



CITY OF KIRKLAND
Department of Finance & Administration
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MEMORANDUM

To: David Ramsay, City Manager

From: Tracey Dunlap, Director of Finance and Administration
Robin Jenkinson, City Attorney
Erin Leonhart, Intergovernmental Relations Manager

Date: February 4, 2010

Subject: Annexation State Sales Tax Credit

RECOMMENDATION:

City Council approve the resolution and ordinance implementing the annexation state sales tax credit effective July 1, 2010.

BACKGROUND DISCUSSION:

An important part of the implementation strategy for annexation is the use of the annexation state sales tax credit to assist the City in providing municipal services in the area where the revenues are not yet sufficient to fund those services. To be eligible for the credit this year, the Department of Revenue (DOR) must be notified not later than March 1, 2010. This necessitates adoption of the credit at the February 16 City Council meeting. This memorandum provides a summary of the relevant legislation and an overview of our current discussions regarding the City's eligibility to receive the credit in 2010.

Summary of Legislation

In 2006 the legislature enacted the annexation sales tax credit. The following excerpt from the bill report of a 2009 bill that amended the original legislation provides a useful recap of the key provisions of the 2006 legislation:

*"**Background:** In 2006 legislation was enacted allowing a city to impose a sales and use tax to provide, maintain, and operate municipal services within a newly annexed area. The tax is a credit against the state sales tax, so it is not an additional tax to a consumer. The tax is for cities that annex an area where the newly received revenues received from the annexed area do not offset the costs of providing services to the area.*

There are several requirements that have to be met before a city may impose the tax. The city must:

- *Have a population less than 400,000;*
- *Be located in a county with a population greater than 600,000;*

- *Annex an area consistent with its comprehensive plan;*
- *Commence annexation of an area having a population of at least 10,000 prior to January 1, 2010; and*
- *Adopt a resolution or ordinance stating that the projected cost to provide municipal services to the annexation area exceeds the projected general revenue the city would otherwise receive from the annexed area on an annual basis.*

The tax rate is 0.1 percent for each annexation area with a population between 10,000 and 20,000 and 0.2 percent for an annexation area over 20,000. The maximum cumulative tax rate a city can impose is 0.2 percent. The tax must be imposed at the beginning of a fiscal year and must continue for no more than ten years from the date it is first imposed. All revenue from the tax must be used to provide, maintain, and operate municipal services for the annexation area. The revenues may not exceed the difference of the amount the city deems necessary to provide services for the annexation area and the general revenue received from the annexation. If the revenues do exceed the amount needed to provide the services, the tax must be suspended for the remainder of the fiscal year. Prior to March 1 of each year, the city must notify the Department of Revenue of the maximum amount of distributions it is allowed to receive for the upcoming fiscal year."

During the 2009 Legislative Session, Senate Bill 5321 amended the original State Sales Tax Legislation. There were several changes related to populations of cities eligible for the credit, the rates of the credit cities could collect and an extension of the credit to 2015. Since Kirkland "commenced" annexation by the original deadline of January 1, 2010, the extension to 2015 is immaterial as are changes related to populations of areas annexed. The primary portion of SB 5321 that does impact Kirkland is Section 2, which addresses the ability to grandfather casinos licensed by the State Gambling Commission as of July 26, 2009.

Sales Tax Credit Mechanics

The ten-year state sales tax credit is an integral part of the annexation financial plan. The State has not issued formal guidance as to how the state sales tax credit will be administered and what specific documentation will be required to demonstrate shortfalls, however, meetings have been initiated with the State Auditor's Office to discuss the issue. At this stage, we are monitoring the experiences of Auburn and Renton, which had annexations that qualify for the credit and will be subject to audit of the sales tax credit for 2008. Auburn's experience to date has provided two insights: (1) that detailed record-keeping will be necessary to demonstrate qualifying costs, and (2) that timing is critical to maximize the credit. We will continue to stay in contact with both jurisdictions, and others considering this option, to track their "lessons learned."

The state sales tax credit will help bridge the gap between revenues and expenditures in the annexation area. It is important to note that the credit is only available up to the amount needed to offset shortfalls due to annexation. RCW 82.14.415 requires the City to provide DOR with an estimate of the revenues, expenditures, and anticipated shortfall (labeled, "new threshold amount") in the annexation area for the next fiscal year. The estimates are based on the State's fiscal year which is July 1 through June 30. The City must also provide notice of any applicable tax rate changes by March 1 of each year. DOR will then begin the monthly distributions on July 1 and continue until the threshold amount has been reached or end on June 30 of the following year. The distribution is also set up to match the State's fiscal year of July through June.

