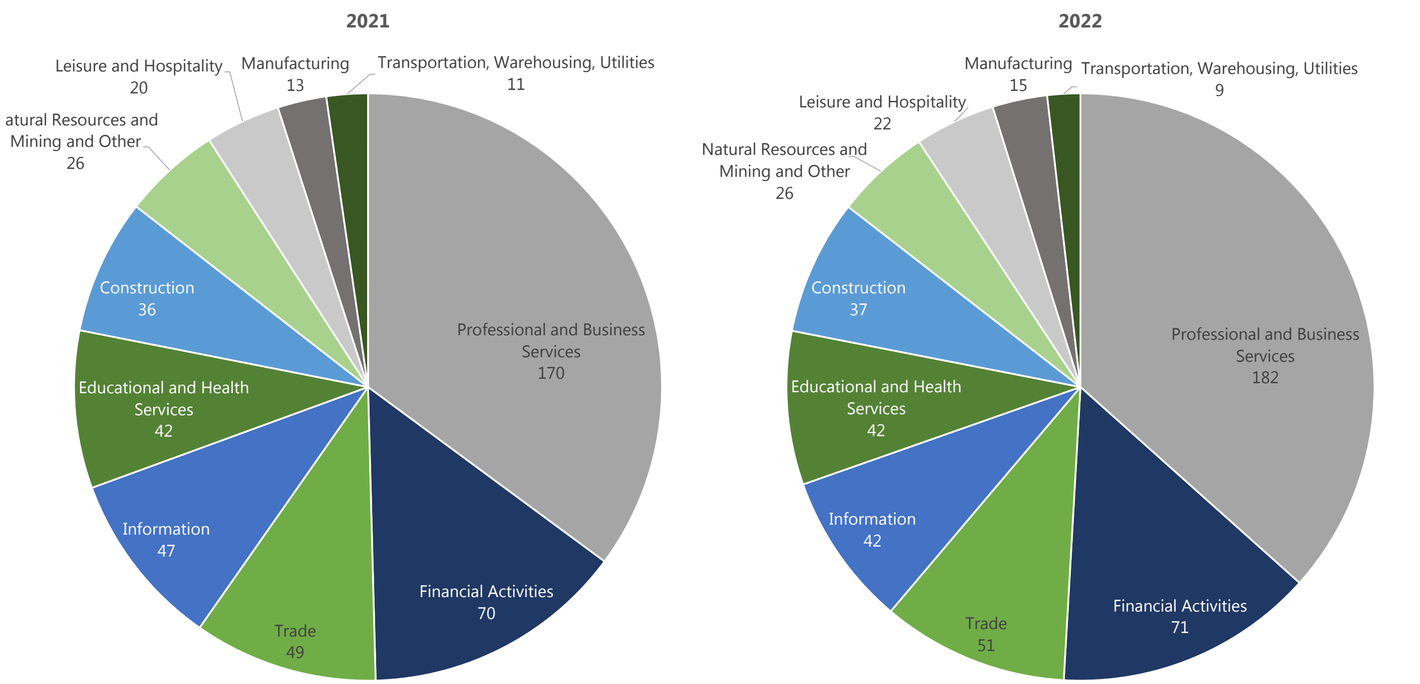


Chart 4: PET Paid By Sector (Dollars in Millions)

