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**Finance Committee**

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**HB 2186**

**Brief Description:** Concerning investing in Washington families by improving the fairness of the state's excise tax system by narrowing or eliminating tax preferences, imposing a business and occupation tax surcharge while eliminating tax liability for small businesses, enacting an excise tax on capital gains, modifying the real estate excise tax, making administrative changes, and implementing marketplace fairness in Washington.

**Sponsors:** Representatives Lytton, Jinkins and Macri.

**Brief Summary of Bill**

- Imposes a seven percent tax on adjusted Washington capital gains.
- Makes changes to the business and occupation tax (B&O), including imposing a 20 percent surtax on certain activities, increasing the filing threshold, repealing the small business credit, creating a new deduction of \$250,000, and repealing several preferential rates.
- Eliminates or narrows several tax preferences.
- Reforms the real estate excise tax.
- Requires the reporting of subcontractor information to the Department of Revenue.
- Requires marketplace facilitators, referrers, and their sellers to collect and remit sales of use tax, or comply with notice and reporting requirements.
- Expands liability for unpaid tax obligations for sales and use taxes, B&O tax, cigarette taxes, and other tobacco product taxes.
- Sets a new interest rate for tax refunds.
- Makes transfers of new revenue to the Education Legacy Trust Fund.

**Hearing Date:** 4/3/17

**Staff:** Tracey O'Brien (786-7152).

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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:**

### Capital Gains.

Most property owned by an individual for personal purposes is a capital asset, including a house, furniture, a car, stocks, and bonds. The sale of these items may result in a capital loss or a capital gain. At the federal level, the gains on some of these capital assets may be subject to taxation, and the losses may be deducted, plus \$3,000 if filing jointly, when computing an individual's net capital gain for tax liability purposes. The holding period for short-term capital gains or losses is less than one year. The holding period for long-term capital gains or losses is more than one year.

At the federal level, some property is exempted from capital gains. This includes stock in trade and other inventory, accounts, or notes receivable, depreciable property, real estate used in a trade or business, and certain hedging transactions. In addition, an individual may not need to report the sale or exchange of a main home.

An individual filing a 1040 federal return will calculate any capital gains or losses on Form 8949 and report the gain or loss on Schedule D. Capital gains are taxed generally at a lower rate than the tax rates that apply to other income. The rates are determined by the source of the net capital gain. For Tax Year 2016, the six maximum capital gains rates are 0 percent, 15 percent, 20 percent, 25 percent and 28 percent. If the net capital gain resulted from the sale of collectibles, the 28 percent rate applies; however, if the gain is not from the sale of collectibles, small business stock or unrecaptured section 1220 gain, and the regular tax rate that would apply is 10 or 15 percent, then the capital gains rate is 0 percent.

### 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. Currently, an out-of state businesses that has at least \$53,000 in property in Washington, \$53,000 in payroll in Washington, or receipts in Washington of at least \$267,000, will have substantial nexus for the imposition of the B&O tax.

A taxpayer may have more than one B&O tax rate, depending on the types of activities conducted. Major B&O 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 preferential rates also apply to specific business activities.

In addition, there are other tax preferences, including credits and deductions, that a business may be eligible to utilize to reduce their tax liability. For example, a taxpayer engaging in activities subject to different B&O tax rates may be eligible for a Multiple Activities Tax Credit. A taxpayer may also be eligible for a small business credit that will either eliminate or reduce their B&O tax liability. In general, credit is \$35 per month multiplied by the number of months in the reporting period.

A business that does not owe other taxes or fees to the Department of Revenue (DOR) and that has annual gross proceeds of sales, gross income, or value of products for all B&O tax

classifications less than \$28,000 per year, or \$46,667 if at least 50 percent of their taxable income is from certain activities, does not have to file an annual B&O tax return.

### Real Estate Excise Tax.

The sale of real estate is subject the real estate excise tax (REET). The tax base is the selling price of the real estate, without any deduction for mortgages, liens or other debts. The tax is typically paid by the seller. A transfer of controlling interests in entities that own property in Washington is also subject to REET.

The state REET rate is a flat 1.28 percent. The state revenue is distributed, through June 30, 2019, as follows: 98 percent to the State General Fund, 2 percent to the Public Works Assistance Account, 4.1 percent to the Education Legacy Trust Account, and 1.6 percent to the City/County Assistance Fund. Any penalties assessed for delinquent tax payments are deposited into the Housing Trust Fund. In addition, counties retain 1.3 percent of the state tax collected to cover administrative costs. In Fiscal Year 2016, the state REET resulted in \$959,492,000 in revenue, which was a 18.6 percent increase; however, during the recession in 2008-2011, REET revenues experienced negative growth.

