

Taxing That Spoonful of Sugar in Seattle

by Michelle DeLappe and Eric Siedentopf



Michelle DeLappe



Eric Siedentopf

Michelle DeLappe is a principal with Garvey Schubert Barer in Seattle. She can be reached at mdelappe@gsblaw.com. Eric Siedentopf is director of sales & excise tax at Costco Wholesale.

In this edition of Skookum Tax News, the authors focus on one of Seattle's newest taxes imposed on the distribution of sweetened beverages. DeLappe and Siedentopf discuss the tax, related compliance burdens and strategies, the city's goals with the tax, and ongoing research that will evaluate whether it ultimately achieves those goals.

The views expressed in this article are those of the authors only, are intended to be general in nature, and are not attributable to Garvey Schubert Barer or Costco Wholesale.

Copyright 2018 Michelle DeLappe and
Eric Siedentopf.
All rights reserved.

Sweetened beverage taxes (SBTs) are all the rage, and Seattle is one of the latest cities to join the trend. This article explains how the Emerald

City's SBT works and details practical considerations for those working to comply with the tax in cities serving as laboratories for SBT experiments.¹ It also looks at what Seattle hopes to achieve with the SBT and how it will measure its success.

How the New Tax Works

A tax on distributing "sweetened beverages" to Seattle retailers became effective January 1, 2018.² Seattle retailers that bring sweetened beverages from outside the city also must pay the tax.³ On March 31 Seattle started receiving its first revenue from this tax, which is remitted quarterly or annually with business taxes.⁴ This year the city expects \$14.8 million from the SBT.⁵

Any nonalcoholic beverage, syrup, or other concentrate used to prepare beverages with caloric sweeteners is subject to the tax. According to the new ordinance, that means "any substance or combination of substances that contains calories, is suitable for human consumption, and that humans perceive as sweet";⁶ the rule lists many offending sweeteners, ranging from agave to isomaltulose to turbinado sugar.

After vigorous debate, the City Council decided to exempt artificially sweetened diet drinks,⁷ not to mention beverages whose first

¹ See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (observing that in the federal system "a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country").

² City of Seattle Ordinance 125324, section 17.

³ Seattle Municipal Code (SMC) 5.53.020.

⁴ SMC 5.53.050.

⁵ City of Seattle, "Sweetened Beverage Tax 2018 Investments."

⁶ SMC 5.53.020.

⁷ *Id.* Seattle Tax Rule 5-953.IA.11.i.

ingredient is milk (including nondairy milk alternatives) — something of grave importance to the many Seattleites fueled by lattes.⁸ Also exempt are pure fruit or vegetable juices, sweetened medications, infant formula, and meal replacement drinks, among others.⁹

The tax applies to each beverage's volume at a rate of 1.75 cents per whole fluid ounce.¹⁰ For concentrates — including syrup, powder, frozen, or gel mixtures — this rate applies to the largest volume of resulting beverage prepared according to manufacturer instructions or industry practice.¹¹ To guide taxpayers trying to calculate the tax on “whole fluid ounces” when the package sold consists, for example, of a four-pack of 15.8-ounce bottles, the city's FAQ says: “What does it mean to calculate the tax on whole fluid ounces? Exactly that.”¹² Fortunately the FAQ provides more useful examples, however, that make clear that one 15.8-ounce bottle would be taxed as 15 whole ounces, but the four-pack would be taxed as 63 ounces (15.8 x 4 = 63.2).

Because of concerns raised by small manufacturers, distributors need not pay tax on products from manufacturers that have obtained certification from the city as having annual worldwide gross income of \$2 million or less.¹³ Manufacturers with sales higher than that but less than \$5 million can qualify for a reduced tax rate.¹⁴ And direct sales by manufacturers to consumers are exempt.¹⁵

Because the city has limited authority to create new taxes, it styles the SBT as “a privilege tax on every person engaging within the City in business as a distributor of sweetened beverages.”¹⁶ The ordinance specifically disavows its being “a sales tax or use tax or other excise tax on the sale, consumption, use,

or gross receipts of sweetened beverages.”¹⁷ Seattle has authority to impose privilege taxes as part of its power to issue business licenses.¹⁸ Unlike Washington's business and occupation tax and Seattle's business license tax, the city intends to tax each sweetened beverage (or the activity of distributing any particular sweetened beverage) only once, not in a pyramiding fashion.¹⁹

SBT Compliance in Seattle and Elsewhere

Complying with these new taxes poses challenges for distributors and retailers, such as ascertaining who is responsible for remitting the tax, identifying which products are subject to the tax in each city, and determining whether to state the tax separately from the product's cost and how to charge it.

