

HOUSE BILL REPORT

HB 2038

As Reported by House Committee On: Finance

Title: An act relating to investing in the education legacy trust account for K-12 basic education and higher education by narrowing or eliminating tax preferences and extending taxes set to expire.

Brief Description: Investing in the education legacy trust account for K-12 basic education and higher education by narrowing or eliminating tax preferences and extending taxes set to expire.

Sponsors: Representatives Carlyle, Hunter, Ormsby, Tharinger, Reykdal and Pollet.

Brief History:

Committee Activity:

Finance: 4/19/13, 4/23/13 [DPS].

Brief Summary of Substitute Bill

- Extends permanently the 0.3 percent business and occupation (B&O) surtax on service businesses.
- Eliminates the preferential B&O tax rate of 0.275 percent for travel agents and tour operators.
- Eliminates the preferential B&O tax rate of 0.138 percent for resellers of prescription drugs.
- Repeals the sales and use tax exemption for bottled water.
- Repeals the nonresident sales and use tax exemption for tangible personal property.
- Narrows the high technology tax credit for research and development.
- Expires the high technology sales and use tax deferral program on July 1, 2013.
- Eliminates the public utility tax deduction for the in-state portion of interstate transportation.
- Narrows the B&O and sales and use tax exemptions for import commerce.

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.

- Repeals the use tax exemption for extracted fuel produced by an extractor or manufacturer during the extracting or manufacturing activity.

HOUSE COMMITTEE ON FINANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 8 members: Representatives Carlyle, Chair; Tharinger, Vice Chair; Fitzgibbon, Hansen, Lytton, Pollet, Reykdal and Springer.

Minority Report: Do not pass. Signed by 5 members: Representatives Nealey, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Condotta, Vick and Wilcox.

Staff: Jeffrey Mitchell (786-7139).

Background:

Sales and Use Tax.

Retail sales taxes are imposed on retail sales of most articles of tangible personal property, digital products, and some services. A retail sale is a sale to the final consumer or end user of the property, digital product, or service. If retail sales taxes were not collected when the user acquired the property, digital products, or services, then use taxes apply to the value of property, digital products, or services when used in this state. The state, most cities, and all counties levy retail sales and use taxes. The state sales and use tax rate is 6.5 percent. Local sales and use tax rates vary from 0.5 percent to 3.0 percent, depending on the location.

Business and Occupation Tax.

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. Businesses must pay the B&O tax even though they may not have any profits or may be operating at a loss. A business may have more than one B&O tax rate, depending on the types of activities conducted. Major tax rates are 0.471 percent for retailing; 0.484 percent for manufacturing, wholesaling, and extracting; and 1.8 percent for services, and activities not classified elsewhere. Several lower rates also apply to specific business activities.

B&O Surtax on Certain Services.

A temporary B&O surtax of 0.3 percent, starting April 1, 2010, was imposed on the B&O service tax category, bringing the total rate to 1.8 percent. In addition, the small business tax credit was doubled for businesses with over 50 percent of their taxable activity subject to the 0.3 percent surtax. The additional surtax rate does not apply to scientific research and development, hospitals, and qualifying food co-ops. The surtax is set to expire on June 30, 2013.

Preferential B&O Tax Rates on Travel Agents, Tour Operators, and Resellers of Prescription Drugs.

Travel agents and tour operators have a preferential B&O tax rate of 0.275 percent on their gross income. Without this preference, travel agents and tour operators would be taxed under the general service and other rate at 1.8 percent.

Prior to court cases in the 1970s, travel agents paid B&O taxes on commissions earned from arranging intrastate travel only because of the court's interpretation of the United States (U.S.) Commerce Clause. However, in 1970 the Washington Supreme Court upheld the constitutionality of taxing travel agents on commissions for interstate travel arrangements. Because of this, in 1975 the Department of Revenue (DOR) updated tax rules to reflect the court decision. This expanded the B&O tax base for travel agents, including interstate travel arrangement commissions. The Legislature adopted a preferential B&O rate for travel agents, which has since been expanded to allow tour operators to claim the preferential rate.