DOR has indicated that because the annexation is not effective until June 1, 2011, the City is not eligible for the credit until July 1, 2011. As a result, the City would not receive the first distribution until September 30, 2011. This is based on DOR's interpretation of the language in the statute that provides that the tax may only be imposed by a city "that annexes an area." The City's position is that Ordinance 4229 accepting the annexation and setting the effective date meets the intent of "annexing an area," as no further legislative action is required for the annexation to take place.

Other factors supporting our position include:

- The City has been and will continue making expenditures necessary to serve the annexation area well in advance of the effective date of the annexation. For example, the City has begun to hire and train police officers to ensure that sufficient staffing is in place on June 1, 2011. Both DOR and the State Auditor's Office have indicated that the City can begin accumulating costs toward the credit in advance of the effective date. It stands to reason that the sales tax credit can be implemented to help fund those costs.
- The effective date of the annexation, June 1, 2011, falls within the State's fiscal year that begins July 1, 2010.
- Beginning the credit in 2010 does not obligate the State to pay more; it starts the ten-year period sooner. In fact, it results in less outlay by the State overall because:
 - Kirkland will begin drawing on the funding during an historical low point in sales tax revenue; and
 - The first year's draw will be based upon the current City sales tax receipts (without the annexation area).

If the credit is not effective until mid-2011, the City will have incurred several million dollars in transition costs for which no revenue is received from the annexation area or the state sales tax credit. Attachment A provides a graphic representation of the sales tax mechanics under both interpretations.

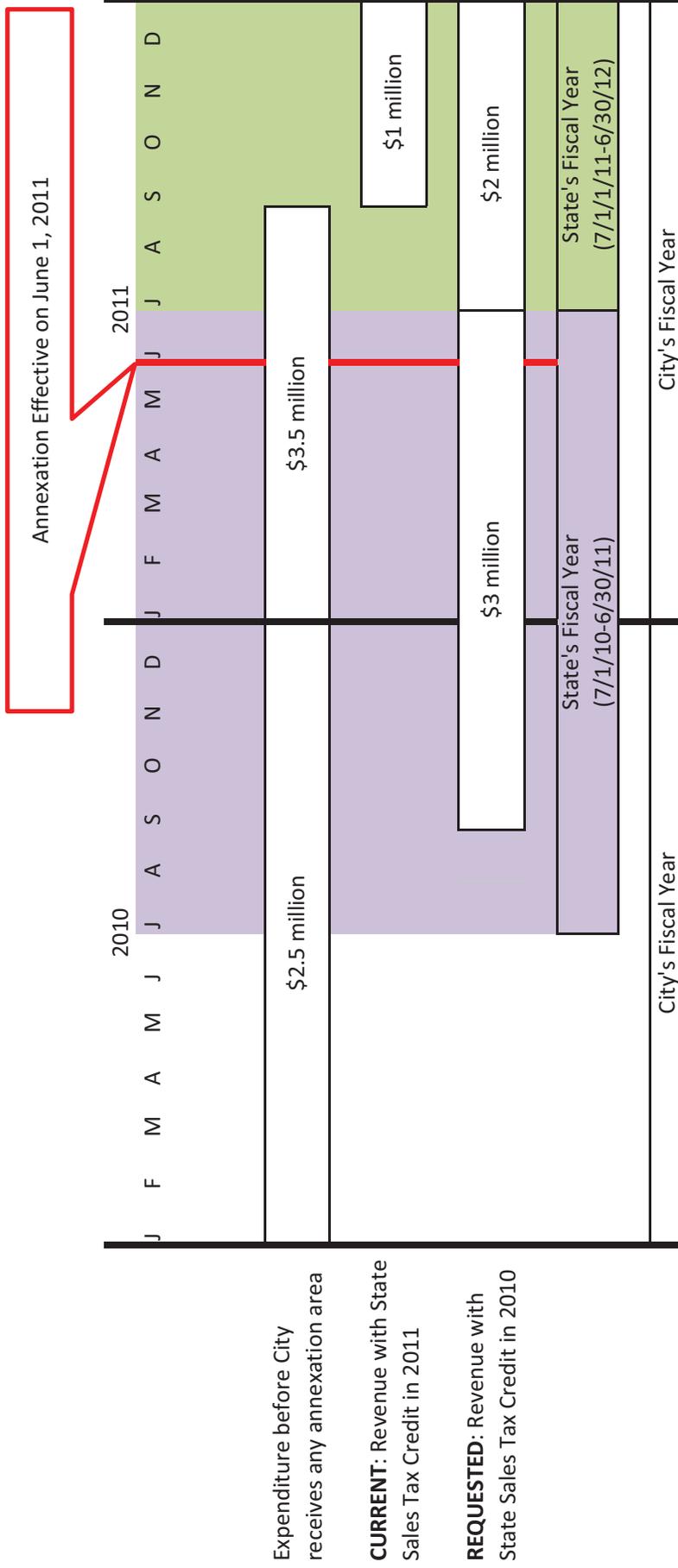
Earlier projections of the available state sales tax credit estimated that an average of \$4.4 million per year would be available over ten years (with the amount lower than the average in the early years, growing as retail sales increased). That average amount has declined since those projections due to the decline in sales tax of almost 20% to about \$3.5 million. If the first year of the credit begins in 2011, the estimated state sales tax credit available would be about \$3.2 million based on estimated sales tax in the existing City and the annexation area. By taking the credit one year early (starting in 2010), the credit will only apply to the existing City sales tax, so the City will forego the credit on the annexation area, which is approximately \$225,000. However, as the graphic in Attachment A illustrates, taking the credit in 2010 offers a significant cash flow benefit and provides the City with a means to fund incremental annexation staffing during the transition.