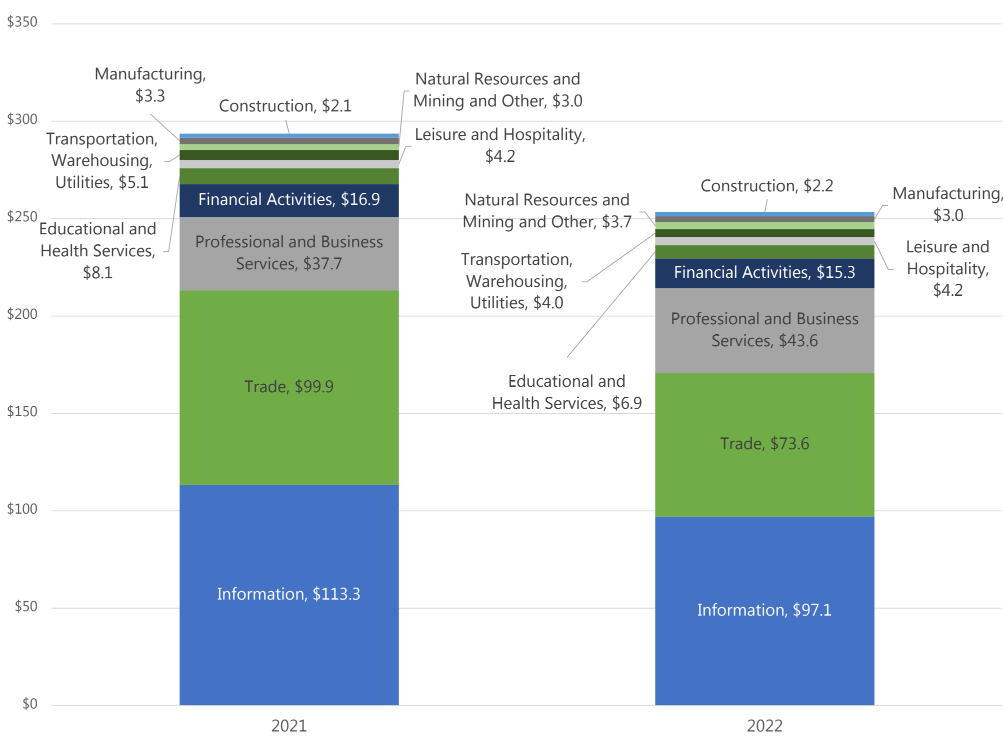
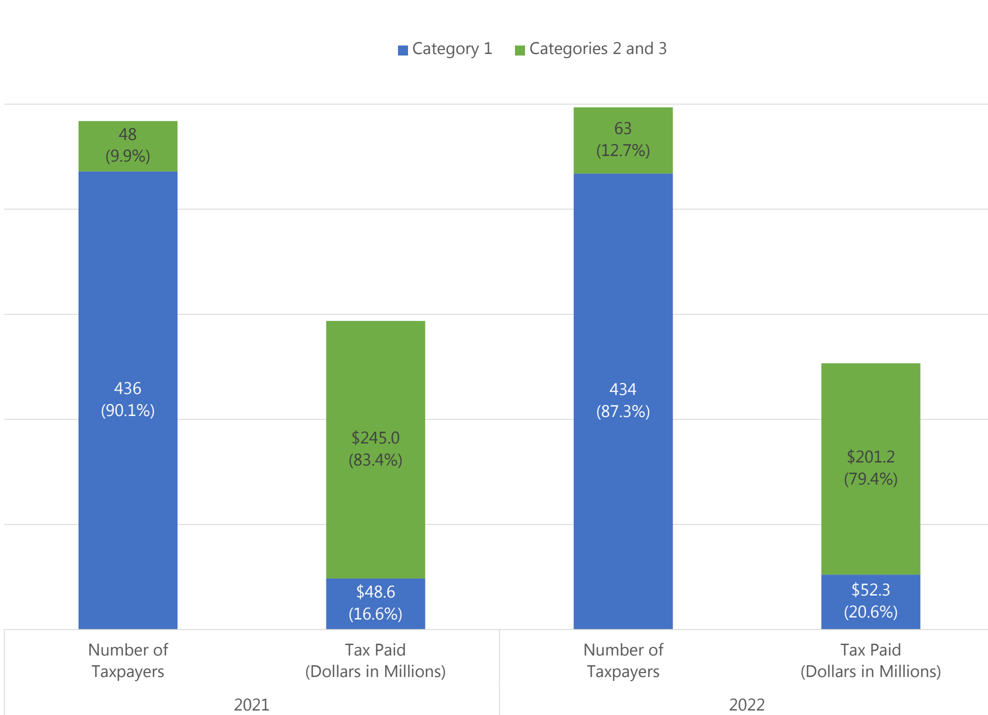


Chart 5: Taxpayers and PET Paid By Amount of Payroll Expense



Taxpayers with higher payroll expense pay higher PET rates. Data from the OERF shows that the taxpayers with the highest payroll expense pay the vast majority of the tax.

Most payroll expense taxpayers fall in Category 1—they have total payroll expense of $7 million to $100 million. (See the rate table on page 2 for the inflation-adjusted thresholds.) But Category 1 taxpayers pay a small portion of the tax. For example, in 2021, Category 1 taxpayers numbered 436 (90.1% of the total) and paid $48.6 million (16.6% of the total).

Conversely, there are few taxpayers in Category 2 (total payroll expense of $100 million to $1 billion) and Category 3 (total payroll expense of $1 billion or more), but they pay most of the tax. In 2021, the 48 taxpayers in Categories 2 and 3 (9.9% of all taxpayers) were responsible for $245.0 million in revenues (83.4% of all revenues) (OERF 2023c). (See Chart 5.)

Categories 2 and 3 were combined by the OERF before releasing the data. To protect taxpayer anonymity, the city does not report data unless a group has at least five members. Thus, there are fewer than five firms that pay the highest rates imposed on companies in Category 3. Earlier this year, the OERF specified, "The largest 10 taxpayers account for 70% of total revenue, and essentially all the revenue decline in 2022 is accounted for by these top 10 taxpayers" (OERF 2023b).

In April, the OERF noted, "The majority of revenues are generated from relatively few firms, concentrated in the technology sector. This sector has been significantly affected by the shift to hybrid work, and is also one where a significant share of compensation is tied to stock values" (OERF 2023d). Indeed, the OERF has found a correlation between PET payments and stock values and remote work practices (OERF 2023d).

Consequently, the OERF has suggested that PET revenues dropped in 2022 in part because technology sector stock performance was generally weaker in 2022 than in 2021 (OERF 2023b). Additionally, high 2021 taxes may have given firms more of an incentive to carefully track where employees worked in 2022. To the extent that employees worked from homes or offices outside of Seattle, that could limit an employer's tax liability. Note, too, that although companies are beginning to require more employees to work from the office this year, companies had to choose their reporting method for 2023 in April. Thus, collections in 2023 may still be impacted by uncertainty about remote work.

Comment

With a deep revenue decline in 2022, the PET is shaping up to be a volatile tax source. This should concern the city, as revenue volatility compromises budget sustainability. When revenues are less stable, a government must maintain higher levels of reserves to sustain programs during downturns. Otherwise, it will have to reduce spending or increase taxes.

Ultimately, as the OERF notes, "Revenues are generated from relatively few firms and depend on their individual financial performance" (OERF 2023b). As they go, so go the PET revenues. Consequently, it would behoove the city to foster a business climate that—despite the PET—encourages businesses to grow in the city.

References

Office of Economic and Revenue Forecasts (OERF). 2023a. Revenue data received Feb. 7 and Feb. 23.

——. 2023b. "2022 Year-End Revenue Report." March 9.

——. 2023c. Revenue data received March 23.

——. 2023d. "Economic and Revenue Update." April 10.