Imposing the tax at the distributor level, upstream from retail sales, is attractive to the taxing authorities for numerous reasons. As a practical matter, it benefits the administering jurisdiction by limiting the number of taxpayers. This means fewer registrations to issue and track, fewer tax returns to process, and fewer audits to perform. Theoretically, compliance is easier because there are simply fewer accounts to manage. It can also be easier for the retailer because it is one tax return fewer to file. Though embedding the tax as a component of product cost introduces pricing variability across jurisdictions, that challenge exists for other reasons that sellers must deal with anyway. A seller's tax function requires fewer resources when compliance for a given tax is accomplished entirely by its vendors.

But imposing tax early in the stream of commerce can create uncertainty for both taxing authorities and sellers regarding the taxed status of product held by anyone other than the prototypical taxpayer. Some lawmakers attempt to mitigate this issue by requiring presentation of tax separate from goods being sold for every transaction up to and including the retail sale.

⁸ SMC 5.53.020.

⁹ *Id.*

¹⁰ SMC 5.53.030.

¹¹ SMC 5.53.030.A.

¹² “Frequently Asked Questions (FAQs) for the Sweetened Beverage Tax – City of Seattle.”

¹³ SMC 5.53.050.A.

¹⁴ SMC 5.53.030.B.1.

¹⁵ SMC 5.53.050.B.

¹⁶ SMC 5.53.030.A.

¹⁷ SMC 5.53.060.

¹⁸ RCW 35.22.280(32).

¹⁹ Seattle Tax Rule 5-953.II.A. (“The tax shall be imposed only once with respect to distribution of any individual item of sweetened beverage, and is not a tax on a retail sale to a consumer.”).

And yet, this places a burden on sellers whose systems may not be capable of handling a segregated tax value.

Beverage taxes, including those recently imposed by Seattle and San Francisco, often need not be separately stated on sales documents. Rather, lawmakers' intent is to make SBTs a component of the product's cost. Subject items are simply more expensive than they were before imposition of the tax. That is good news for sellers' IT departments, which may otherwise have to create new capabilities in their purchasing and selling systems. But that effort may simply shift to the sellers' tax department, which will need to identify the SBT due.

A seller physically located within a beverage tax jurisdiction must evaluate which of its suppliers will be remitting the tax. Any gap in tax-paid product naturally places the in-city seller in the position of taxpayer. Since there is no legal requirement to segregate the tax on all transactions, reviewing invoices won't provide a definitive answer on whether SBT has been assessed by the vendor. A seller could try to resolve this quandary by creating its own attestation document that asks vendors to affirmatively declare whether SBT has been remitted on subject items for all deliveries made within the taxing jurisdiction. Since products and vendors change over time, a seller relying on vendor attestations may be best served by introducing the step into new vendor or item setup processes. If that's not feasible, periodically conducting new reviews may be the next best option. The effectiveness of attestation documents to mitigate subsequent liability is unknown with those new taxes. Even so, the exercise offers the seller a tool from which tax compliance decisions can be made.

Determining which products are subject to SBT presents another challenge for several reasons. First, each city has its own definition of what is taxable. Second, there is no easy way to reliably capture product attributes needed to determine taxability under each definition. Manufacturers are very familiar with the ingredients and volume of their products, but distributors, wholesalers, and retailers may have no reason normally to distinguish beverages based on ingredients or to track the volume of

each container or case sold. The seller's principal concern is the demand for each product and its contribution to margin. There isn't any way to automatically determine the ingredient data, either: Inventory systems typically do not process ingredient data from vendors or manufacturers; nor do they have a place to add the information manually. Though existing classification data (for example, merchandise department, EBT eligibility flag, merchandise category, sales tax category) can be used to narrow the number of potentially taxable products, a human being will at some point need to look at product labels and record information in a standalone spreadsheet or database.

Then there is the question of how to add the tax to the item within the seller's existing system. The basic choices are to incorporate the SBT into the item's cost or to state it separately from the selling price posted on the shelf or sales receipt. The seller's system capabilities may influence this decision: If the system lacks a way to link a fixed value to a merchandise item (akin to coupons but with positive dollar values), then burying the tax in the cost and sales price may be necessary.

Segregating tax on sales documents has several advantages. First, it facilitates tax exemptions that may be permitted by allowing the seller to easily remove the tax from the item price. This is also desirable for sellers selling both into and outside the jurisdiction. For example, some online retailers are imposing SBTs as a separate surcharge when shipping taxable beverages to consumers in taxing jurisdictions. Second, separate statement of the tax helps the seller ensure it has properly charged for the SBT. The SBT's effective rate is generally 45-65 percent of the selling price for volume sales. This high rate can easily exceed the seller's margin by a factor of many, so the seller must be careful to include the tax.