Current Status

On January 25, as a follow up to conversations with Representative Larry Springer, the City Council sent a letter to our local legislators requesting that they pursue a clarification of legislative intent during the current legislative session to confirm that funding can be accessed prior to the effective date of annexation. Attachment B contains a copy of the letter, which further articulates the City's rationale. As of the date of this memo, it appears that our

legislators will assist us in pursuing clarification of our eligibility with DOR. Due to the notification deadlines, staff recommends that Council pass the attached resolution and ordinance to ensure that Kirkland can begin drawing on the state sales tax credit in 2010.

City of Kirkland Pre-Annexation Expenditures versus State Sales Tax Credit Receipts



Notes:

1. Only currently known expenditures shown -- does not include accumulated prior costs
2. Annexation effective date is in State's current fiscal year (2011-2012)

January 25, 2010

Sent via email to:
Washington State Representatives & Senators



RE: ANNEXATION SALES TAX CREDIT

Dear...:

After many years of study, the City of Kirkland is proceeding with annexation of the three neighborhoods to our north. The Kirkland City Council adopted an ordinance annexing the area on December 15, 2009 with an effective date of June 1, 2011. Kirkland's current population of 49,010 will increase to approximately 81,000 and the land area will increase from seven square miles to over eleven square miles. This annexation represents a major increase in population and land area and will require a significant investment of resources. It is toward that end that we are seeking your support.

The City of Kirkland seeks legislative clarification that the City can impose the annexation sales tax credit provided for in RCW 82.14.415 on the City's revenues beginning in 2010 to pay for costs incurred preparing for the effective date, using the logic that the City "annexed" when the City Council approved Ordinance 4229, formally accepting the annexation area to the City of Kirkland and setting an effective date.

The City's goal is to plan for as smooth a transition as possible to providing services in the annexation area. Financial constraints preclude hiring and training all of the needed staff before the effective date of annexation, when revenues from the area begin to accrue to the City. Some services will be phased in as resources become available to the City. However, we recognize that public safety services are essential, the City will be hiring staff in advance in order to be prepared to provide police service on the effective date of annexation. Because of the substantial lead time for training of new officers, we will be hiring police officers well before the effective date of annexation and, more importantly, before revenues from the annexation area begin to accrue to offset those costs.

The pre-annexation cost of the staffing transition for selected, general fund department staff is projected to be \$6 million. This does not include the pre-annexation cost of staff in many support departments, nor does it include street maintenance and surface water staffing. In addition, the City will incur the start-up costs of equipping new staff with computers, police vehicles, and other equipment.

Given the significant start-up costs of annexation, we are requesting that the State partner with Kirkland on the immediate pre-annexation transition costs attributable to public safety and related staffing.

The State of Washington is a critical partner in the annexation effort and the State's 10-year annexation financial assistance will help with essential transition funding as we move forward with annexation. The sooner we can access those funds, the better our financial position will be on the effective date (see attached graphic illustration). If allowed this flexibility, over the 10 year period of the credit, the total amount for which Kirkland would be eligible will be a lesser burden to the State because Kirkland would begin drawing on the funding during an historical low point in sales tax revenue and the first year's draw will be based upon current City of Kirkland (without annexation area) sales tax revenues. Thank you for your consideration.