Local governments are also authorized to impose a REET. Cities and counties are authorized to impose a 0.25 percent REET to finance capital improvements or capital projects specified in a comprehensive plan. A city and county may also impose a 0.5 percent REET for general purposes, so long as the city or county does not impose the option 0.5 percent retail sales tax. In addition, a county may impose a 1.0 percent REET to finance the acquisition and maintenance of conservation areas, and 0.5 percent to finance the acquisition, construction and operation of affordable housing for low to moderate income persons, or persons with special needs.

### 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 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 3.1 percent, depending on the location.

### Nexus.

Nexus is required before a taxing jurisdiction can impose taxes on an entity. In the case of sales or use taxes, nexus is necessary in determining whether an out-of-state business selling products into a state is liable for the collection of sales or use taxes for that state. A legal analysis of nexus involves the Dormant Commerce Clause and the Due Process Clause in the U.S. Constitution. If a tax violates either, it will be invalid. The Dormant Commerce Clause analysis focuses on the structural concerns on the national economy, and whether the tax inhibits interstate commerce. The Due Process analysis focuses on the authority of a state to impose the tax on a particular taxpayer.

In 2015 Washington adopted "click through" nexus. Under this nexus standard, certain remote sellers are required to collect and remit Washington sales tax for sales made into the state, and

may also have to pay B&O tax on their Washington sales. A remote seller is covered by "click through" nexus if the remote seller: enters into agreements with Washington residents who, for a commission or other consideration, refer potential customers to the remote seller, such as by a link on a website; and generate more than \$10,000 in gross receipts during the prior calendar year under such agreements from sales into this state.

#### Interest Rate on Refunds.

The DOR must pay interest on refunds, and must impose interest on assessments. The Legislature determines the method for calculating the interest rates. The method of calculation, and the rates themselves, have changed over the years.

The current calculation for the interest rate is the federal short-term rate, plus 2 percent. For Calendar Year 2017, the rate for both assessments and refunds is 3 percent. The rates for refunds and assessments have been identical since Calendar Year 1998.

#### **Summary of Bill:**

##### **Part I – Capital Gains**

A 7 percent tax is imposed on the adjusted capital gain of an individual for the privilege of selling or exchanging long-term capital assets, or receiving Washington capital gains. This tax is in addition to any other taxes imposed by state and local governments. This tax also applies to beneficial owners who are individual owners of long-term capital assets held by pass through, or other disregarded entity, to the extent the individual's ownership interest in the entity is reported for federal tax purposes.

A "Washington capital gain" is defined as an individual's adjusted capital gains allocated to this state less \$25,000 for an individual, or \$50,000 if filing jointly. "Adjusted capital gain" is defined as the net federal long-term capital gain plus any loss from a sale or exchange that is exempt from the tax imposed in this chapter, and less any gain from a sale or exchange that is exempt from the tax imposed in this chapter, to the extent such gain or loss was included in calculating federal net long-term capital gain.

Long-term assets can include real estate and intangible or tangible personal property. For real estate, the capital gains tax applies if the real property sold or exchanged is in Washington, or the majority of the fair market value of the property is in this state. For intangible personal property, capital gains will apply if taxpayer was domiciled in WA at the time of sale or exchange. For tangible personal property, capital gains tax will apply if property was located in Washington at time of sale or exchange. The sale of tangible personal property will also be subject to the states capital gains tax if: (1) property was located in Washington at any time during the current or immediately preceding taxable year, (2) taxpayer was a Washington resident at time of sale or exchange, and (3) was not subject to income or excise tax on the adjusted capital gain by another taxing jurisdiction.

The following assets are exempt from the capital gains tax:

- Residential dwellings that are a single family residence, a residential condominium, a residential cooperative unit, or a floating home, including accessory dwelling units.

- Retirement assets, including 401(k), a tax-sheltered annuity and custodial account, deferred compensation plans, individual retirement accounts (IRAs), Roth IRAs, employee defined contribution program, employee defined benefit program or similar retirement saving vehicle.
- Assets condemned by the government.
- Cattle, horses, or breeding livestock held for more than 12 months if 50 percent of taxpayer's gross income for the year is from farming or ranching.
- Agricultural or timber lands that the taxpayer has regular, continuous, and substantial involvement in the operation of the land, and meets the federal criteria for "material participation" for 10 years previous to sale.
- Property used in a trade or business if it qualifies for depreciation under federal law.
- Timber or receipts from a Real Estate Investment Trust.

