FINAL BILL REPORT
ESHB 2314

C 514 L 05

Synopsis as Enacted

Brief Description: Modifying revenue and taxation.

Sponsors: By House Committee on Finance (originally sponsored by Representative McIntire).

House Committee on Finance

Background:

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. The tax is imposed on the gross receipts from all business activities conducted within the state. Although there are several different rates, the most common rates are 0.471 percent for retailing, 0.484 percent for wholesaling, and 1.5 percent for service activity. Businesses that are involved in more than one kind of business activity are required to segregate their income and report under the appropriate tax classification based on the nature of the specific activity.

Retail Sales Tax. The retail sales tax applies to the selling price of tangible personal property and of certain services purchased at retail. The tax base includes goods and certain services, including charges made for the use of facilities to perform services such as cleaning. The tax is imposed at a 6.5 percent rate by the state. Cities and counties may impose a local tax at a rate up to a maximum of 3.1 percent; currently, local rates imposed range from 0.5 percent to 2.4 percent. Sales tax is paid by the purchaser and collected by the seller.

Use Tax. The use tax is imposed on items used in Washington that were not subject to the retail sales tax, and includes purchases made in other states and purchases from sellers who do not collect Washington sales tax. The state and local use tax rates are the same as those imposed under the retail sales tax. Use tax is paid directly to the Department of Revenue.

Extended Warranties. The sales tax applies to manufacturer's warranties that are included in the retail selling price of an article. The sales tax does not apply to any other sales of warranties.

Self-service Laundry Facilities. Coin-operated laundry facility services offered in apartment buildings for the exclusive use of tenants are exempt from retail sales and use taxes and are subject to the B&O tax service classification. However, stand-alone laundry establishments must collect and remit retail sales and use taxes and are subject to the B&O tax retailing classification.

Delivery Charges for Direct Mail. For B&O, retail sales, and use taxes, the amount of tax is based on statutory definitions that apply tax to the full amount paid by the customer, without any deduction for expenses paid by the seller such as the cost of materials used, labor costs, or delivery costs. Notwithstanding the statutory provisions requiring inclusion of delivery costs, the Department of Revenue (DOR) issued administrative rules more than 30 years ago that allowed printers and mailing bureaus to deduct the cost of postage when calculating B&O and retail sales taxes, if the postage is purchased for a customer and the customer is charged for the postage. Legislation enacted in 2002 caused the DOR to review its rules on printers and mailing bureaus. The DOR discovered that it lacked the statutory authority for the portions of the rules that allow printers and mailing bureaus to deduct postage when calculating B&O and retail sales taxes.

Taxpayers are entitled to rely on rules and other written advice of the DOR until the written rules or advice is modified by the DOR. In January 2005, the DOR issued new rules for printers and mailing bureaus, effective July 1, 2005. On and after that date, printers and mailing bureaus may not deduct postage when calculating taxes.

Liquor Liter Tax. The liquor liter tax is imposed at the rate of $2.4408 per liter on the sale of spirits in the original package. Revenues generated by the first $1.9608 per liter are deposited in the State General Fund. Revenues generated by $0.07 per liter are dedicated to youth violence prevention and drug enforcement. The remaining $0.41 per liter is deposited in the Health Services Account.

Nonprofit Boarding Homes. A licensed boarding home is a facility that provides board and domiciliary care to seven or more residents. Domiciliary care includes assistance with the activities of daily living and assumes general responsibility for the safety and well-being of the resident. Some boarding homes offer limited nursing services and others specialize in serving people with mental health problems, developmental disabilities, or dementia.

Licensed boarding homes providing room and domiciliary care to residents pay B&O taxes at a rate of 0.275 percent. Amounts received from the Department of Social and Health Services (DSHS) for adult residential care, enhanced adult residential care, or assisted living services for medicaid recipients are deducted from income before B&O taxes are determined.

Comprehensive Cancer Centers. Nonprofit cancer centers are exempt from property tax, but do not qualify for B&O tax exemptions or sales and use tax exemptions.

Nonprofit blood, bone, and tissue banks are exempt from property tax. Nonprofit blood, bone, and tissue banks are exempt from B&O tax to the extent the amounts received are exempt from federal income tax. The purchase and use of medical supplies, chemicals, or specialized materials by a nonprofit blood, bone, or tissue bank is exempt from sales and use tax.