Sincerely,
KIRKLAND CITY COUNCIL

By Joan McBride, Mayor

Attachment

ORDINANCE NO. 4237

AN ORDINANCE OF THE CITY OF KIRKLAND RELATING TO ADOPTING A NEW CHAPTER 5.07 OF THE KIRKLAND MUNICIPAL CODE IMPOSING A SALES AND USE TAX AS AUTHORIZED BY RCW 82.14.415 AS A CREDIT AGAINST THE STATE TAX RELATING TO ANNEXATIONS.

WHEREAS, on April 7, 2009, the City Council of the City of Kirkland passed Resolution R-4751 which directed the City Clerk to file a notice of intent to annex the Finn Hill, Kingsgate and North Juanita Annexation Area with the King County Boundary Review Board; and

WHEREAS, the Boundary Review Board held a public hearing on the proposed annexation on June 8, 2009, and approved the annexation on July 9, 2009; and

WHEREAS, the City Council passed Resolution R-4763 calling for an election which was held pursuant to State statute on November 3, 2009; and

WHEREAS, the King County Council transmitted a certified abstract of the vote in the November 3, 2009, general election; and

WHEREAS, the annexation of the Finn Hill, Kingsgate and North Juanita Annexation Area was approved by the voters residing in the area; and

WHEREAS, the City Council passed Ordinance No. 4229 on December 15, 2009, annexing the Finn Hill, Kingsgate and North Juanita Annexation Area, an area that has a population of at least ten thousand people; and

WHEREAS, the City Council finds and determines that the projected cost of at least \$5 million to provide municipal services to the annexation area exceeds the projected general revenue estimated to be zero that the City would otherwise receive from the annexation area for the July 1, 2010 – June 30, 2011 fiscal year; and

WHEREAS, pursuant to RCW 82.14.415, the City is authorized, under the circumstances of this annexation, to impose a sales and use tax as authorized with that tax being a credit against the state tax.

NOW, THEREFORE, be it resolved by the City Council of the City of Kirkland as follows:

Section 1. A new Chapter 5.07 of the Kirkland Municipal Code is hereby created to read as follows:

5.07.010 Imposition of tax.

(a) There is imposed a sales or use tax, as authorized by RCW 82.14.415, which tax shall be collected from those persons who are taxable by the state under Chapters 82.08 and 82.12 RCW upon the occurrence of any taxable event within the city.

(b) The rate of the tax imposed under this chapter shall be 0.2 percent, and shall be in addition to other taxes authorized by law.

5.07.020 Definitions.

1. "Annexation area" means the Finn Hill, Kingsgate and North Juanita annexation area, as described in Exhibit A to Resolution No. R-4751, passed April 7, 2009, and includes all property described in the Ordinance.

2. "Municipal services" means those services customarily provided to the public by city government.

3. "Fiscal year" means the State's fiscal year beginning July 1st and ending the following June 30th.

4. "Threshold amount" means the maximum amount of tax distributions as determined by the city in accordance with KMC 5.07.070 that the Washington State Department of Revenue shall distribute to the city generated from the tax imposed under this chapter in a fiscal year.

5.07.030 Credit against state tax.

The tax authorized under this section shall be a credit against the state tax under Chapter 82.08 or 82.12 RCW. The Washington State Department of Revenue shall perform the collection of such taxes on behalf of the city, at no cost to the city, and shall remit the tax to the city as provided in RCW 82.14.060 and 82.14.415.

5.07.040 Term of tax.

(a) The tax imposed by this chapter shall only be imposed at the beginning of a fiscal year and shall continue for no more than 10 years from the date the tax is first imposed. Tax rate increases due to additional annexed areas shall be effective on July 1st of the fiscal year following the fiscal year in which the annexation occurred; provided, that notice is given to the Washington State Department of Revenue as set forth in KMC 5.07.070.

(b) The tax shall also cease to be distributed to the city for the remainder of the fiscal year once the threshold amount, as set forth pursuant to KMC 5.07.070, has been reached. Distributions of tax under this chapter shall begin again on July 1st of the next fiscal year and continue until the new threshold amount has been reached or June 30th, whichever is sooner. Any revenue generated by the tax in excess of the threshold amount shall belong to the state of Washington. Any amount resulting from the threshold amount less the total fiscal year distributions, as of June 30th, shall not be carried forward to the next fiscal year.

