
Appropriations Committee

HB 2269

Brief Description: Relating to investing in education and essential public services by modifying and improving the fairness of Washington's tax system.

Sponsors: Representatives Hunter, Carlyle and Sullivan.

<p style="text-align: center;">Brief Summary of Bill</p> <ul style="list-style-type: none">• Declares the act may be known and cited as the investing in education and essential public services by modifying and improving the fairness of Washington's tax system act.

Hearing Date: 6/22/15

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 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

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.

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.

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 percent. The 0.484 percent rate was adopted in 1998 (lowered from 1.5 percent) 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.

Currently, Washington cannot impose wholesaling B&O tax on sales of goods that originate outside the state unless the goods are:

- received by the purchaser in this state; and
- the out-of-state seller has physical presence nexus (i.e. the same physical nexus requirement that is used for sales tax purposes).

Both the criteria must be met for the seller to be subject to Washington B&O taxation. In 2010 Washington adopted an economic presence test for nexus with respect to service-related activities but not wholesaling or retailing 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 based on inflation.)

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 percent. Additional local rates are allowed. The combined state and local rate in most areas is 1.78 percent.

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. The REET also does not apply to a deed given in lieu of foreclosure to satisfy a mortgage or deed of trust.

Local Government Data with Respect to Building Permits.

Building permit applicants must provide information to a local government in which a building permit is sought regarding the general contractor, but not subcontractors. This information is not shared by all localities with state agencies.

Late Payment Penalties.

Under current law, late excise tax returns receive a penalty of:

- 5 percent from one day after the due date to the last day of the month following the due date;
- 15 percent from the first day of the second month following the due date to the last day of that month; and
- 25 percent from the first day of the third month and thereafter.

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 State General Fund.

Summary of Bill:

This act may be known and cited as the investing in education and essential public services by modifying and improving the fairness of Washington's tax system act.

Appropriation: None.

Fiscal Note: Not requested.

Effective Date: The bill takes effect 90 days after adjournment of the session in which the bill is passed.