
Finance Committee

HB 2224

Brief Description: Investing in education and essential public services by modifying and improving the fairness of Washington's excise tax system by enacting an excise tax on capital gains, narrowing or eliminating tax preferences, reinstating a previously expired business and occupation surtax while increasing the small business tax credit, and implementing marketplace fairness in Washington.

Sponsors: Representatives Carlyle, Hunter, S. Hunt, Kagi and Walkinshaw.

Brief Summary of Bill

- Imposes a 5 percent tax on capital gains.
- Reinstates the 0.3 percent business and occupation (B&O) surtax on service businesses.
- Increases the small business credit for service businesses.
- 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 0.138 percent 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.
- Eliminates the preferential B&O tax rate of 0.484 percent for royalty income.
- Authorizes additional methods of establishing nexus for purposes of business and occupation and sales taxes.
- Limits the availability of a real estate foreclosure exemption.

Hearing Date: 3/31/15

Staff: Jeffrey Mitchell (786-7139).

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 3.0 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 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. A B&O tax credit is provided for businesses whose B&O tax liability is below a certain level. The credit varies depending on the amount of B&O tax due (the total of all classifications) after all other B&O tax credits have been taken. The amount of the small business B&O credit for service-related business is \$840 per year, which completely exempts a service business with annual B&O gross income below \$56,000 and provides a partial reduction in B&O liability for a service business with gross income at or below \$112,000.

B&O Surtax on Certain Services and the B&O Small Business Credit.

A temporary B&O surtax of 0.3 percent was imposed on the B&O service tax category between July 1, 2010, and July 1, 2013, 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 did not apply to scientific research and development and hospitals.

Capital Gains Taxes.

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 income 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. The long-term capital gains tax rates for 2014 are: 0% for taxpayers in the 10% or 15% marginal income tax brackets; 15% for taxpayers in the 25%, 28%, 33%, or 35% marginal income tax brackets; and 20% for taxpayers in the 39.6% top bracket

In addition to the federal CGT, capital gains are often subject to state income taxes. Most states do not have separate capital gains tax rates. Instead, most states tax capital gains as ordinary income subject to the state's income taxes rates. Washington has neither an income tax nor any specific excise tax on capital gains.

Preferential B&O Tax Rate for Travel Agents and Tour Operators.

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 1.5 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 United States (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.

Preferential B&O Tax Rate 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 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, Including Bottled Water.

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.

Preferential B&O Tax Rate for Royalty Income.

Currently, royalty receipts are apportioned using a single factor receipts method and taxed at a rate of 0.484%. The 0.484% rate was adopted in 1998 (lowered from 1.5%) to align software royalty receipts with the rates for software manufacturing. Royalty income is compensation for the use of intangible personal property such as copyrights, patents, licenses, franchises, trademarks, and similar items.

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.

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.

Nexus.

As currently interpreted by the United States Supreme Court, the commerce clause of the United States Constitution prohibits states from imposing sales or use tax collection obligations on out-of-state businesses unless the business has a substantial nexus with the taxing state. Under the Court's decision in *Quill Corp. v. North Dakota* (1992), a substantial nexus for sales and use tax collection purposes requires that the taxpayer have a physical presence in the taxing state. Physical presence can be established through a taxpayer's own activities in the taxing state, or indirectly, through independent contractors, agents, or other representatives that act on behalf of the taxpayer in the taxing state.

In 2010, Washington adopted an economic presence test for nexus with respect to service-related activities. For these classifications, a business does not need to have a physical presence to have nexus and be subject to Washington tax. Economic nexus is established by having sales in excess of \$267,000 to Washington customers. (The threshold is adjusted from year-to-year.)

Real Estate Excise Tax (REET) Foreclosure Exemption.

The REET is imposed on each sale of real property, including transfers of ownership and transfers of controlling interests in entities that own property in the state. Real property includes any interest in land or anything affixed to land. The state tax rate is 1.28%. Additional local rates are allowed. The combined state and local rate in most areas is 1.78%.

The REET does not apply to transfers made in foreclosure proceedings or through enforcement of a judgment, including foreclosures that occur through auction without court oversight. REET also does not apply to a deed given in lieu of foreclosure to satisfy a mortgage or deed of trust.

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 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 9.0 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 9.0 percent to 8.0 percent by July 1, 2034. It is set at 8.5 percent starting July 1, 2014; 8.25 percent starting July 1, 2016; and 8.0 percent starting July 1, 2034. The definition of general state revenues includes the state property tax because it is deposited in the General Fund.

Summary of Bill:

B&O Surtax on Certain Services and the B&O Small Business Credit.

