
Finance Committee

HB 2038

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 Summary of Bill

- Permanently extends the 0.3 percent business and occupation (B&O) surtax on service businesses.
- Eliminates the preferential B&O tax rate of 0.484 percent for insurance agents.
- 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 0.275 percent for stevedoring.
- Repeals the sales and use tax exemption for bottled water.
- Repeals the nonresident sales and use tax exemption for tangible personal property.
- Modifies and extends the beer tax.
- Imposes sales and use tax on janitorial services.
- Modifies 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.
- Eliminates the preferential B&O tax rate of 0.138 percent for resellers of prescription drugs.
- Repeals the use tax exemption for extracted fuel produced by an extractor or manufacturer during the extracting or manufacturing activity.

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.

Hearing Date: 4/19/13

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 product or service 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 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 Insurance Agents, Travel Agents, Tour Operators, Stevedoring, and Resellers of Prescription Drugs.

Washington law provides a preferential B&O tax rate for insurance agents. Insurance agents pay at a rate of 0.484 percent on the commissions they receive. These insurance businesses are referred to collectively as "contractors." The contractor who owns or manages the agency is referred to as an "agent," and the contractor who sells insurance is referred to as the "sub-agent."

Contractors are paid commissions by insurance companies to sell their products. If the contractor works out of an agency, the agent pays B&O tax on the full commission, and the sub-agent pays tax on his or her share of the commission. The shared portion of the commission is taxed twice. This is by design in the B&O tax and is known as "pyramiding."

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 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.

Stevedoring and associated activities currently include labor, service, and transportation activities where cargo is loaded or unloaded to or from vessels or barges involved in waterborne interstate and foreign commerce. These businesses currently pay a preferential B&O rate of 0.275 percent. Without this preference, stevedoring would be taxed under the general service and other rate at 1.8 percent.

In 1978, the U.S. Supreme Court ruled that Washington's B&O tax was on the local activity of stevedoring only and did not infringe on import or export activities. Thus, the B&O tax did not violate the federal Commerce Clause. The Court emphasized that interstate commerce must bear its fair share of the state tax burden.

The result of the court decision was that stevedoring activities, which had previously been untaxed, were now subject to B&O tax under the service and other activities classification. Including the temporary surcharge in place at the time, stevedoring activities paid a B&O tax rate of 1.06 percent. Two subsequent rate changes, decreasing the B&O rate, occurred and the current preferential rate is 0.275 percent.

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, is 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.

Beer Tax.

In 2010, an additional excise tax on beer was levied at \$15.50 per barrel of 31 gallons. There is an exemption for the first 60,000 barrels sold by small breweries. The additional excise tax rate is set to expire June 30, 2013.

Janitorial Services.

Under current law, janitorial services are explicitly exempt from the definition of retail sale. Businesses providing janitorial services report their gross income under the service and other classification and have a B&O tax rate of 1.8 percent.

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 the 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.

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

Current law provides an exemption from 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 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 account. Money in the ELTA can only be used for K-12 and higher education.

Summary of 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 Insurance Agents, Travel Agents, Tour Operators, Stevedoring, and Resellers of Prescription Drugs.

The preferential rates for insurance agents, travel agents, tour operators, stevedoring, 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.)

Beer Tax.

The additional beer tax from 2010 is modified and permanently extended. The additional tax for large breweries is reduced from \$15.50 per barrel to \$7.75. The exemption for small breweries is removed and an additional beer tax of \$4.65 per barrel is imposed.

Janitorial Services.

The definition of retail sale is modified to include janitorial services. Businesses providing janitorial services will be required to collect retail sales tax on the income they receive and report their gross income under the B&O retailing classification will be 0.471 percent.

Modify 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 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. 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.

Appropriation: None.

Fiscal Note: Requested on April 16, 2013.

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