

# HOUSE BILL REPORT

## HB 2078

---

### As Reported by House Committee On: Ways & Means

**Title:** An act relating to funding K-3 class size reductions by narrowing and repealing certain tax exemptions.

**Brief Description:** Funding K-3 class size reductions by narrowing and repealing certain tax exemptions.

**Sponsors:** Representatives Jinkins, Reykdal, Lytton, Billig, Frockt, Moscoso, Fitzgibbon, Tharinger, Ryu, Ladenburg, Stanford, Sullivan, Green, Van De Wege, Moeller, Springer, Pettigrew, Maxwell, Dickerson, Kagi, Ormsby, Upthegrove, Hasegawa, Appleton, Rolfes, McCoy, Carlyle, Liias, Kenney, Eddy, Darneille, Pedersen, Orwall, Hunt, Cody, Kirby, Roberts, Takko, Blake, Seaquist, Goodman, Haigh, Hudgins, Dunshee, Sells, Finn, Clibborn and Morris.

#### **Brief History:**

##### **Committee Activity:**

Ways & Means: 4/21/11, 5/11/11 [DPS].

#### **Brief Summary of Substitute Bill**

- Eliminates the business and occupation tax deduction for interest on first mortgages and deeds of trust on residential properties for financial institutions that operate in more than 10 states.
- Transfers revenue associated with the cap on this deduction to the Education Legacy Trust Account for K-3 class size reductions.

---

#### **HOUSE COMMITTEE ON WAYS & MEANS**

**Majority Report:** The substitute bill be substituted therefor and the substitute bill do pass. Signed by 15 members: Representatives Hunter, Chair; Darneille, Vice Chair; Hasegawa, Vice Chair; Carlyle, Dickerson, Haigh, Hudgins, Hunt, Kagi, Kenney, Ormsby, Pettigrew, Seaquist, Springer and Sullivan.

**Minority Report:** Do not pass. Signed by 10 members: Representatives Bailey, Assistant Ranking Minority Member; Dammeier, Assistant Ranking Minority Member; Orcutt,

---

*This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.*

Assistant Ranking Minority Member; Chandler, Haler, Hinkle, Parker, Ross, Schmick and Wilcox.

**Staff:** Rick Peterson (786-7150).

**Background:**

Washington's major business tax is the business and occupation (B&O) tax. The B&O tax is imposed on the gross receipts of business activities conducted within the state, without any deduction for the costs of doing business. Revenues are deposited in the State General Fund. A business may have more than one B&O tax rate, depending on the types of activities conducted. There are a number of different rates. The main rates are: 0.471 percent for retailing; 0.484 percent for manufacturing, wholesaling, and extracting; and 1.8 percent for professional and personal services, interest earned on loans by financial institutions, and activities not classified elsewhere.

A B&O tax deduction is available to financial institutions for interest earnings on loans secured by first mortgages or deeds of trust on residential properties. An originating lender that sells mortgage loans onto the secondary market, but continues to service the loans, may deduct the fees for servicing these loans.

---

**Summary of Substitute Bill:**

A financial business that is located in more than 10 states may not deduct from business and occupation (B&O) tax amounts derived from interest earnings on loans secured by first mortgages or deeds of trust on residential properties.

Each June the Department of Revenue will estimate the revenue associated with the restriction on the B&O deduction for interest earnings on loans secured by first mortgages or deeds of trust on residential properties. By July 1 the State Treasurer will transfer this amount to the Education Legacy Trust Account to be used for K-3 class size reductions.

**Substitute Bill Compared to Original Bill:**

The substitute bill removes the repeal of the sales tax exemption for nonresidents. The substitute bill eliminates the first mortgage interest deduction for banks that operate in more than 10 states, which replaces the \$100 million threshold for the first mortgage deduction.

---

**Appropriation:** None.

**Fiscal Note:** Available. New fiscal note requested on May 12, 2011.

**Effective Date of Substitute Bill:** The bill contains an emergency clause and takes effect on August 1, 2011.

## **Staff Summary of Public Testimony:**

(In support) By the end of this session over \$10 billion will have been cut from the state budget. This has had a staggering effect on education. Reducing K-3 class sizes has a long-term impact on performance. Reading begins in the early grades and after grade 3 the students are reading to learn. This first mortgage deduction is unique to Washington. The mortgage market is a national market and Washington does not have lower mortgage rates due to this exemption. The first home mortgage interest deduction is an inefficient method of stimulating the economy. The bulk of the deduction is taken on homes that have already been built so it has no stimulative effect on today's economy. There are far more cost-effective ways to stimulate housing. This will not magically solve your budget problem but will target some of the most painful cuts to the most vulnerable populations and ameliorate the pain in a thoughtful and compassionate fashion. This will have less of a negative impact on the economy than cuts to services will. We urge you to refer this to the people as authorized by Initiative 1053 and let the people decide how they want to provide services.