In 1999, a question arose as to whether the Fred Hutchinson Cancer Research Center qualified as a blood, bone, or tissue bank for purposes of B&O, sales, and use tax exemptions. Litigation ensued. In 2003, the Thurston County Superior Court ruled that the Fred Hutchinson Cancer Research Center was not eligible for these exemptions. The court decision also invalidated the exemptions for bone and tissue banks, because the title of the original enactment of the exemptions was limited to blood banks. In 2004, the Legislature re-enacted the exemptions for bone and tissue banks.

Property Tax. Property taxes are levied by state and local governments. Property taxes apply to both real property, which includes land, buildings, and fixtures attached to buildings, and personal property, which includes all other property, including tangible and intangible property. With regard to personal property, household items and furnishings are exempt, as are business inventories, but other business personal property is subject to tax.

Property taxes are administered by the counties at the local level for most types of property. The county assessor determines assessed value for each property. The county assessor also calculates the tax rate necessary to raise the correct amount of property taxes for each taxing district. The property tax bill for an individual property is determined by multiplying the assessed value of the property by the tax rate for each taxing district in which the property is located.

Aerospace Industry Incentives.   In 2003, the Legislature enacted certain tax incentives provided to manufacturers of airplanes and airplane components. Eligible firms include subcontractors and suppliers that are manufacturers. Among the incentives enacted is a credit against the B&O tax for certain property taxes paid. The property tax payments that are eligible include:

- property taxes paid on new buildings and the land upon which the buildings are located, or on renovations or expansions to existing buildings, if the buildings are used in the manufacturing of commercial airplanes or their components; and
- property taxes paid on new machinery and equipment that is exempt from sales and use taxes under exemptions originally enacted in 1995 for manufacturers, if the property is used in manufacturing commercial airplanes or components of such airplanes.

Leasehold Excise Tax. The leasehold excise tax applies to interests in publicly owned real or personal property. The tax is "in lieu" of property taxes that would otherwise be paid on the property if the property were privately held. The tax is based on the amount of contract rent, which is the amount paid for the use of the public property. The state tax is imposed at a rate of 12.84 percent. Local governments may impose a tax of up to 6 percent. Local leasehold excise taxes are credited against the state tax.

The DOR has issued rules that provide that a taxable leasehold interest is established through both possession and use, and the lessee must have some identifiable dominion and control over a defined area to satisfy the possession element.

Amphitheaters.   The Clark County fairgrounds is the site of an outdoor amphitheater with seating for 18,000 persons for concerts and other events.   In 2002, the Clark County Commission approved a twenty year lease for the facility with Quincunx of Washington, a subsidiary of Q-Prime, a firm that manages a number of popular entertainers. Pursuant to the agreement, Quincunx built the amphitheater with its own funds. Upon completion of construction in July 2003, ownership and title to the amphitheater vested in the County. Under the lease terms, Quincunx is granted both the right of possession to the amphitheater and the use of parking areas as well, including non-exclusive easement to those areas. Payments made under the lease agreement are subject to state and local leasehold excise taxes.

Historic Automobile Museum. In August of 2002, the City of Tacoma provided for the use of eight acres of land adjacent to the Tacoma Dome for the purposes of constructing a historic car museum. The agreement was made with the Harold E. LeMay Museum nonprofit organization. The organization is seeking to begin construction of a museum in 2007 and to begin museum operations in 2008. Construction of the museum will be subject to retail sales and use taxes.

Nursing Home Maintenance Fee. Historically, state Medicaid programs have used a variety of mechanisms such as provider taxes, provider donations, and intergovernmental transfers to increase federal Medicaid revenues. The federal government has placed restrictions on these mechanisms in order to limit the extent to which states may use federal funds to cover the state share of Medicaid costs. These restrictions include requirements that provider taxes be broad-based, which means the tax must apply to all providers of the same class, regardless of whether the provider participates in Medicaid or not. Provider taxes must also be imposed at a uniform rate, and they may not include any direct or indirect "hold harmless" provision which guarantees repayment of the tax to all providers.

In 2003, the state levied a new tax of $6.50 per patient day of care on nursing homes. The tax applies to all patient days of care, except those paid by the federal Medicare program. The tax does not apply to nursing homes owned and operated by public agencies. It also does not apply to 36 private facilities the federal government agreed could be exempted from the tax without violating Medicaid federal rules.