A preferential B&O tax rate of 0.138 percent is provided to persons that warehouse and resell prescription drugs to retailers, hospitals, clinics, health care providers, or other providers of health care services. This tax preference was enacted to help Washington wholesalers that compete with out-of-state firms that are not subject to B&O tax due to a lack of sufficient nexus with the state. The state was unable to restrict the preferential rate only to companies with in-state warehouses. Therefore, out-of-state wholesalers with nexus in Washington also qualify for the preferential B&O tax rate. Without the preferential B&O tax rate, these businesses would pay the wholesaling B&O tax rate of 0.484 percent.

Sales and Use Tax Exemption for Food and Food Ingredients.

Washington specifically exempts "food and food ingredients" from state and local sales and use taxes. Therefore, any food product included within the definition of "food and food ingredients" is exempt from sales and use tax. "Food and food ingredients" is defined to mean substances, whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. Prepared food, soft drinks, and dietary supplements are excluded from the definition and therefore subject to sales and use tax. However, bottled water is included within the definition and therefore exempt from sales and use tax.

Nonresident Sales Tax Exemption.

A sales tax exemption is allowed to a resident of a state, possession, or Canadian province that does not impose a retail sales tax, use tax, value added tax, gross receipts tax, or similar generally applicable tax of 3 percent or more on purchases of goods for use outside the state. The exemption does not apply to items or services consumed in the state such as hotel stays or meals at restaurants. Retailers are not required to make tax exempt sales to qualifying nonresidents. A vendor may choose to collect sales tax on purchases made by qualifying nonresidents or to sell merchandise tax free.

Tax Credit for High Technology Research and Development.

Current law provides a B&O tax credit for qualified Research and Development (R&D) spending through July 1, 2015. To qualify, R&D must be conducted in the fields of:

- advanced computing;
- advanced materials;
- biotechnology;
- electronic device technology; or

- environmental technology.

The credit for each taxpayer may not exceed \$2 million or the amount of tax liability for the calendar year, whichever is less. Taxpayers taking the credit must submit an annual survey to the DOR.

High Technology Sales and Use Tax Deferral Program.

In order to qualify for the high technology R&D sales and use tax deferral/waiver, a business or nonprofit must invest in a new R&D facility or expand, renovate, or equip an existing facility.

Beneficiaries are required to submit an application to the DOR prior to beginning construction of a facility or acquiring machinery and equipment. As long as the facility or machinery and equipment continues to qualify for the intended purpose, the deferred sales and use taxes do not need to be repaid. Beneficiaries must submit an annual survey each year and continue the qualified use of the facility for eight years. The deferral program expires July 1, 2015.

Public Utility Tax Deduction on the In-state Portion of Interstate Transportation.

Current law provides an exemption from Public Utility Tax (PUT) for truck hauls if any portion involves interstate transportation. In 1935, the U.S. Supreme Court interpreted the federal Commerce Clause in the U.S. Constitution to bar a direct tax on gross receipts from activities related to interstate transportation. Consistent with constitutional analysis of Commerce Clause prohibitions at the time, the Tax Commission interpreted the statute to prohibit the state from taxing the in-state portion of interstate transportation activities under PUT.

Taxing the in-state portion of interstate transportation activities is now recognized as constitutional, so long as the tax satisfies the four-prong "Complete Auto" test. Washington's practice of not collecting PUT on the in-state portion of interstate transportation activities is no longer necessary to comply with Supreme Court doctrine.

The B&O and Sales and Use Tax on Import Commerce.

Current law provides an exemption from the B&O tax for the sale of tangible personal property in import or export commerce and an exemption from retail sales tax for sales of tangible personal property if the sale is exempt from the B&O tax. In general, wholesale sales are the primary type of sale exempt from the B&O tax under this exemption.

Use Tax Exemption for Extracted Fuel.

Fuel consumed by manufacturers or extractors is exempt from use tax when the fuel is used in the process of manufacturing or extracting at the same plant. The fuels for which the exemption generally applies are to wood by-products, also referred to as "hog fuel," and to refinery fuel gas.

A court decision made shortly before the Legislature created the preference in 1949 dealt with the taxability of a wood product manufacturer, the initial primary user of the exemption. There were no refineries operating in Washington when this preference was enacted in 1949. There are currently five active refineries in Washington.

Deposit of Sales and B&O Taxes.

Almost all revenues derived from sales and B&O taxes are deposited into the State General Fund. The Education Legacy Trust Account (ELTA) was created in 2005. Currently, the Washington estate tax is the sole source of revenue for the ELTA. Money in the ELTA can only be used for K-12 and higher education.

