

HOUSE BILL REPORT

HB 2641

As Amended by the Senate

Title: An act relating to implementing the recommendations of the investment income tax deduction task force for the business and occupation tax.

Brief Description: Implementing the recommendations of the investment income tax deduction task force for the business and occupation tax.

Sponsors: By Representatives Gombosky, Cairnes, Kessler, Morris, Berkey, Edwards, Kenney, Linville, Ogden and Conway; by request of Governor Locke.

Brief History:

Committee Activity:

Finance: 2/5/02, 2/7/02 [DP].

Floor Activity:

Passed House: 2/14/02, 97-0.

Senate Amended.

Passed Senate: 3/7/02, 39-10.

Brief Summary of Bill

- Eliminates the business and occupation taxation of investment income received by businesses that might be considered financial businesses, except for banking businesses, lending businesses, security business, loans or the extension of credit, revolving credit arrangements, installment sales, and the acceptance of payment over time for goods or services.

HOUSE COMMITTEE ON FINANCE

Majority Report: Do pass. Signed by 11 members: Representatives Gombosky, Chair; Berkey, Vice Chair; Cairnes, Ranking Minority Member; Conway, Morris, Nixon, Orcutt, Roach, Santos, Van Luven and Veloria.

Staff: Bob Longman (786-7139).

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. All business activities are subject to the B&O tax unless there is a specific exemption or deduction. There is a B&O deduction for dividends received by a parent corporation from its subsidiaries. There is also a deduction for the investment of income for all persons other than those "engaging in banking, loan, security, or other financial businesses." In other words, only banking, loan, security and "other" financial businesses pay the B&O tax on investment income. Private investors are not taxed. Investment income received by nonfinancial businesses is not taxed.

There has been some question and litigation over what "other financial business" means for B&O tax purposes. The state Supreme Court has defined a financial business as one that meets both of these requirements: (1) The business has a primary purpose of earning income through utilization of significant cash outlays; and (2) the business is comparable to a banking, loan, or security business. This interpretation was most recently applied in the Simpson Investment Company case decided in July 2000. The Simpson Investment Company is a parent holding company of four corporations: Simpson Timber Company and its subsidiaries; Simpson Paper Company and its subsidiaries; Simpson (formerly Western Pacific) Extruded Plastics and its subsidiary; and Simpson Foreign Sales Company. Simpson Investment gets the majority of its income as dividends from its subsidiaries. These dividends are exempt from tax and were not at issue in the case. Simpson Investment also gets a small portion of its income from interest on bank deposits, stock dividends, and profits from market hedging and futures trading. The Department of Revenue (DOR) assessed the B&O tax on this income. Simpson Investment appealed, and the Supreme Court upheld the department. The court held that Simpson Investment was a financial business.

During the 2001 session, the Legislature considered a number of proposals in response to the Simpson decision, and enacted legislation that was intended to delay any change in the manner or extent of taxation of certain investment income as a result of that decision. This legislation was vetoed by the Governor. However, the Governor directed the DOR to adhere to the spirit of the vetoed bill and to not change or expand the application of the law to include activities that were not previously subject to tax. He further directed the department to work closely with all affected parties to develop a new proposal for consideration by the Legislature. The department formed a task force and held several meetings during the interim between legislative sessions. The task force recommended legislation to the Governor.

Summary of Bill:

The term "other financial business" is no longer used for B&O tax purposes. Instead, tax is specifically applied to banking businesses, lending businesses, security businesses, loans or the extension of credit, revolving credit arrangements, installment sales, and the

acceptance of payment over time for goods or services.

Banking business means a national or state-chartered bank, a mutual savings bank, a savings and loan association, a trust company, an alien bank, a foreign bank, a credit union, a stock savings bank, or a similar entity chartered under banking laws.

Lending business means making secured or unsecured loans of money, or extending credit, when more than one-half of the gross income is earned from such activities and more than one-half of the business's total expenditures are incurred in support of such activities.

Security business means a securities broker, dealer, or broker-dealer, as those terms are defined in securities regulation laws. Mutual funds, family trusts, and other collective investment vehicles are not securities businesses, and are not subject to the B&O tax.

The existing deduction for dividends received by a parent company from its subsidiary is modified to expressly include distributions from capital account. These dividends and distributions are also deductible when received from subsidiary entities that are not corporations.

EFFECT OF SENATE AMENDMENT(S):

Interest on loans between a subsidiary company and its parent are not subject to tax if the total investment and loan income is less than 5 percent of the annual gross receipts of the business.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill contains an emergency clause and takes effect immediately.

Testimony For: There is a great deal of uncertainty as to who must pay tax as a financial business. The statutory phrase "other financial business" is vague. Potential investors are uneasy about investing in this state due to this uncertainty. This bill eliminates a disincentive to locate in this state. It encourages family-owned newspapers and other businesses in Washington to keep investment activities in this state and use investment income to expand business activities here. This legislation has the full support of the Washington State Bar Association and the Association of Washington Business.

Testimony Against: None.

Testified: Mike Bernard, Association of Washington Business; Patrick Clarkson, Frank

Russell Company; Warren Thompson, Frank Russell Company; Jim Hedrick, Office of Financial Management; and Rowland Thompson, Allied Daily Newspaper.