

# HOUSE BILL REPORT

## ESSB 6143

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### As Passed House:

March 9, 2010

**Title:** An act relating to modifying excise tax laws to preserve funding for public schools, colleges, and universities, as well as other public systems essential for the safety, health, and security of all Washingtonians.

**Brief Description:** Modifying excise tax laws to preserve funding for public schools, colleges, and universities, as well as other public systems essential for the safety, health, and security of all Washingtonians.

**Sponsors:** Senate Committee on Ways & Means (originally sponsored by Senator Prentice).

### Brief History:

#### Committee Activity:

None.

#### Floor Activity:

Passed House: 3/9/10, 52-45.

### Brief Summary of Engrossed Substitute Bill

- Provides a statutory method for determining whether service businesses have substantial nexus for the purpose of imposing state business and occupation (B&O) taxes.
- Establishes a gross receipts, single-factor apportionment formula for allocating service and royalty income to Washington.
- Allows the Department of Revenue (DOR) to disregard certain transactions intended to disguise income, disguise the purchase or sale of property, or avoid use tax.
- Closes loopholes used to avoid use taxes and real estate excise taxes (REET).
- Places an annual cap of \$100 million on the first mortgage B&O tax deduction.
- Eliminates the nonresident sales tax exemption.
- Eliminates the direct seller's representative (DSR) B&O tax exemption on April 1, 2010.

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*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.*

- Retroactively narrows the DSR B&O tax exemption.
- 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.
- Suspends sales tax exemption for nutrient management equipment, facilities, and related services for beef cattle feeding operations between April 1, 2010 and July 1, 2015.
- Makes corporate board of directors fees subject to the B&O tax at the 1.5 percent tax rate.
- Replaces the current aircraft excise tax with a tax imposed on the fair market value of the aircraft.
- Narrows the use tax exemption for motor vehicles and trailers used in interstate commerce.
- Narrows the REET exemption for property transfers related to foreclosure sales.
- Expands the authority of the DOR to pursue individuals for certain sales taxes of limited liability business entities.
- Eliminates the B&O tax credit for new employment for international service activities.
- Extends state and local sales and use taxes to candy, bottled water, cosmetic medical services, and custom software services.
- Increases cigarette taxes by \$1 per pack.
- Increases taxes on other tobacco products such as cigars and moist snuff.
- Extends and modifies rural county tax incentive programs.
- Clarifies the definition of "gross revenue" for purposes of the public utility district privilege tax.
- Imposes a 0.5 percent B&O surtax for three years on certain services.
- Lowers B&O manufacturing rate on sterling engines used to convert solar heat into electricity.
- Exempts wax, ceramic materials, and labor related to creating investment castings.
- Extends tax incentives for aluminum industry to 2017.
- Extends reduced B&O tax rate for FAR part 125 aircraft repair facilities.
- Exempts metropolitan park districts and nonprofit organizations that operate publicly-owned accredited zoos from B&O tax.

- Defers the payment of state and local sales and use tax on the construction of a performing arts center located in a city with population between 115,000 and 150,000.

**Staff:** Rick Peterson (786-7150).

**Background:**

Business and Occupation Taxes.

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. Revenues are deposited in the State General Fund. There are several rate categories, and a business may be subject to more than one B&O tax rate, depending on the types of activities conducted.

Sales and Use Taxes.

Retail sales and use taxes are imposed by the state, most cities, and all counties. Retail sales taxes are imposed on retail sales of most articles of tangible personal property, digital products, and some services. The state sales tax rate is 6.5 percent. Local tax rates vary from 0.5 percent to 3 percent, depending on the location. The average local tax rate is 2.4 percent, for an average combined state and local tax rate of 8.5 percent.

The use tax applies to the acquisition of tangible personal property (TPP), digital products, and some services that were not subject to sales tax. The use tax statute is very specific as to which TPP acquisitions it applies to: any article of TPP purchased at retail, or TPP acquired by lease, gift, repossession, or bailment; or TPP extracted or produced by the person using the TPP. The tax is measured by the value of the item at the time of first use within the state. Use tax rates are equivalent to retail sales tax rates. The Department of Revenue (DOR) rules state that, "[a] transfer of capital assets to or by a business is deemed not taxable to the extent the transfer is accomplished through an adjustment of beneficial interest of the business."

Nexus.