Summary of Substitute Bill:

Business and Occupation Surtax on Certain Services.

The 0.3 percent B&O surtax is made permanent. The permanent total tax rate is 1.8 percent. Hospitals, scientific research, and development will continue to be exempt from the surtax. The small business credit remains the same with the higher credit for service businesses that report at least 50 percent of their income under the service and other classification.

Preferential B&O Tax Rate on Travel Agents, Tour Operators, and Resellers of Prescription Drugs.

The preferential rates for travel agents, tour operators, and resellers of prescription drugs are repealed. These businesses are subject to the service and other tax rate of 1.8 percent and qualify for the increased small business credit if at least 50 percent of their income is reported under the service and other classification.

Sales Taxes on Bottled Water.

State and local sales and use taxes are extended to bottled water by removing bottled water from the food and food ingredients sales tax exemption.

Exemptions are provided for bottled water dispensed by a prescription and for persons whose primary source of drinking water is unsafe. Generally, sales tax must be paid at the time of purchase of the bottled water. However, the person can seek a refund if the total amount paid in state and local sales taxes exceeds \$25.

Nonresident Sales Tax Exemption.

The nonresident sales tax exemption for tangible personal property is eliminated. (The nonresident sales tax exemption for motor vehicles, boats, and trailers to be licensed in another state is not impacted under the bill.)

Narrow the Tax Credit for High Technology Research and Development.

The legislation limits the availability of the high technology B&O tax credit to businesses with an annual gross income of \$10 million or less. Businesses that do not qualify for the credit in 2013 are not required to repay any credit claimed prior to the effective date of the change.

Repeal the High Technology Sales and Use Tax Deferral Program.

The high technology sales and use tax deferral program is terminated on July 1, 2013. The DOR may not issue any new deferral certificates after this date. It would grandfather in

businesses already in the deferral program as long as current law requirements continue to be met.

Repeal the PUT Deduction on the In-state Portion of Interstate Transportation.

The legislation repeals the PUT deduction for income on the in-state portion of interstate transportation of goods and passengers by truck, rail, and some water transportation. The legislation provides apportionment rules to determine the portion of income attributed to Washington. The PUT rate for these businesses is 1.926 percent.

Narrow the B&O and Sales and Use Tax Exemptions for Import Commerce.

This legislation disallows the B&O exemption for import commerce except for aerospace products. Therefore, businesses with sufficient nexus in Washington are required to pay B&O tax on the in-state portion of their import transactions.

Repeal the Use Tax Exemption for Extracted Fuel.

The legislation repeals the use tax exemption for fuel produced by an extractor or manufacturer when the fuel is directly used in the same extracting or manufacturing activity that produced the fuel; however, the exemption for hog fuel is retained. The value of the extracted fuel is based on the wellhead price, as published by the U.S. Energy Information Administration.

Deposit of Additional Tax Revenues.

The additional B&O and beer taxes are deposited directly into the ELTA. Because other new revenues in the bill cannot be directly tracked, these additional amounts are estimated twice a year by the DOR and transferred from the State General Fund to the ELTA.

Substitute Bill Compared to Original Bill:

The substitute bill removes the provisions of the bill permanently extending the beer tax; imposing sales tax on janitorial services; and eliminating the preferential B&O tax rate for insurance agents and stevedoring. In addition, the timing of the transfers from the General Fund to the ELTA are changed to keep the tax collections and transfers within the same fiscal year. The transfers are exempt from the requirement to reduce the General Fund expenditure limit by the amount of the transfers. The substitute bill excludes the additional revenue from the calculation of General Fund revenues for purposes of calculating the state debt limit. Other technical corrections are made that do not change the intent of the underlying bill.

Appropriation: None.

Fiscal Note: Preliminary fiscal note available.

Effective Date of Substitute Bill: The bill contains an emergency clause and takes effect on July 1, 2013, except for section 202 relating to B&O taxes, which takes effect July 1, 2015.

Staff Summary of Public Testimony:

(In support) This legislation is not about taxes. It is about our children. The bill treats tax preferences with the same level of scrutiny that state programs undergo. Budgets are reflective of values and priorities. House Bill 2038 is fair to all residents of Washington.

The state needs to fund education and give kids the opportunity to succeed and provide an educated work force for Washington businesses. High-tech firms are forced to recruit overseas to find qualified people to fill positions. Businesses need the state to fund higher education for a trained and educated workforce to drive our economy forward. The increased cost of higher education over the past four years is astounding and not smart economic policy.