Third, segregating the tax can allow the seller to direct tax amounts to a specific general ledger account. This is particularly useful if the seller is wholly responsible for remitting the SBT and does not pay any tax to its suppliers. Accumulating SBT in a liability account like sales tax can serve as the primary source of reportable sales. This benefit largely disappears, however, if

any SBT is paid to suppliers. In that case, something less than 100 percent of the SBT collected on sales will be remitted to the government since some amount collected represents reimbursement for tax-paid product. Carrying a mixture of tax-paid and tax-due products therefore requires a compliance solution reliant on item-level information. Lastly, segregation provides consumers transparency, showing what products bear the SBT and to what extent — allowing them to make fully informed decisions.

Determining where the tax applies for those who ship into a beverage tax city can also be difficult. This requires evaluating every ship-to address in relation to city boundaries. As with sales tax calculation, ZIP codes alone do not provide the precision necessary for accurate results. For example, several ZIP codes cover addresses both within and outside Seattle city limits. The U.S. Postal Service creates and modifies ZIP codes to serve its mail delivery needs, not to support tax boundary determination. If the seller already uses a third-party engine for sales tax calculation, that same software may provide assistance with determining sales situs or even maintaining content relevant to SBT.

To further complicate things, Seattle's SBT has an exemption based on subsequent shipment outside Seattle. This exemption does not operate like a traditional sales tax exemption, however, and it must be managed differently. It is not based solely on the purchaser's intent to resell the product; a Washington reseller's permit or other documentation supporting a sales tax exemption has no bearing on the SBT exemption. Rather, the purchaser completes an exemption certificate specific only to Seattle's SBT. The city must validate the certificate before it becomes effective. Effectively, the city makes the exemption decision for each unique combination of seller and buyer. So those making sales to redistributors must develop some method of identifying their customers' exempt status where it exists, and must do so apart from similar sales tax data and exemption decision processes. Sellers must maintain redistribution certificates in their records, and they may not fit into a seller's existing exemption documentation

system. Expensive manual procedures may be the only available solution pending considerable software development.

Self-serve soda fountains present a particularly difficult dilemma. Self-serve machines operated by customers offer various beverage choices side by side for an identical price. Customers freely select the beverage after making the purchase and may even mix beverages. But the SBT may not apply to all the beverage choices. Seattle's SBT, for example, excludes artificially sweetened diet beverages. Retailers have several options:

- charge a higher price for customers based on what type of beverage they indicate they will select;
- spread the SBT across all the dispensed products resulting in a higher but still identical price for all beverage choices; or
- leave prices unchanged and absorb the SBT in the retailer's margin.

Each option comes at a cost. For example, pricing the tax-inclusive and tax-exclusive beverages in accordance with their costs would require the retailer to redevelop its menus, reprogram its cash registers, etc. This also implies sufficient autonomy to make significant pricing changes, which retailers, such as franchisees, may lack. Having employees operate the self-serve machines would not solve the problem, either; it would be an expensive infrastructure change, increase the labor cost for each transaction, and effectively eliminate the option of using some of the newer fountain machines specifically designed to be operated by consumers (such as those offering 100 or more flavors that can be combined in any way the consumer chooses).

Educating customers about the SBT is also important. Customers who are also sellers likely already know about the tax and may not require any education from their vendors beyond knowing whether the tax has been paid. Retail consumers' knowledge is less likely to be so complete. When retail consumers pose tax questions to sales staff, how should staff react? Everyone benefits when the tax information provided to consumers is consistent and accurate. That may be most easily accomplished by drafting answers to frequently asked

questions and distributing them through all customer service channels.

Sweetened Beverage Tax Goals

Like most cities (and countries) that have adopted an SBT, Seattle aims to reduce consumption of sugary drinks and related health problems. The targeted health problems, such as childhood obesity and its health effects, are serious and increasingly prevalent, particularly among African-American and Hispanic children.²⁰ Of 13 reasons listed in Seattle's ordinance for the new tax, nearly all emphasize access to healthy foods and nutritional problems such as diabetes, obesity, and tooth decay, particularly as they affect "low income communities and communities of color."²¹

At the same time, SBT critics have noted the tax's regressive nature, which is exacerbated by Seattle's exemption of diet soda and lattes — the types of drinks favored among higher-income populations.²² Another important aspect of the debate has been concerns about the tax's impact on Seattle businesses and restaurants and the jobs they provide in the city.²³