A "resident" is an individual domiciled in WA during the entire taxable year. A resident also includes a person who is not domiciled in WA during the taxable year, but maintained a place of abode, and was physically present in Washington for more than 183 days during the taxable year. Such person will be resident for that portion of year in which domiciled or maintained a place of abode. If an individual maintained no permanent place of abode in this state during entire taxable year, maintained a permanent place of abode outside of Washington for an entire taxable year, and spent an aggregate of no more than 30 days in Washington, the person is considered a nonresident.

Deductions are allowed for amounts prohibited by the United States or Washington constitutions or laws. In addition, a deduction for Washington capital gains tax paid is available for the B&O tax. Credits are allowed equal to the amount of any legally imposed income or excise tax paid by the taxpayer to another jurisdiction.

The administrative provisions for the DOR apply to this new tax, and additional provisions for the filing, payment, and applicable penalties are included. The DOR may enter into reciprocal agreements with other states to offset delinquent taxes.

It is a class C felony for knowingly attempting to evade payment of the capital gains tax. It is a gross misdemeanor for knowingly failing to pay tax, make returns, keep records, or supply information required.

All revenues from the capital gains tax will be deposited into the Education Legacy Trust Account.

## **Part II – Business and Occupation Rate Changes & Deduction**

The filing threshold for B&O taxes is increased to \$150,000. A deduction of \$250,000 is authorized for businesses with gross income of less than or equal to \$250,000. If a business' gross income is greater than \$250,000, but less than \$500,000, there is a deduction of \$100,000.

If a taxpayer claims a multiple activities tax credit, they can claim a credit instead of deduction. The credit for a calendar year will be equal to lesser of tax due or the amount:

- for person with gross income of less than or equal to \$250,000, \$250,000 multiplied by highest applicable B&O rate to taxpayer; or

- for person with gross income of greater than \$250,000, but less than \$500,000, \$100,000 multiplied by the highest applicable B&O rate to the taxpayer.

A 20 percent surcharge on the B&O tax is imposed for selected business activities:

- Beginning July 1, 2017: extractors, manufacturers, most retailers, real estate brokers, digital products/services, nonprofit research and development, insurance producers, hospitals, salmon canning, radioactive waste clean-up, wholesalers, insurance agents, radio & TV broadcasters, government contractors, printers, publishers highway contractors, extracting or processing for hire, warehousing, contest of chance, international investment management, custom software, loan interest, royalties, professional employer organizations, day care, chemical dependency services, and grocery distribution co-ops.
- Beginning July 1, 2024: meat slaughter and processing for wholesale.

The small business B&O credit is repealed.

### **Part III – Eliminating or Narrowing Tax Preferences**

The sales tax exemption for bottled water is eliminated; however, there are exceptions for medically prescribed water, or if a person's primary source of drinking water is considered unsafe.

The preferential B&O rate for warehousing and reselling prescription drugs is repealed.

The use tax exemption for self-produced fuel is narrowed to include only biomass fuels. The use tax for refinery fuel gas is 3.852 percent. The value of refinery fuel gas is set to the United States natural gas wellhead price.

The preferential B&O tax rate on international investment management services of .275 percent is repealed, thereby imposing the general service rate of 1.5 percent on this class of services.

The nonresident sales tax exemption is converted to a remittance program. Refunds may only be requested by nonresidents for the immediately preceding calendar year, and must be for at least \$25. In addition, a non-resident may only make one refund request per calendar year. The request must include proof of nonresident status as prescribed by DOR. Penalties are created for making fraudulent statements or submitting fraudulent documents.

### **Part IV – Real Estate Excise Tax**

New graduated real estate excise tax (REET) rates based on the value of property sold are imposed. The rates are as follows:

- 0.75 percent if selling price is less than \$250,000.
- 1.028 percent if selling price is equal to or greater than \$250,000 and less than \$1 million.
- 2 percent if the selling price is equal to or greater than \$1 million but less than \$5 million.
- 2.5 percent if the selling price is equal to or greater than \$5 million.