Education is the best bang for our buck when it comes to growing the economy. Thirty cents paid on every \$100 of income does not seem like too much to pay given the wise purpose the funds are intended for. Do not fund K-12 by cutting funds to early learning and higher education. Funding for education should come from new revenue rather than more cuts to the state's vulnerable population. Low income schools need funding right now. Parent-teacher associations are paying for things like trash can liners, disinfectant, and even books.

The state should also zero-in on other loopholes that benefit nonfinancial, multi-national, high-tech businesses that hurt the economy by not paying any taxes. Preferential tax breaks are not fair. Cutting them would create an economy that works for everybody and creates middle class jobs. The state needs to end tax breaks that have failed bi-partisan performance evaluations and direct funds to education.

This legislation would free up funds for public safety and avoid more cuts to health and safety-net programs. The state's programs for public safety are down to the minimum and it is not safe for the citizens or the people serving the state in public safety. It is hard to provide all the services we need, but it needs to be done and the Legislature needs to choose to fund education without cutting vital services.

All tax exemptions need to be reviewed periodically and closed if they do not work, so the funds can go to better use. The government should not be picking winners and losers in the private sector, but these tax preferences do that by giving tax breaks to some businesses and not others. It is time to put education before these tax breaks. This list of tax expenditures to close might not be the best but it is a step in the right direction. The extracted fuel exemption was passed before any refineries entered the state and now the refineries are using 98 percent of the exemption. It is time to support a good solid revenue system including repealing some of these exemptions. Taxes are about civilization. It is the price paid for civilization.

(Opposed) The B&O tax is the most regressive tax that a service industry can pay. Businesses pay the B&O tax on every dollar earned. Of that one dollar, 40 cents goes to consultants who pay the B&O on it and then maybe there is even another tier that pays again. The tax is pyramiding. It was supposed to be temporary and the Legislature was taken at its word to let the additional tax expire.

The B&O tax is a "personal" income tax since it cannot be passed on to consumers. The only way to stay in business with higher taxes is to cut employees. This bill will hinder small businesses that drive the economy.

The insurance industry is experiencing a reduction in business by up to 30 percent. Insurance rates are structured by the Legislature so there is no way to pass the increased taxes on to consumers.

Wholesale drug margins average between 1 and 2 percent. As a result of the preferential rate, wholesale drug companies have expanded facilities and employment in Washington. If the current rate were eliminated, it would represent a 250 percent increase in the tax rate.

The last three governors have recognized that Washington is the most trade-dependent state in the country. One in four jobs is dependent on trade in the state. The agricultural industry is 13 percent of the state's economy and the second largest export category. Repealing the PUT deduction would divert cargo to Canada and other regions that Washington ports compete against. The state's trade competitiveness would be significantly impacted.

The question of tax on water has already been answered. People voted "NO - stay out of our grocery carts." Businesses have made huge investments on equipment to expand the bottled water and other beverage industries in the state. This bill would cause these businesses to rethink further expansion and job creation. Eliminating the exemption would be harmful for businesses.

Retailers in Washington do not sell anything that cannot be purchased somewhere else, so consumers will go elsewhere. This bill leaves everyone wondering, "Who's next?" Our property taxes already fund education.

In a sense, this is levying a new tax on small breweries that they have not paid in the past. Paying the B&O tax is fine, but this new tax on small breweries will not help grow the industry in Washington.

The tax on janitors will put some out of business as business owners go "in-house" to get the job done, so they will not have to pay sales tax on the service. The large decision this bill intends to make is based on incomplete information in the tax preference review report. The bio-tech industry is a 10 to 13-year cycle, which means that the return on investment is just now starting to be seen. Therefore, it is too early to end the incentive. The high-tech sector does not oppose the extension of the B&O tax, but the tax incentives for the high-tech sector need to stay in place. Repealing this exemption will create a competitive disadvantage for Washington refineries.

The Senate offers a better approach to funding education without raising taxes.

