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**Finance Committee**

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**HB 2971**

**Brief Description:** Limiting tax preferences that have been the subject of administrative or judicial appeals.

**Sponsors:** Representatives Hunter and Conway; by request of Department of Revenue.

**Brief Summary of Bill**

- Eliminates the direct seller's representative (DSR) business and occupation (B&O) tax exemption on July 1, 2010.
- Retroactively narrows the DSR B&O tax exemption.
- Allows the first mortgage B&O deduction only for loans that are retained by the lender.
- Modifies the preferential B&O tax rate for manufacturing and wholesaling activities related to perishable meat products.
- Clarifies tax preferences for manufacturing and wholesaling activities related to fresh fruits and vegetables.

**Hearing Date:** 1/28/10

**Staff:** Jeffrey Mitchell (786-7139).

**Background:**

Direct Seller Business and Occupation Exemption.

A business and occupation (B&O) tax exemption is provided for certain out-of-state sellers that sell consumer products exclusively to or through a direct seller's representative (DSR). Broadly, a "DSR" is defined to mean a person who buys consumer products for resale in either the home or some other forum that does not constitute a permanent retail establishment. There is no explicit requirement in the statute that the seller make sales of only consumer products through the DSR nor an explicit requirement that prohibits downstream sales of consumer products from being sold at retail from a permanent retail establishment. Traditionally, the

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exemption has been used by out-of-state sellers engaged in sales of consumer products exclusively through in-home parties or door-to-door selling. A seller qualifying for the exemption does not owe B&O tax on wholesaling or retailing of the consumer products. (The representative owes B&O tax on the commission.) In *Dot Foods, Inc. v. Dep't of Revenue*, Docket No. 81022-2 (September 10, 2009), the Washington Supreme Court held that the exemption also applies to out-of-state businesses selling non-consumer products through its representative in addition to consumer products and to out-of-state businesses for consumer products ultimately sold at retail in permanent retail establishments. Many out-of-state businesses selling consumer products in this state could be eligible for the exemption under this expanded interpretation or could easily restructure their business operations to qualify for the exemption. The state has asked the Washington State Supreme Court to reconsider its decision.

#### First Mortgage Business and Occupation Deduction.

Washington law provides a deduction for financial institutions for interest earnings on loans secured by first mortgages or deeds of trust on residential properties. The Washington Supreme Court, in *Homestreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444 (2009), held that a mortgage lender was entitled to the deduction for the portion of interest it retained for servicing loans and mortgage-backed securities that it sold on a service-retained basis on the secondary market. Put differently, the *Homestreet* decision allows an originating lender that sells mortgage loans onto the secondary market but continues to service the loans to deduct service fees.

#### Preferential Tax Rate for Manufacturers of Products Derived from Certain Agricultural Products.

Washington law provides a preferential tax rate for the business of slaughtering, breaking, or processing of perishable meat products and the wholesaling of such perishable meat products. In *Agrilink Foods, Inc. v. Dep't of Revenue*, 153 Wn.2d 392 (2005), the Supreme Court held that the preferential B&O tax rate applies to the processing of perishable meat products into nonperishable finished products, such as canned food. There had been a question as to whether the finished product had to also be a perishable meat product.

A business and occupation tax exemption is provided for manufacturing by canning, preserving, freezing, processing, or dehydrating fresh fruits or vegetables, and selling such products at wholesale by the manufacturer to purchasers who transport the goods out of state in the ordinary course of business. This exemption expires July 1, 2012, and is replaced by a preferential B&O tax rate.

#### **Summary of Bill:**

##### Direct Seller Business and Occupation Exemption.

The direct seller's representative (DSR) business and occupation (B&O) tax exemption is eliminated beginning July 1, 2010.

A retroactive change is made to the DSR B&O exemption that narrows the exemption by requiring the DSR to have purchased only consumer products to qualify for the exemption. This retroactive change will prevent companies that might have otherwise qualified for the exemption, absent the changes made in this bill, from seeking a refund. The retroactive change will not impact the taxpayer that prevailed in the *Dot Foods* decision, if there is a final judgment, not subject to appeal, entered by a court before July 1, 2010.

First Mortgage Business and Occupation Deduction.

The first mortgage B&O deduction is limited to only interest received on loans secured by first mortgages or deeds of trust on residential properties. In other words, a lender selling loans onto the secondary market but continuing to service the loans for a fee would not be able to deduct the service fees.

Preferential Tax Rate for Manufacturers of Products Derived from Certain Agricultural Products.

The exemption for slaughtering, breaking, or processing perishable meat products or selling these perishable meat products at wholesale is modified by requiring that the end product be: a perishable meat product; a nonperishable meat product that is comprised primarily of animal carcass by weight or volume, other than a canned meat product; or a meat by-product.

The tax preference for fruit and vegetable manufacturers is modified by requiring that the end product be comprised either exclusively of fruits or vegetables, or any combination of fruits, vegetables, and certain other substances that, cumulatively, may not exceed the amount of fruits and vegetables contained in the product measured by weight or volume.

A number of conforming amendments are made to update statutory cross references that would become incorrect upon enactment of the bill.

**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date:** The bill takes effect July 1, 2010, except for sections 101, 102, and 403, which take effect immediately, and section 306, which takes effects effect July 1, 2011.