In addition, REET will be paid when a lender or creditor receives property through a foreclosure proceeding or by enforcing a judgment. It will also be imposed when property is sold at a foreclosure or sheriff's auction, or if the property is transferred by order of the court in a foreclosure, or judgment enforcement proceeding.

#### **Part V – Local Governments/Building Permits**

Upon final inspection of a residential dwelling, the local jurisdiction that issued the building permit is required to obtain general information of any subcontractors that worked under the building permit. Local jurisdictions must provide all collected information to the DOR on a monthly basis, who may share the information with Department of Labor and Industries and Employment Security Department. The local jurisdictions are permitted to charge the contractor a fee to defray costs of information collection.

#### **Part VI – Remote Sellers, Referrers & Marketplace Facilitators**

Beginning January 1, 2018 remote sellers, referrers, and marketplace facilitators that meet the statutory criteria must remit sales or use tax, or comply with the notice and reporting requirements in this act. An election by a marketplace facilitator, referrer, or remote seller to collect and remit sales or use tax can only be changed upon written notice to DOR, will not take effect until January 1 of the calendar year at least 12 months past the date of election to collect and remit, and written notice must occur at least 30 days prior to the election being changed.

This act applies to marketplace facilitators or remote sellers that have gross receipts sourced to Washington of at least \$10,000. A referrer must comply with this act if during the current or previous calendar year, the gross business income received from its referral services sourced to Washington, whether or not they are subject to sales or use tax, is at least \$10,000.

#### Notice and Reporting Requirements.

A seller that meets the nexus criteria in this act, but not the physical presence nexus, and who does not collect and remit sales or use tax on all taxable retail sales into Washington, must comply with the report and notice requirements.

A seller, other than a referrer, must post a conspicuous notice on its website or catalog, as well as its invoices or sales receipts that include a statement for Washington consumers that sales or use tax is due on certain purchases, and that Washington requires the purchaser to file a use tax return. In addition, this seller must also provide an annual report to each Washington consumer that the seller did not collect sales or use tax on any sales and must include the details on the consumer transactions in the previous year. Finally, a seller, other than a referrer, must file an annual report with the DOR that includes Washington purchasers' information, and an affidavit signed under penalty of perjury from a seller's officer affirming that seller has made reasonable efforts to comply with consumer notice and reporting requirements. These reporting requirements do not apply to sellers registered with DOR to collect and remit sales and use tax, and who make a reasonable effort to comply with current requirements.

A referrer must also post conspicuous notice on its platform that informs Washington purchasers that sales or use tax is due on certain purchases, and a purchaser may have to file a use tax return

with the DOR. Annually, a referrer must send a report to its marketplace sellers to whom the referrer transferred a potential purchaser located in Washington during the previous year. The report to a referrer's seller must state that Washington imposes a sales or use tax on retail sales, and a seller meeting the Acts requirements must either collect and remit sales or use tax, or comply with the states notice and report requirements for sellers. The referrer must also send a report to the DOR that includes a list of sellers who received notice, and affidavit signed under the penalty of perjury from a referrer's officer that the referrer has made reasonable efforts to comply with the notice and reporting requirements under this act.

### Penalties.

A penalty is imposed on a seller, other than referrer, who fails to provide notice to consumers at the time of purchase, or to post a conspicuous notice in the amount of \$20,000. A penalty is imposed on a seller, other than a referrer, who fails to provide a report to its purchasers of all sales in the previous calendar year in the amount of 8.5 percent of gross taxable sales in Washington for the calendar year.

A penalty is imposed on a referrer that fails to post a notice to consumers on its platform in the amount of \$20,000. A penalty in the amount of 8.5 percent of gross taxable sales in Washington is imposed on a referrer who fails to provide the required report to its sellers.

A penalty is imposed on any seller who fails to file a report with DOR of \$25 per failure, but not less than \$20,000.

All penalties are cumulative and must be imposed within four years of the close of the calendar year.

A seller is entitled to a conditional waiver if the seller enters into a written agreement to fully comply with all notice and reporting requirements beginning on a date acceptable to DOR. The DOR may grant a waiver for one or more violations; however, the DOR may not grant more than one request by a seller for a waiver. The conditional waiver can be invalidated if the seller fails to comply.