Seattle has earmarked SBT revenue for various purposes, many of which are tied to the city's race and social justice initiatives: it will "fund services that will promote healthy food choices, expand access to healthy and affordable food, reduce disparities in social, developmental, and education readiness and learning for children, assist high school graduates to enter college, and expand services for the birth-to-five population and their families."²⁴ There has been some concern

expressed about the proportion slated for administrative costs: Of the \$14.8 million in tax expected in 2018, the city anticipates spending nearly \$1.5 million on administrative costs regarding the tax;²⁵ and out of \$2 million slated for a program that provides fresh produce vouchers to low-income households, \$1.6 million is for administrative costs.²⁶

Determining Whether the Goals Have Been Met

Seattle has committed to spending \$500,000 annually on academic research into the tax's effects on behavior, health, and economic outcomes for at least five years.²⁷ The research must include assessing its effects on "economic outcomes (such as household food expenditures, beverage prices and sales, jobs, and store revenue) and health behaviors and outcomes."²⁸ For at least four years, a University of Washington obesity epidemiologist and a public health official will lead a multidisciplinary team in conducting the study.²⁹ The research will include a survey of 800 adults (approximately half low income) and 600 children (mostly low income) about their attitudes about sugary drinks to assess whether they change over the course of the study.³⁰ Researchers will also analyze jobs, revenue, and store sales data to determine whether the tax results in revenue loss, whether consumers begin to buy beverages outside Seattle, and whether retailers pass the tax through to consumers (or spread the price increase to other products).³¹ The study will also assess stakeholder perceptions about the tax's implementation with about 10 interviews of tax administrators, city officials, food distributors, and food retailers.³²

²⁰ See, e.g., Asheley Cockrell Skinner et al., "Prevalence of Obesity and Severe Obesity in US Children, 1999-2016," 141, 3 *Pediatrics* (Mar. 2018).

²¹ City of Seattle Ordinance 125324 introductory recitals.

²² See, e.g., Zosha Millman, "Seattle City Council Votes on Sugary Beverage Tax," *Seattle P-I* (June 5, 2017) ("public health officials and community advocates . . . pointed out that diet sodas and other drinks that use non-caloric sweeteners are favored by richer and whiter demographics, meaning that, statistically speaking, the tax would end up hitting people of color and low-income communities harder").

²³ See, e.g., Lisa Jennings, "Seattle Approves Tax on Sweetened Beverages; Business Groups and Restaurant Operators Voice Opposition," *Nation's Restaurant News* (June 7, 2017).

²⁴ City of Seattle Ordinance 125324 introductory recitals. See also City of Seattle Race and Social Justice Initiatives.

²⁵ *Supra* note 5.

²⁶ Daniel Beekman, "Prices Going Up for Sugary Drinks as Seattle Tax Kicks In," *The Seattle Times*, Dec. 31, 2017.

²⁷ City of Seattle Ordinance 125324, section 5.B.

²⁸ *Id.*

²⁹ University of Washington Nutritional Sciences Program Announcements, "Jesse Jones-Smith Co-Leads Study of Soda-Tax Impact on Seattle Health, Economics" (Dec. 27, 2017).

³⁰ "Evaluation of Seattle's Sweetened Beverage Tax," presentation to Sweetened Beverage Tax Community Advisory Board (Oct. 13, 2017).

³¹ *Id.*

³² *Id.*

Conclusion

SBTs are one of the newest sin taxes designed to increase the cost of a behavior that is deemed undesirable. Though this general category of tax has a long history, whether it is effective in reducing the targeted behavior is not entirely clear. To the extent they are effective, the programs that rely on them will face decreased funding over time. There is an incongruity, for example, for those who believe the SBT will change behavior and who at the same time want stable funding for Seattle's race and justice initiatives. If the tax succeeds in reducing consumption of sugary beverages, the city will need to find other revenue sources for those programs. But no matter what side of the sin tax debate one is on, one thing is clear: as shown in this article, compliance with those new taxes is complex — far more so than lawmakers likely realize. ■

taxanalysts®

Education | Debate | Fairness | Transparency



We're on a mission.

Shining a light on unfair tax policies and pushing for a level playing field, we work every day to strengthen open government and fairness in tax systems.

We publish world-class news and analysis, host and provide speakers for conferences on topics that matter, provide material for free on taxanalysts.org, and pursue the release of important public information through the Freedom of Information Act.

taxanalysts.org

501(c)(3) Non-Profit Organization

Publisher of Tax Notes