Nexus is the level of connection with a state necessary under the U. S. Commerce Clause to permit a state to impose a tax or a sales tax collection duty on out-of-state businesses doing business in the state. A state tax is constitutional under the U. S. Commerce Clause if it is assessed against a taxpayer with whom the state has a substantial nexus, is fairly apportioned, is nondiscriminatory, and is fairly related to the services provided by the state. Of these requirements, the substantial nexus requirement is often the most difficult to determine. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Supreme Court (Court) held that

out-of-state businesses must have a "physical presence" in the state for there to be "substantial nexus" sufficient under the U. S. Commerce Clause to impose a sales tax collection duty. However, the Court was less clear in indicating whether the physical presence standard extends to other taxes. The proper nexus standard for state taxation of out-of-state businesses has been a contentious issue since the Quill decision. Numerous state courts have since affirmed economic presence standards, holding that a state may tax businesses with no physical presence within its borders.

Washington uses a physical presence standard to determine whether a business has nexus with Washington. A physical presence standard requires a business to own or use real or personal property in this state, employ employees in this state, or engage, directly or through an agent, in activities in this state significantly associated with the business' ability to establish or maintain a market for its products or services in this state. A few examples of nexus-creating activities include: soliciting sales in this state through employees or other representatives; installing or assembling goods in this state, either by employees or other representatives; maintaining a stock of goods in this state; renting or leasing TPP in this state; or making repairs or providing maintenance or service to property sold in this state.

#### Apportionment.

Generally, a business performing service-taxable activities inside and outside the state must apportion to Washington the gross income derived from Washington activities as determined by a separate accounting method. However, if a separate accounting is impractical or inaccurate, Washington law provides an apportionment formula based on the cost of doing business in Washington versus the cost of doing business everywhere. More specifically, the apportionment formula is a fraction. The numerator of the fraction is the cost of doing business in Washington, and the denominator is the total cost of doing business everywhere. A business' total income, earned inside and outside of Washington, is multiplied by the resulting fraction/percentage to determine the amount of service income subject to Washington's B&O tax. Under Washington law, only service-taxable activities are subject to the apportionment formula.

Financial institutions are subject to a different formula for apportionment. State law requires that the rules for financial institutions be consistent with uniform rules for apportionment developed throughout the nation. The DOR has issued a rule that provides a standard, three-factor formula for financial institutions. The apportionment percentage is the average of a receipts factor, payroll factor, and property factor. The financial institutions total gross income, earned inside and outside of Washington, is multiplied by the resulting percentage to determine the amount of income subject to Washington's B&O tax.

Royalty income is not apportioned in this state. Instead, royalties are allocated to the domicile of the business.

#### Tax Avoidance Transactions.

Courts and agencies apply a variety of tests to address tax avoidance under several related doctrines. (Because of their similarity, it can be difficult to distinguish between them.) In general, these doctrines were developed at the federal level, but many have been adopted by

states as well. These judicial doctrines have a basic theme: to invalidate a transaction that would achieve a result contradictory to the intent or basic structure of the tax code provisions at issue.

The following are examples of judicial doctrines commonly used to address tax avoidance:

*Economic Substance Doctrine.* The economic substance doctrine states that a transaction's tax benefits will not be allowed if the transaction does not have economic substance. This common law doctrine is an effort by the courts to enforce legislative intent in situations in which a literal reading of statutory code would allow a taxpayer to circumvent this intent. The doctrine is used frequently at the federal level to determine whether tax shelters or strategies used to reduce tax liability are considered "abusive" by the Internal Revenue Service.

*Sham Transaction Doctrine.* This doctrine looks for transactions where the economic activities giving rise to the tax benefits do not occur.

*Substance Over Form Doctrine.* This doctrine is based on the premise that if two transactions have the same economic result, they should have the same tax result. To achieve this similar tax result, it can be necessary to look at the substance of the transaction rather than the formal steps taken to implement it.

*Step Transaction Doctrine.* The step transaction doctrine treats a series of formally separate steps as a single transaction to determine what really was going on with the transaction.

*The Assignment of Income Doctrine.* Under this doctrine, a taxpayer is subject to tax on all income properly attributable to the taxpayer, regardless of whether the taxpayer actually receives the income and regardless of the taxpayer's accounting method.

*Business Purpose Doctrine.* Courts will invalidate a transaction for tax purposes under this doctrine when it appears that the taxpayer was not motivated by a business purpose other than to avoid tax or secure some tax benefit. This judicial inquiry largely is dependent on the taxpayer's intent.