### Definitions.

A "marketplace facilitator" is a person that contracts with sellers to facilitate, for consideration, regardless of whether its deducted as fees from transaction, the sale of the seller's products through a catalog, or a physical or electronic marketplace, and engages:

- Directly or indirectly, through one or more affiliated persons in: communicating offer/ acceptance between the buyer and seller; owning or operating the infrastructure (electronic or physical) that brings buyers and sellers together; providing virtual currency; or software development or research and development related to marketplace operated; and
- Payment processing services; fulfillment or storage services; listing for sale for consideration; setting prices; branding sales as those of the marketplace facilitator; order taking; advertising/promotion; or providing customer service/assisting with returns and exchanges.



A "marketplace seller" is a seller that makes retail sales through a physical or electronic marketplace operated by a marketplace facilitator, regardless of whether the seller is required to be registered with the DOR.

A "referrer" is defined as a person who contracts or otherwise agrees with a seller to list or advertise for sale items in any medium, receives a commission, fee or other consideration from seller for listing or advertising, transfers a potential purchaser to a seller or an affiliated person to complete the sale and does not collect receipts from the purchasers for the transaction.

A "remote seller" refers to any seller who does not have a physical presence in this state, and makes sales to purchasers.

#### Liability for unpaid taxes.

A marketplace facilitator or referrer is relieved of liability for failure to collect the correct sales or use tax if it can show that the error was due to incorrect information from an unaffiliated seller. The seller would be solely liable for unpaid tax. A marketplace facilitator or referrer is also relieved of liability, if: (1) the sale was made in marketplace facilitator's marketplace or directly resulting from referral by referrer; (2) the seller is unaffiliated; and (3) failure to pay the tax, not due to sourcing the sale. The maximum amount of relief is phased in, and represents a percentage of a marketplace facilitator's total tax due, or a percentage of a referrer's taxable retail sales in Washington.

The marketplace seller is relieved of liability for failure to collect and remit the correct sales or use tax if: there is documentation that the marketplace facilitator is registered with the DOR, and it will collect all applicable taxes on behalf of the marketplace seller made through the facilitator's marketplace. In addition, a marketplace seller is relieved of liability for all taxes on sales made through a marketplace facilitator if the marketplace seller is also a remote seller, and the marketplace facilitator provides the seller with written confirmation that the facilitator has elected to comply with notice and reporting requirements in lieu of collecting sales or use tax.

The relief of liability does not affect the obligation of any purchaser to remit sales or use tax concerning any applicable taxable transaction in which the seller or seller's agent does not collect and remit sales tax.

Class action lawsuits are prohibited against a marketplace facilitator on behalf of buyers arising from overpayment of sales or use tax. In addition, this act is subject to compliance with the streamlined sales and use tax agreement and federal law.

Nothing in this act relieves sellers or consumers currently subject to sales or use tax from their responsibilities under chapters 82.08 and 82.12 of the RCW, nor prevents the DOR from administering or enforcing those taxes.

#### **Part VII – Expanding Individual Liability for an Entity's Unpaid Tax Obligations**

Officers and other persons with the responsibility to remit taxes are liable for the recoverable tax liability. This recoverable tax liability includes B&O taxes, sales or use taxes, cigarette taxes and other tobacco products taxes.

## **Part VIII – Interest Rate on Tax Refunds**

Beginning January 1, 2018, the interest rate on tax refunds will be the federal short-term rate.

## **Part IX – Transfers to the Education Legacy Trust Account**

The DOR must estimate the increase in general fund revenue from the B&O rate changes, the narrowing of tax preferences, and the sales and use tax changes (parts II, III & VI of the Act) by June 15, and December 15, of each year. The State Treasurer must transfer an amount equal to DOR's estimate from the general fund to the Education Legacy Trust Account (ELTA) by the last workday of the second and fourth quarters.

The DOR must estimate the increase in general fund revenue from the changes in the real estate excise tax (part IV of the Act by September 15, April 15, June 15 and December 15 of each year. The State Treasurer must transfer an amount equal the DOR's estimate from the general fund to the ELTA by the last workday of each quarter.

The transfers from the State General Fund to the ELTA are exempted from the requirement to lower the state expenditure limit. The transfers to the ELTA under this Act are also excluded from calculations of constitutional and statutory debt limits.

## **Part X – Conforming Amendments**

## **Part XI – Miscellaneous**

This act applies prospectively and includes a savings clause, and a severability clause.

**Appropriation:** None.

**Fiscal Note:** Not requested.

**Effective Date:** The bill contains an emergency clause and takes effect on July 1, 2017, except Section 801 (interest rate) and Part IV (Remote Sellers, Referrers, and Marketplace Facilitators) take effect January 1, 2018.