

# HOUSE BILL REPORT

## HB 2796

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### As Reported by House Committee On: Finance

**Title:** An act relating to investing in education by narrowing or eliminating certain tax preferences.

**Brief Description:** Investing in education by narrowing or eliminating certain tax preferences.

**Sponsors:** Representatives Carlyle, Hunter, Freeman, Walkinshaw, Ryu, Tarleton, Jinkins, Tharinger, Fey, Pollet, Ormsby, Van De Wege, Roberts, S. Hunt, Riccelli, Moscoso and Farrell.

#### **Brief History:**

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

Finance: 2/28/14, 3/4/14 [DP].

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

- Eliminates the preferential business and occupation tax rate for resellers of prescription drugs.
- Repeals the sales and use tax exemption for bottled water.
- Changes the nonresident sales and use tax exemption for tangible personal property into a remittance program.
- Narrows the use tax exemption for extracted fuel produced by an extractor or manufacturer during the extracting or manufacturing activity.

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### HOUSE COMMITTEE ON FINANCE

**Majority Report:** 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 3 members: Representatives Nealey, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Vick.

**Staff:** Jeff Mitchell (786-7139).

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*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.*

## **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 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 1.5 percent for services, and activities not classified elsewhere. Several lower rates also apply to specific business activities.

### Preferential Business and Occupation Tax Rates for Resellers of Prescription Drugs.

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 the 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 for 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.

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.

Deposit of Sales and Business and Occupation Taxes.

Almost all revenues derived from sales and the 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.

State Expenditure Limit.

First enacted in 1993 by Initiative 601, the state expenditure limit allows expenditures from the State General Fund to grow each fiscal year by the fiscal growth factor, which is the average annual growth in state personal income over the prior 10 fiscal years. Whenever the cost of any state program or function is shifted from the State General Fund or moneys are transferred from the State General Fund to another fund or account, the state expenditure limit must be lowered to reflect the shift or transfer.

State Debt Limit.

The state Constitution limits the issuance of state general obligation debt. The State Treasurer may not issue a general obligation bond if the amount of interest and principal payments in any year, along with debt payments for existing bonds, would exceed 9 percent of the average of the annual general state revenue collections for the previous six fiscal years. The constitutional debt limit is reduced over time from 9 percent to 8 percent by July 1, 2034. It is set at 8.5 percent starting July 1, 2014; 8.25 percent starting July 1, 2016; and 8 percent starting July 1, 2034. The definition of general state revenues includes the state property tax because it is deposited in the State General Fund.

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**Summary of Bill:**

Preferential Business and Occupation Tax Rate for Resellers of Prescription Drugs.

The preferential B&O tax rate for resellers of prescription drugs is repealed. Prescription drug resellers would pay the general wholesaling rate of 0.484 percent.

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 is converted to a remittance program. Out-of-state residents will owe sales tax initially, but may apply to the Department of Revenue for a remittance of Washington sales taxes paid in the prior calendar year. The person may seek a remittance of both state and local sales tax. The amount of the remittance claim must exceed \$25.

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 biomass fuel is retained.

For refinery fuel gas, the value of the extracted fuel for purposes of use tax is based on the wellhead price, as published by the United States Energy Information Administration.

Deposit of Additional Tax Revenues.

The additional taxes from repealing the extracted fuel tax exemption and eliminating the preferential B&O tax rate for resellers of prescription drugs are deposited directly into the ELTA. Because other new tax 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.

State Expenditure Limit.

The transfers from the State General Fund to the ELTA are exempted from the requirement to lower the state expenditure limit.

State Debt Limit.

New tax revenues initially deposited in the State General Fund are explicitly excluded from the calculation of general state revenues for purposes of the state debt limit determination.

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**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date:** The bill contains an emergency clause and takes effect on June 1, 2014.

**Staff Summary of Public Testimony:**

(In support) Closing loopholes and preferences makes sense fiscally and is a common sense policy. There is a higher proven return on investment by taking this money and spending it on education; therefore it should be a priority. This will help short-term goals and help in the long term by putting money in the pocket of our classified workers, many of whom are low income. This will be placing money back into the economy and will create an educated work

force that will also benefit our economy. This bill incentivizes the early learning system and will improve stability; increases the availability of quality early learning programs; and creates accountable measures aimed at producing positive outcomes for kids. Prioritize the children of our state. All kids deserve a strong start in life and high quality learning is a critical part of our state's education system and lays a solid foundation for our future. This bill provides critical resources to the Education Legacy Trust Fund. These specific investments provide necessary funds for early learning and restores the voter-approved cost of living increase for educators. Restoring these investments would be critical for students in the state for the opportunity to succeed. Narrowing these tax preferences is a reasonable first step and a great proposal in finding a reliable and stable funding source for education without putting other programs in jeopardy. For the out-of-state sales tax exemption, Oregonians should pay the same taxes in Washington as Washingtonians have to pay. The oil refineries are the most profitable industry in the world, and they can absorb this tax increase. Bottled water isn't food. You aren't taxing the water, you are taxing the bottling. If you don't want to pay the tax, go get it from the faucet.

(Opposed) There is a concern about the activities of the Legislature in introducing single bills to dedicate funding to education. It is our state's paramount duty to educate our kids, and we should have an education budget that is discussed foremost in the budget process and not as an afterthought with individual taxation bills. The nonresidential sales tax exemption would erase an incentive for customers to shop at our businesses in Washington. The nonresident sales tax exemption would especially impact our boarder areas, with Oregon, Idaho, and British Columbia. This bill creates a disincentive to shop in Washington and could cause businesses to lose up to \$45 million in sales per year according to the DOR estimates. Lost sales to Washington businesses would mean fewer jobs, and this would have a negative impact on both our cities and our state. The Washington economy is still struggling to get out of recession and repealing the nonresident sales tax exemption would only prolong the recovery. The JLARC recommended continuing the exemption because it was meeting the intended purpose of the Legislature. Bottled water is regulated as a food and inspected as a food. We are responsible for the recall, safety, and anti-terrorism rules that involve any other food manufacturers. Water is necessary to survive. It is a healthy product. It has been shown in the past that taxing bottled water would create a 10 percent drop in revenue to family businesses who are the local bottlers. There is no evidence that the extracted fuel tax preference was originally intended to be limited to hog fuel. Secondly, the refineries have never been questioned by the DOR or the State of Washington regarding the exemption and to call it a loophole is simply incorrect. Finally, it is putative to place the tax level at the sales and use tax rate of 8.6 percent when it would be taxed at 3.6 percent if provided by a utility. Eliminating the current B&O rate for resellers of prescription drugs would significantly increase our tax rate and put us at a competitive disadvantage.

**Persons Testifying:** (In support) Lani Todd, Service Employees International Union 925; Melissa Johnson, Washington State Association of Head Start and Early Learning action Alliance; Shawn Lewis, Washington Education Association; and Steve Leaky, America's Edge; and Nick Federici, Our Economic Future Coalition.

(Opposed) Amber Carter, Association of Washington Business; Bruce Tornquist, Competitive Edge Marketing; Mark Johnson, Washington Retailers Association; Greg Hanon, Western

States Petroleum Association; and Cindy Holmston and Rob Makin, Washington Wholesale Drug Association.

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