The tax generates approximately $34 million per year of revenue for the State General Fund. Medicaid payment rates were increased in 2003 to cover the cost of the tax on patient days of care paid by the state Medicaid program. After accounting for the state share of that increased Medicaid payment, net state revenues from the tax total about $22 million per year.

Washington Main Street Program. Many communities may have traditional downtown business districts or neighborhood commercial districts that are in need of revitalization. In 2002, legislation was enacted that provides assistance to communities to revitalize downtown or neighborhood commercial districts. The legislation allows such districts to receive allocations of certain incremental local retail sales and use tax revenues attributable to economic growth to pay for revitalization costs. These allocations must be authorized by the legislative authority of the city or town in which the district is located.

The Department of Community Trade and Economic Development (DCTED) Downtown Revitalization Program (DRP) assists communities throughout the state to revitalize the economy, appearance and image of traditional business districts through training, technical assistance and the organization of local resources. Utilizing the Main Street methodology developed by the National Trust for Historic Preservation, the DRP emphasizes four critical areas of revitalization: organization, promotion, design and economic restructuring. Since July 1, 2003, 10 Washington communities have been certified as Main Street communities.

High Technology Research and Development B&O Tax Credit. The B&O tax allows a credit for certain operational research and development (R&D) expenditures in high-technology businesses. The credit is provided to businesses, including qualifying nonprofit organizations, that make R&D expenditures in excess of 0.92 percent of taxable income.

In the 2004 session, the Legislature modified the high technology R&D B&O tax credit. The amount of credit that may be taken is based on amounts spent on R&D in excess of 0.92 percent of a business' total taxable amount for the year. In addition, calculation of the credit by for-profit firms must be based on the average tax rate of the firm for the tax reporting period, rather than 1.5 percent, the requirement prior to the 2004 changes. The credit is equal to the average tax rate multiplied by the amount spent on R&D in excess of 0.92 percent of the business total taxable amount.

The 2004 changes to the high tech R&D B&O tax credit provided a definition of "average tax rate" based on a business' taxable income. However, for the purposes of the B&O tax, the measure of tax for some firms includes more than taxable income. For firms that manufacture products, the measure of tax is based on the value of the products manufactured. The manner in which "average tax rate" is defined means that the amount of credit that may be taken by firms that engage in manufacturing activities is higher than if the calculation were based on the entire measure of tax for B&O purposes.

As part of the 2004 changes, businesses that take the high tech B&O tax credit for R&D spending must submit an annual survey. The survey, which includes employment, wage, and other information, is in addition to an annual report that must be submitted with information relating to the credit calculation. Both the survey and report are due by March 31 of the year following the year the credits were taken. The amount of taxpayer credit reported on the survey may be disclosed to the public. If the survey is not completed by the due date, the business is not eligible for the credit. No exceptions are allowed for failure to file even if the failure was for reasons beyond the taxpayer's control.

Cigarette Taxes. Cigarettes are subject to tax at a rate of 142.5 cents per pack of 20 cigarettes. Retail sales and use taxes are also imposed on sales of cigarettes. Revenue from the first 23 cents of the cigarette tax goes to the State General Fund. The next 8 cents are dedicated to water quality improvement programs through June 30, 2021, and to the State General Fund thereafter. The next 101 cents goes to the Health Services Account. The remaining 10.5 cents are dedicated to the Violence Prevention and Drug Enforcement Account.

Student Achievement Fund. I-728 was approved by voters in the November 2000 general election. Under this initiative, a portion of the state property tax is dedicated for educational purposes by transferring revenues into the Student Achievement Fund. Under I-728, allowable uses of the Student Achievement Fund include: hiring more teachers to reduce class sizes and making necessary capital improvements; creating extended learning opportunities for students; providing professional development for educators; and providing early childhood programs.

The amount of state property taxes dedicated to the Student Achievement Fund is: $254 per full-time equivalent (FTE) student in the 2004-05 school year; $300 per FTE student in the 2005-06 school year; $375 per FTE student in the 2006-07 school year; and $450 per FTE student in the 2007-08 school year. In subsequent school years, the $450 per student amount increases by inflation measured by the implicit price deflator. The allocation rate to school districts from the Student Achievement Fund each year is equal to the per student amount of state property tax placed in the Student Achievement Fund.

