

SENATE BILL REPORT

SB 5929

As of April 26, 2017

Title: An act relating to 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.

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: Senator Rossi.

Brief History:

Committee Activity: Ways & Means: 4/26/17.

Brief Summary of Bill

- Imposes a 7 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 or 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.

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.

- Makes transfers of new revenue to the Education Legacy Trust Fund.

SENATE COMMITTEE ON WAYS & MEANS

Staff: Dean Carlson (786-7305)

Background: Capital Gains. A capital gains tax (CGT) is a tax on the profit realized on the sale of non-inventory assets that are purchased at a lower price than the sales price. The most common capital gains are realized from the sale of stocks, bonds, and real estate. Under the federal tax code, individuals and corporations pay tax on the net total of all their capital gains just as they do on other sorts of income. The amount of federal CGT depends on both the tax bracket of the individual and the amount of time the capital asset was held before being sold. Short-term capital gains are taxed at the individual's ordinary income tax rate, and are defined as capital assets held for a year or less before being sold. Currently, long-term capital gains are generally taxed at a preferential rate in comparison to ordinary income for federal income tax purposes.

In addition to the federal tax, capital gains are often subject to state income taxes. Most states do not have separate CGT rates. Instead, most states tax capital gains as ordinary income subject to the state's income tax rates.

There are many varied definitions of an excise tax and an income tax. The Merriam-Webster dictionary has the following definitions:

- income tax - a tax on the net income of an individual or a business; and
- excise tax - (1) an internal tax levied on the manufacture, sale or consumption of a commodity; (2) any of various taxes on privileges often assessed in the form of a license fee.

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. 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. 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.

Real Estate Excise Tax. The sale of real property is subject to the real estate excise tax (REET). The tax base is the selling price of the real property, 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 the 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 (ELTA), and 1.6 percent to the City/County Assistance Fund.

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 optional 0.5 percent retail sales tax. In addition, a county may impose a 1 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. 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 Department of Revenue (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 (CY) 2017, the rate for both assessments and refunds is 3 percent. The rates for refunds and assessments have been identical since CY 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 the taxpayer was domiciled in Washington at the time of sale or exchange. For tangible personal property, capital gains tax will apply if property was located in Washington at the time of the sale or exchange. The sale of tangible personal property will also be subject to the states capital gains tax if: (1) the property was located in Washington at any time during the current or immediately preceding taxable year; (2) the taxpayer was a Washington resident at the time of the sale or exchange; and (3) the sale 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:

- any residential dwelling, which means property that consists solely of a single-family residence, a residential condominium unit, or a residential cooperative unit, including an accessory dwelling unit, a multifamily residential building consisting of common walls and fewer than four units, or a floating home;
- retirement assets, including 401(k), a tax-sheltered annuity and custodial account, deferred compensation plans, individual retirement accounts (IRAs), Roth IRAs, employee defined contribution programs, employee defined benefit programs or similar retirement saving vehicles;
- assets condemned by the government;
- cattle, horses, or breeding livestock held for more than 12 months if 50 percent of the 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 a sale;
- property used in a trade or business if it qualifies for depreciation under federal law; and
- timber or receipts from a Real Estate Investment Trust.

A resident is an individual domiciled in Washington during the entire taxable year. A resident also includes a person who is not domiciled in Washington 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 a resident for that portion of the year in which domiciled or maintained a place of abode. If an individual maintained no permanent place of abode in this state during the 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 taxes prohibited by the US or Washington constitutions or laws. In addition, a deduction for Washington CGT 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 and Deduction. The filing threshold for B&O taxes is increased to \$150,000. A deduction of \$250,000 is authorized for businesses with a taxable amount of less than or equal to \$250,000. If a business' taxable amount is greater than \$250,000, but less than \$500,000, there is a deduction of \$100,000.

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 or services, nonprofit research and development, insurance producers, hospitals, salmon canning, radioactive waste clean-up, wholesalers, insurance agents, radio and television 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; and
- beginning July 1, 2024: newspapers.

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 US natural gas wellhead price.

The preferential B&O tax rate on international investment management services of 0.275 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 CY, and must be for at least \$25. In addition, a nonresident may only make one refund request per CY.

Part IV: Real Estate Excise Tax. New graduated state REET rates based on the value of real property sold are imposed. The rates are as follows:

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

In addition, the 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. The DOR may share the information with the Department of Labor and Industries and the Employment Security Department. The local jurisdictions are permitted to charge the contractor a fee to defray the 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 the DOR, will not take effect until January 1st of the calendar year at least 12 months past the date of election to collect and remit, and the 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 reporting and notice requirements.

A seller, other than a referrer, must post a conspicuous notice on its website or catalog, as well as on 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 purchaser that the seller did not collect sales or use tax on any sales, and must

include the details on the purchaser's 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 the seller has made reasonable efforts to comply with consumer notice and reporting requirements. These reporting requirements do not apply to sellers registered with the DOR to collect and remit sales and use tax, and who make a reasonable effort to comply with current requirements.

A referrer must 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 reporting requirements for sellers. The referrer must also send a report to the DOR that includes a list of sellers who received notice, and an affidavit signed under the penalty of perjury from a referrer's officer stating 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 a referrer, who fails to provide notice or post a conspicuous notice to consumers at the time of purchase, 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 CY in the amount of 8.5 percent of gross taxable sales in Washington for the CY.

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 of \$25 per failure, but not less than \$20,000, is imposed on any seller who fails to file required reports with the the DOR.

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 the 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 a 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 an offer and 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 the 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 or promotion, or providing customer service and assistance 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 a 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 a marketplace facilitator's marketplace or directly resulting from referral by the referrer; (2) the seller is unaffiliated; and (3) the seller fails 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.

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.

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 product 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 tax changes, the narrowing of tax preferences, and the sales and use tax changes—Parts II, III and VI of the act—by June 15th and December 15th of each year. The State Treasurer must transfer an amount equal to the DOR's estimate from the General Fund to the 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 REET—Part IV of the act—by September 15th, April 15th, June 15th, and December 15th of each year. The State Treasurer must transfer an amount equal to 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. Technical changes are made to existing law to reflect the changes made in the rest of the bill.

Part XI: Miscellaneous. This act applies prospectively and includes a savings clause, and a severability clause.

Appropriation: None.

Fiscal Note: Requested on April 21, 2017.

Creates Committee/Commission/Task Force that includes Legislative members: No.

Effective Date: The bill contains an emergency clause and takes effect on July 2, 2017, except for section 801 and Part VI which take effect January 1, 2018.