Washington has the 48th largest class sizes in the country. Only California and Utah are worse. Since that count was taken, three supplemental budgets eliminated Initiative 728 class size funding and eliminated K-4 class size reduction funding. Carried forward into the next biennium, that is \$1 billion of spending on class size reductions taken out of the next budget. This will result in four additional students per class. Smaller class sizes do make a difference. Please continue to look for solutions for our overcrowded class rooms. Reductions in class size have a significant impact on student achievement in the lower grades in the short term and the long term. It is one of the few educational innovations that has been proven by research gold standards. Many interventions after grade 3 are less effective. These early years form the foundation. Tax breaks are spending. Is spending on these tax breaks more important than spending on K-3 class size reductions—something the voters and the Legislature have repeatedly said is a priority for the state? The dropout cost is \$10,500 per year for life. Everyone benefits when children succeed in school.

(Opposed) We understand that this legislation is primarily directed at the large national banks. In many cases these financial institutions have provided capital in this state to home buyers, consumers, and businesses for more than a century. The large national banks provide two-thirds of the home mortgage and business lending in Washington. The mortgage units are separate business units and they fully load the costs of making mortgage loans into their mortgage offerings. Mortgage lending is a thin margin business. If a 1.8 percent tax is added to these mortgages it will be reflected in the costs of the mortgages to Washington home buyers. First-time homebuyers will be hit because underwriting standards will also narrow. This puts banks at a further competitive disadvantage as credit unions will not pay this tax. When the business and occupation (B&O) tax was first applied to financial institutions the tax was not applied to home mortgages in order to keep these mortgages affordable. The Legislature recognized that these loans had a low margin and did not want to discourage banks from participating in the residential market. Removing this exemption will have a particularly serious impact on portfolio lenders. Portfolio lenders do not sell their loans and so will have no way to discount or rebase the loans they have in place when this tax change goes into effect. Collectively, Washington's community banks lost \$3.4 billion from 2008 to 2010, 14 banks have failed, and many others are under regulatory orders. Due to low

margins on residential loans, this bill will either increase mortgage costs, or loan availability will decrease at a time when the housing market needs to recover.

The nonresident sales tax exemption has been on the books since 1980. During the last recession when the Legislature made the state sales tax rate permanent at 6.5 percent, a lower rate was enacted for the border counties. Although overturned by the Washington Supreme Court, past legislative bodies have been interested in the issue of taxes at the border between a state that does not have a sales tax and ours. The impact on small businesses in the City of Vancouver is significant. The repeal of the nonresident sales tax exemption will have a negative impact on a struggling economy and end up costing Washington retailers sorely needed sales. Many Washington retailers on the border with Oregon attribute 20 to 30 percent of their sales to Oregon residents. To lose even half that amount in this recession would be devastating. Retailers in other places in Washington rely on sales to tourists, especially Alaska residents. Elimination of the nonresident exemption will also reduce the B&O tax.

Even though the sales tax exemption for car dealers is not removed, it will be a huge challenge to explain to out-of-state buyers that although they have to pay sales tax on all other items they do not have to pay sales tax on vehicles. This will drive down vehicle sales which are the single largest source of sales tax revenue for the state. There are family owned businesses in downtown Vancouver that rely on Oregon shoppers for 25 percent of their business. If an 8.2 percent tax is charged then these sales will dwindle and the state will not see the revenue because Oregonians don't pay sales tax and they won't come to Vancouver to buy jewelry or furniture. Portland is a larger metro area and they have many options. The unemployment rate in Clark County is 12.9 percent; please do not make it worse.

**Persons Testifying:** (In support) Representative Jinkins, prime sponsor; Randy Parr, Washington Education Association; Ilene Dickerson; Shannon Rasmussen; Ramona Hattendorf, Washington State Parent Teacher Association; Lani Todd, Service Employees International Union 925; Ted Yellman; Jack Hunter; Teri Wood and Becky Hester, Stand for Children; Andy Nicholas, Washington Budget and Policy Center; Nick Federici, Protecting our Economic Future; David Black, Service Employees International Union Healthcare 1199 Northwest; Hannah Lidman, League of Education Voters; Amnon Shoenfeld, King County; Jim Dawson, Fuse Washington; Adrienne Thompson; Steven Seagull; David Lord, Disability Rights Washington; John-Paul Chaisson-Cardenas, Washington Community Action Network; Roy O'Neill; and Shelly Robbins, The QuickSource, Inc.

(Opposed) Denny Eliason, Washington Bankers Association; Cindy Holmstrom, Washington Financial League; Brent Beardall, Washington Federal; Rick Wickman, Identity Clark County; Mark Johnson, Washington Retail Association; Amber Carter, Association of Washington Business; Scott Hazelgrove, Washington Auto Dealers Association; and Kelly Parker, Vancouver Chamber of Commerce.

**Persons Signed In To Testify But Not Testifying:** None.