The 0.3 percent B&O surtax on service activities is permanently reinstated. The total tax rate is 1.8 percent. Hospitals and scientific research, and development will continue to be exempt from the surtax. The small business credit for businesses that report at least 50 percent of their income under the service and other classification is increased to \$1,800 per year, which exempts the first \$100,000 of service income.

Capital Gains Tax.

Beginning January 1, 2016, an annual state net capital gains tax (CGT) is imposed on the sale or other voluntary exchange of capital assets by resident individuals, trusts, and estates during the year. The tax rate is 5 percent. The tax rate is applied to the capital gains amount reported on the federal income tax return. For resident individuals, all capital gains from the sale or exchange of intangible personal property, such as stock, are allocated to Washington. Capital gains from real estate transactions are allocated to Washington if the real property is located in Washington. Generally, capital gains from the sale or exchange of tangible personal property are allocated to Washington if the property was located in Washington at the time of the transaction.

All taxpayers must file with the state Department of Revenue (Department), a CGT return for each taxable year; however, a person with no tax liability is not required to file a tax return. The due date of the state CGT return is the due date for the federal income tax return, unless otherwise required by the Department. The first state CGT returns are due in 2017.

For taxpayers filing joint federal tax returns, a \$50,000 deduction is provided. For taxpayers filing other returns, a \$25,000 deduction is allowed. The sale of a person's primary residence is not subject to CGT.

Preferential B&O Tax Rate on Travel Agents, and Tour Operators.

The preferential rates for travel agents, tour operators, and resellers of prescription drugs are repealed. Travel agents and tour operators 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. Resellers of prescription drugs are subject to the 0.484 percent wholesaling rate.

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.

Preferential B&O Tax Rate for Royalty Income.

The preferential B&O tax rate for royalty income is eliminated. This income is subject to the 1.8 percent B&O tax rate and would qualify for the increased small business credit.

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 DOR for a remittance of Washington state sales taxes paid in the prior calendar year. The amount of the remittance claim must exceed \$25.

Nexus.

Five new nexus tiers are established that would require out-of-state businesses to collect Washington state sales taxes and/or pay retailing or wholesaling B&O tax for sales made to Washington residents .

The tiers are:

- Click-through nexus– creates nexus for out-of-state remote sellers who enter into agreements with Washington residents who, for a commission or other consideration, refer potential residents 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 the state.
- Remote sellers' representative nexus – creates nexus for retail sales tax purposes for out-of-state remote sellers selling through a remote seller's representative that has physical presence nexus in Washington. The remote seller representative is required to notify the remote sellers of their responsibility to collect and remit retail sales tax when their sales meet a certain threshold.
- Marketplace facilitator nexus – creates nexus for out-of-state remote sellers for retail sales tax purposes when the remote seller makes sales into the state through an online marketplace facilitator that has physical presence nexus in Washington. The marketplace facilitator is required to collect the retail sales tax for remote sellers who meet a certain sales threshold.
- Credit card/payment facilitator nexus– creates nexus for out-of-state remote sellers (meeting a certain sales threshold) for retail sales tax purposes where the remote seller has an agreement with a credit card company/payment facilitator that has physical presence nexus in Washington.

- Economic nexus – creates nexus for B&O tax purposes and retail sales tax purposes on all retail sales attributable to Washington based on income thresholds. Applies an economic nexus standard to retail sales formerly governed by physical presence nexus.

Real Estate Excise Tax (REET) Foreclosure Exemption.

This proposal would require that real estate excise tax (REET) be paid if:

- a lender or creditor receives property through a foreclosure proceeding or by enforcing a judgment;
- property is sold at a foreclosure or sheriff's auction; and
- property is transferred by order of the court in a foreclosure or a judgment enforcement proceeding.

The following would remain exempt:

- transfers to a lender or creditor to avoid the foreclosure process ("deed in lieu of foreclosure");
- if the selling price is greater than the lien or security interest on the property, transfers by sale at a foreclosure or sheriff's auction; and
- transfers to the United States, or to this state or its instrumentalities, as the lender or creditor, in a foreclosure proceeding or by enforcing a judgment.

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 tax is based on the wellhead price, as published by the U.S. Energy Information Administration. The refinery fuel is subject to a rate of 3.852 percent.

Deposit of Additional Tax Revenues.

The B&O and surtax is deposited directly into the ELTA. Because other new B&O and sales tax revenues in the bill cannot be directly tracked, these additional amounts are estimated twice a year by the Department 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.

Appropriation: None.

Fiscal Note: Requested on March 27, 2015.

Effective Date: The bill contains an emergency clause and takes effect on July 1, 2015.