

---

**Finance Committee**

---

**HB 2996**

**Brief Description:** Investing in a well-qualified and sufficient K-12 public education workforce by narrowing or eliminating tax preferences.

**Sponsors:** Representatives Lytton, Reykdal and Santos.

**Brief Summary of Bill**

- Eliminates the preferential B&O tax rate for travel agents and tour operators.
- Eliminates the preferential B&O tax rate for resellers of prescription drugs.
- Eliminates the sales and use tax exemption for bottled water.
- Converts the nonresident sales tax exemption to a remittance program.
- Narrows a real estate excise tax exemption related to transfers made in foreclosure proceedings or through enforcement of a judgment.
- Eliminates the preferential B&O tax rate for international investment management services.
- Deposits the additional revenues into the education legacy trust account.

**Hearing Date:** 2/26/16

**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

---

*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.*

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.

#### 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 United States Supreme 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.

Until 2015 Washington could not impose the wholesaling Business and Occupation Tax (B&O) on sales of goods that originated outside the state unless the goods were:

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

In 2015 Engrossed Second Substitute Bill 6138 extended economic nexus standards to out-of-state businesses with no physical presence in Washington, but who make wholesale sales into Washington. If these businesses have more than \$267,000 of receipts from this state, then economic nexus standards with Washington will apply and these businesses will be required to remit the wholesaling B&O tax at the rate of 0.484 percent.

#### 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.

#### 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.

#### 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.

#### Preferential B&O Tax Rate for International Investment Management Services.

A preferential B&O tax rate of 0.275 percent is provided for a business providing international investment management services if the firm meets two requirements:

1. It primarily provides investment management services; and
2. At least 10 percent of its gross income is derived from providing these services to either:
  - Persons or collective investment funds residing outside the United States; or
  - Persons or collective investment funds with at least 10 percent of their investments located outside the United States.

In 2010, the adoption of an economic nexus standard for service related income affected businesses that provide IIMS. Therefore, out-of-state businesses that have not physical presence in Washington may owe B&O on income derived from IIMS services provided to Washington residents. Conversely, instate businesses may apportion income out of Washington that was previously taxed, if the income is derived from IIMS services provided to out-of-state customers.

#### 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:**

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

The preferential rate of 0.275 percent for travel agents and tour operators is repealed. Travel agents and tour operators are subject to the service and other tax rate of 1.5 percent.

#### Preferential B&O Tax Rate for Resellers of Prescription Drugs.

The preferential tax rate of 0.138 percent for resellers of prescription drugs is eliminated. 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.

#### 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.

#### 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; or
- 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.

#### Preferential B&O Tax Rate for International Investment Management Services.

The preferential B&O tax rate of 0.275 percent is eliminated thereby imposing the general service rate of 1.5 percent on these services.

#### Deposit of Additional Tax Revenues.

The additional B&O revenues are deposited directly into the ELTA. Because many of the 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 February 23, 2016.

**Effective Date:** The bill takes effect July 1, 2016.