Persons Testifying: (In support) Andy Nicholas, Washington State Policy Center; Nick Federici, Our Economic Future Coalition; Shawn Lewis, Washington Education Association; Frank Ordway, League of Education Voters; Melanie Smith, Wellspring Family Services; Sandra Schroeder, American Federation of Teachers - Washington; Reagan McBride, Minority Executive Director's Coalition; Boris Popovich, Main Street Alliance; Alfred Frajes, Michela Razo, and Jennifer Hartjehausen, League of Education Voters; Lani Todd, Chris Lakey, and Marie Keller, Service Employees International Union 925; Ewan McCartney and Kimberli Swenson, Parent Teacher Association; Dennis Eagle, Washington Federation of

State Employees; John Burbank, Economic Opportunity Institute; Mary Clogsten, AARP; Jerry Reilly, Elder Care Alliance; Pamela McCarty, Sharon Mitchel-Perdue, and Debbie Moore, Service Employees International Union 775; Cathy Renner, Washington State Parent Teacher Association; Emily Murphy, OneAmerica; Bob Cooper, National Association of Social Workers; Chuck Maynard, Teamsters 117; Michael Bow, Department of Corrections; Geoff Simpson, Washington State Council of Firefighters; Christina Wong, Anti Hunger and Nutrition Coalition; Alex Hur, Equality in Washington Coalition; Steve Zemke, Tax Sanity; David Parsons, United Auto Workers 2141; Mike Burgess, Clark County; Miquel Perez-Gibson, Climate Solutions; and Steve Segall, Washington Federation of State Employees.

(Opposed) Peter Schrappen, Northwest Marine Trade Association; Tim Eyman; Peter Rasmussen; Stan Bowman, American Institute of Architects Washington Council; Dan Campbell, American Council of Engineering Companies; Pat McBride, GMS Architects Group; Christophe Allen, Acme Fuel Company; Bill Clarke, Washington Realtors; Alisha Harrison, Mason County Realtors; Terry Wollam, Clark County Realtors; Susie Tracy, Washington State Medical Association, Washington Academy of Eye Physicians and Surgeons, and Washington Ambulatory Surgery Center Association; Patrick Connor, National Federation of Independent Business; Trevor Campbell and Barb Kaisen, Professional Insurance Agents of Washington; Jeff Kyle and Sharon Sparling, National Association of Insurance and Financial Advisors; Chris Free, Washington Association of Health Underwriters; Gordon Baxter: Inland Boatmen's Union, Masters Mates & Pilots Union, Marine Engineers Beneficial Association, and Puget Sound Metal Trades Council; Andrew Barkis, Hometown Property Management; Ted Trask, American Family Insurance; Bob Hashimoto, Sakohara and Hashimoto LLC; Larry Pursley, Washington Trucking Association; Leonard Barnes, Port of Grays Harbor; Jeff Davis, International Longshore and Warehouse Union; Tom Davis, Washington Farm Bureau; Jessica Harbin, Monica Wallace, and John Galluzzo, Farmer's Insurance; Mike Post, McKesson; Herb Krohn, United Transportation Union; Carolyn Crain; Tim Dougherty, International Bottled Water Association and Northwest Bottled Water Association; Jim Connelly, Northwest Bottled Water Association; Brad Boswell, Washington Beverage Association; Anders Johnson, Woodland Truck Line; Chris Foster, Foster's Furniture; Scott Hazelgrove, Washington State Auto Dealer's Association; Brent Van Arnam, Dick Hannah Dealerships; Amber Carter, Association of Washington Business; Kelly Parker, Vancouver Chamber of Commerce; Michael Transue, Washington Beer and Wine Distributors; Mike Bjorke, Marine View Beverage; Craig Stein, C Stein Beverage Group; Meliessa Ogradowski, Red Hook Brewery; Mark Johnson, Washington Retail Association; Amy Rhodes, 7-Eleven; Ryan Hilliard, Hilliard's Brewing; Daniel O'Leary, Duo Brewing; Mike Runion, 7 Seas Brewing; Heather McClung, Schooner Exact Brewery; Mark Gjurasic, Building Owners and Managers Association; Adam Foilz, Able Building Maintenance; Patrick Clark, NKC Partners; Lew McMurrin, Washington Technology Industry Association; Linda Hull, Washington Biotech and Biomedical Association; Tom McBride, TechAmerica; David Bergsvick, Saltchuk Resources, Inc; Trent House, Association of Global Automakers; Penny Ross; Gaylan Prescott, United Steelworkers; and Marjorie Hatter, Phillips 66.

Persons Signed In To Testify But Not Testifying: None.