5.07.050 Use of tax revenue.

All revenue collected under this chapter shall be used solely to provide, maintain, and operate municipal services for the Finn Hill, Kingsgate and North Juanita annexation area.

5.07.060 Limitation of revenues.

The revenues from the tax authorized in this chapter may not exceed that which the city deems necessary to generate revenue equal to the difference between the city's cost to provide, maintain, and operate municipal services for the Finn Hill, Kingsgate and North Juanita annexation area and the general revenues that the city would otherwise expect to receive from the annexation during a year. If the revenues from the tax authorized in this chapter and the revenues from the Finn Hill, Kingsgate and North Juanita annexation area exceed the costs to the city to provide, maintain, and operate municipal services for the annexation area during a given year, the city shall notify the department and the tax distributions authorized in this section shall be suspended for the remainder of the year.

5.07.070 Thresholds.

(a) The threshold amount for the first fiscal year following the annexation and adoption of the tax authorized by this chapter is as follows: \$5 million.

(b) The city finance director shall forward to the Washington State Department of Revenue the amount of the threshold amount for the first fiscal year following the annexation and adoption of the tax.

(c) No later than March 1st of each year, the finance director shall provide the Washington State Department of Revenue with a new threshold amount for the next fiscal year, and notice of any applicable tax rate changes.

Section 2. The City Manager is hereby authorized to implement such administrative procedures as may be necessary to carry out the directions of this legislation.

Section 3. If any provision of this ordinance or its application to any person or circumstance is held invalid, the remainder of the ordinance, or the application of the provision to other persons or circumstances is not affected.

Section 4. This ordinance shall be in force and effect five days from and after its passage by the Kirkland City Council and publication, as required by law.

Passed by majority vote of the Kirkland City Council in open meeting this ____ day of _____, 2010.

Signed in authentication thereof this ____ day of _____, 2010.

MAYOR

Attest:

City Clerk

Approved as to Form:

City Attorney

RESOLUTION R-4803

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF KIRKLAND AUTHORIZING THE CITY OF KIRKLAND TO IMPOSE A SALES AND USE TAX AS AUTHORIZED BY RCW 82.14.415 AS A CREDIT AGAINST STATE TAX, RELATING TO ANNEXATIONS.

WHEREAS, on April 7, 2009, the City Council of the City of Kirkland passed Resolution R-4751 which directed the City Clerk to file a notice of intent to annex the Finn Hill, Kingsgate and North Juanita Annexation Area with the King County Boundary Review Board; and

WHEREAS, the Boundary Review Board held a public hearing on the proposed annexation on June 8, 2009, and approved the annexation on July 9, 2009; and

WHEREAS, the City Council passed Resolution R-4763 calling for an election which was held pursuant to State statute on November 3, 2009; and

WHEREAS, the King County Council transmitted a certified abstract of the vote in the November 3, 2009, general election; and

WHEREAS, the annexation of the Finn Hill, Kingsgate and North Juanita Annexation Area was approved by the voters residing in the area; and

WHEREAS, the City Council passed Ordinance No. 4229 on December 15, 2009, annexing the Finn Hill, Kingsgate and North Juanita Annexation Area, an area that has a population of at least ten thousand people; and

WHEREAS, the City Council finds and determines that the projected cost of at least \$5 million to provide municipal services to the annexation area exceeds the projected general revenue estimated to be zero that the City would otherwise receive from the annexation area for the July 1, 2010 – June 30, 2011, fiscal year; and

WHEREAS, pursuant to RCW 82.14.415, the City is authorized, under the circumstances of this annexation, to impose a sales and use tax as authorized with that tax being a credit against the state tax.

NOW, THEREFORE, be it resolved by the City Council of the City of Kirkland as follows:

Section 1. Purpose. The City Manager is hereby authorized and directed to set the threshold for imposing the sales and use tax credit at \$5 million related to the Finn Hill, Kingsgate and North Juanita Annexation Area to be implemented for July 1, 2010 – June 30, 2011,

fiscal year through the State sales taxes connected with the current City of Kirkland.

Section 2. Implementation. The City Manager is hereby authorized to implement such administrative procedures as may be necessary to carry out the directions of this Resolution.

Passed by majority vote of the Kirkland City Council in open meeting this ____ day of _____, 2010.

Signed in authentication thereof this ____ day of _____, 2010.

MAYOR

Attest:

City Clerk