Estate Tax. Transfers of property belonging to persons domiciled in Washington at the time of their death are subject to a state estate tax. On February 3, 2005, the Washington Supreme Court invalidated Washington's estate tax to the extent it exceeds the tax credit available under the federal estate tax.

In the 2005 session, legislation was enacted that imposes a Washington estate tax independent of the federal estate tax. The legislation includes provisions that allow a deduction of the value of property used primarily for farming. The deduction is available to estates where over 50 percent of the estate value is qualified farm property. In addition, at least 25 percent of the estate value must be real property that was managed as a farm by the decedent or a member of the family.

Summary:

Extended Warranties. Sales and use tax applies to the retail sale and use of all warranties. A warranty seller's B&O tax rate is changed from the 1.5 percent service rate to the 0.471 percent retailing rate.

Self-service Laundry Facilities. An exemption from sales and use taxes is provided for all self-service laundry facilities. The change also modifies the B&O tax classification for such facilities from retail to service, increasing the applicable B&O rate from 0.471 percent to 1.5 percent.

Delivery Charges for Direct Mail. B&O, retail sales, and use taxes do not apply to delivery charges made for direct mail if the charges are separately stated on the billing document given to the purchaser. "Direct mail" means printed material delivered to a mass audience or a mailing list provided by the purchaser without charge to the persons who receive the mail.

Liquor Liter Tax. An additional tax is imposed on liquor at the rate of $1.33 per liter excluding purchases by restaurants. The additional tax is distributed 97.5 percent to the State General Fund, 2.3 percent to the Health Services Account, and 0.2 percent to the Violence Reduction and Drug Enforcement Account.

Nonprofit Boarding Homes. Nonprofit boarding homes are exempt from B&O taxes on amounts received for providing room and domiciliary care. Eligible nonprofit boarding homes are those operated by religious or charitable organizations as part of a nonprofit hospital or public hospital district and exempt from federal income tax as 501(c)(3) organizations.

Comprehensive Cancer Centers. Comprehensive cancer centers are exempt from property tax. Comprehensive cancer centers are exempt from B&O tax to the extent the amounts received are exempt from federal income tax. The purchase and use of medical supplies, chemicals, or specialized materials by a comprehensive cancer center is exempt from sales and use tax. A comprehensive cancer center is defined as one that is recognized by the National Cancer Institute and qualifies as an exempt organization under the federal income tax code.

Aerospace Industry Incentives. The B&O credit allowed for certain property taxes paid by manufacturers of commercial airplanes and airplane components is modified. Property taxes paid with respect to newly acquired or constructed real property are eligible only if the building is used exclusively in the manufacturing of airplanes or airplane components. Property taxes paid with respect to newly acquired machinery and equipment are eligible to the extent that the manufacturer conducts aerospace manufacturing activity relative to other manufacturing activity.

Amphitheaters. An exemption from the leasehold excise tax is provided for leasehold interests in certain public or entertainment areas of an amphitheater. To qualify for the exemption, the following conditions must be met:

- the lessee is responsible for the entire cost of constructing the amphitheater;
- the lessee is not reimbursed for any of the construction costs;
- both the lessee and the lessor sponsor events at the facility on a regular basis;
- the lessee is responsible under the lease agreement to operate and maintain the facility;
- the amphitheater has a seating capacity of over 17,000 persons; and
- the amphitheater is located in a county with a population of between 350,000 and 400,000 persons.

Historic Automobile Museum. Beginning July 1, 2007, a deferral of sales and use taxes is allowed on the construction of structures, fixtures that become part of the structures, and site preparation for a historic automobile museum. The museum must be used to exhibit a collection of at least 500 vehicles. To receive the deferral, the governing board of the organization must be a nonprofit organization and must apply to the DOR. Applications and other information received by the DOR may be disclosed to the public.

Taxes must be repaid beginning in the fifth year after the museum is operationally complete. Ten percent of the tax liability is due each year then for 10 years. If the DOR finds the project to be ineligible during the deferral period or if the project is not operational after five years from when the deferral was issued, deferred taxes must be repaid with interest.

Nursing Home Quality Maintenance Fee. The quality maintenance fee is reduced to $5.25 for the 2005-07 biennium, $3.00 for the 2007-09 biennium and $1.50 for the 2009-11 biennium. After July 1, 2011, the fee is no longer imposed.

Washington Main Street Program. The Washington Main Street Program is created in the Department of Community, Trade, and Economic Development (DCTED), which will provide technical assistance to communities undertaking a comprehensive downtown or neighborhood commercial district revitalization initiative and management strategy. Financial assistance may be provided to communities for certain program costs. The DCTED will develop the criteria for selecting the recipients of assistance and will provide the designation of local projects. Priority for technical and financial assistance must be given to downtown or neighborhood revitalization programs located in a rural county. The DCTED may not provide assistance to cities with population of 190,000 or more.

The DCTED will operate the program in consultation with an advisory committee. In consultation with the committee, the DCTED must develop a plan that must describe the objectives and strategies of the Washington Main Street Program.

The program is funded through a new B&O tax credit. The B&O tax credit is available for 75 percent of the amount a business contributes directly to a local program or 50 percent of the amount contributed to the Main Street Trust Fund. In order to receive a credit, an application must be submitted to the DOR, which may not approve credits before January 1, 2006. Total credits may not exceed $100,000 per calendar year for an individual program or $250,000 per calendar year for a business, and may only be claimed against tax due in the calendar year following approval. The total amount of credits per year statewide is capped at $1.5 million per calendar year. Credit may not be approved for cities with population of 190,000 or more.

<u>High Technology Research and Development B&O Tax Credit.</u> For the purposes of calculating the high technology B&O tax credit for R&D spending, the average tax rate is defined to be based on a business' total annual taxable amount, including both taxable income and the value of the products manufactured. The changes to the high tech R&D B&O credit are retroactive to June 10, 2004. Persons who owe additional tax as a result of the changes are liable for interest, and, with respect to taxes paid after 2005, penalties.

Beginning in calendar year 2007, a person claiming the high tech R&D credit may calculate the credit based on the firm's average tax rate or a specified percentage, whichever is higher. The specified percentage is 0.75 percent in calendar year 2007; 1 percent in 2008; and 1.25 percent in 2009, and 1.5 percent in 2010 and thereafter.

A business claiming the high tech R&D credit must submit the survey for the high tech B&O tax credit electronically, unless cumulative tax relief to the taxpayer from taking any of tax incentives requiring surveys or reports is $1,000 or less. A business that fails to submit a survey as a result of circumstances beyond the control of the taxpayer may receive an extension to file of up to 30 days from the date that the DOR notifies the taxpayer of such extension.

In situations in which the amount of credit reported by a business on the survey is different than the amount reported by the business on its tax return or otherwise allowed by the DOR, the DOR is allowed to report the tax return amount for public disclosure purposes.

<u>Cigarette Tax</u>. The cigarette tax rate is increased by 60 cents per pack of 20 cigarettes on July 1, 2005, to a total tax rate of $2.025 per pack. A portion of the revenues from the new tax, representing existing losses in tax revenues reductions resulting from an expected reduction in overall taxable sales due to the expected increased price per pack, is deposited to existing accounts that receive cigarette tax receipts. The amounts deposited are as follows: 21.7

percent to the Health Services Account, 1.7 percent to the Water Quality Account, 2.3 percent to the Violence Prevention and Drug Enforcement Account, and 2.8 percent to the State General Fund. The net receipts from the new tax are deposited to a new account, the Education Legacy Trust account, for the sole purposes of making deposits into the Student Achievement Fund and for expanding access to higher education through funding for new enrollments and financial aid, and other educational improvement efforts.

Student Achievement Fund. The amount of state property taxes dedicated to the Student Achievement Fund is set at $254 per FTE student for school years 2004-2005 through 2007-2008, $265 per FTE student for school year 2008-2009, $277 for school year 2009-2010, and $278 per FTE student for school year 2010-2011 and thereafter.

Estate Tax. The estate tax deduction for farms is broadened to apply to the estates of some tenant farmers. This applies to estates that do not meet the requirement that at least 25 percent of the value of the estate is qualified farmland. An estate that does not meet the farmland requirement may still deduct the value of real and personal property used for farming purposes if the value of the personal property used for farming equals or exceeds 50 percent of the value of the estate.

Votes on Final Passage:

House	50	48
Senate	25	22

Effective: July 1, 2005
May 17, 2005 (Sections 110(5), 114-116, 1001, 1003, 1004, 1201, 1311 & 1312)
January 1, 2006 (Sections 501 & 1002)
July 1, 2006 (Sections 401-403 & 1107 [1106])
July 1, 2007 (Section 701)