Generally, Washington courts have not used the various doctrines described above, with the exception of the substance over form doctrine, to interpret tax statutes, but instead have relied on traditional methods of statutory construction that include: (1) looking to the plain language of a statute to determine whether the language is ambiguous; (2) giving words their common and ordinary meaning if the words are not ambiguous; (3) evaluating other evidence if language is determined to be ambiguous to ascertain legislative intent; and (4) construing tax exemptions, credits, and deductions narrowly.

#### Real Estate Excise Tax.

The sale of real estate is subject to the state real estate excise tax (REET). The tax is measured by the full selling price, including the amount of any liens, mortgages, or other debts multiplied by the rate of 1.28 percent. State law also authorizes several local REETs.

The REET also applies to transfers of controlling interests in entities that own property in the state. In order for the REET to apply to the sale of a controlling interest in an entity that owns real property, the following must have occurred: (1) the transfer or acquisition of the controlling interest occurred within a 12-month period; (2) the controlling interest was transferred in a single transaction or series of transactions by a single person or acquired by a single person or a group of persons acting in concert; (3) the entity has an interest in real property located in this state; (4) the transfer is not otherwise exempt from tax under state law; and (5) the transfer was made for valuable consideration. A program established in 2005 requires transfers of controlling interests in an entity that owns real property to be reported to the Office of the Secretary of State. Failure to report a transfer of a controlling interest to the Secretary of State can result in interest and penalties, including a 50 percent tax evasion penalty.

The REET is a legal obligation of the seller. Additionally, a statutory lien is placed on the property until the tax is paid. If REET is not properly paid, the DOR may enforce the obligation in an action of debt against the seller, enforce the lien in the same manner as a mortgage foreclosure, or some combination of the two. A buyer may also be liable for the REET unless the buyer notifies the DOR in writing within 30 days following the sale.

#### First Mortgage 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.

#### Nonresident Sales Tax Exemption.

Persons who reside in a state, possession, or Canadian province that imposes a sales tax of less than 3 percent are exempt from Washington retail sales tax on TPP purchased for use outside of Washington (i.e., the exemption does not apply to lodging or meals). Sales to residents of other states may also be exempt if their state of residence allows similar exemption for Washington residents; however, no state currently qualifies under this provision of reciprocity.

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

A 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 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.

#### Tax Preferences for Manufacturers of 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 B&O 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.

#### Sales and Use Tax Exemption for Livestock Nutrient Management Equipment and Facilities.

In 2001 the Legislature provided an exemption from sales and use taxes for dairy nutrient management equipment, facilities, and related services. To be eligible the person had to have a certified dairy nutrient management plan. In 2006 the sales and use tax exemption was broadened beyond dairy to other sectors of the livestock industry that had approved nutrient management plans. A sales and use tax exemption applies to the materials, machinery, equipment, and labor and services purchased or used in relation to the operation, repair, cleaning, alteration, or improvement of livestock nutrient management facilities and equipment. Livestock nutrient management facilities and equipment are machinery, equipment, and structures used in the handling and treatment of livestock manure, such as aerators, agitators, alley scrapers, and augers. The exemption includes repair and replacement parts. The exemption requires facilities and equipment to be used exclusively for activities necessary to maintain a livestock nutrient management plan.

#### Preferential Business and Occupation Tax Rate for Board of Director Income.

The wages of employees are exempt from the B&O tax. Members of corporate boards of directors receive fees for their services. Corporate directors are not employees of the corporation when they engage in their roles as corporate directors.

### Aircraft Excise Tax.

All aircraft must be registered for each calendar year in which it is operated within the state. An excise tax, collected by the Aviation Division of the state Department of Transportation, is imposed when an aircraft is first registered and the tax is subsequently paid annually during January of each year. The tax is a fixed charge that varies based on the type of aircraft. Annual charges range from \$20 to \$125. The tax is levied in lieu of the personal property tax. However, the law exempts several types of aircraft from the excise tax, which in turn subjects an aircraft to the personal property tax. Commercial aircraft principally used in interstate or foreign commerce are an example of aircraft exempt from the aircraft excise tax, but subject to the personal property tax. Ninety percent of the receipts from the tax are deposited in the State General Fund with the remainder going to the Aeronautics Account.

### Use Tax Exemption for Certain Motor Vehicles and Trailers Used in Interstate Commerce.

Motor vehicles and trailers owned or leased by a holder of a carrier permit issued by the interstate commerce commission are exempt from use tax. The exemption also applies to TPP and services related to the repairing, cleaning, or altering of the motor vehicles or trailers. To qualify for the use tax exemption the motor vehicle or trailer must be used "in substantial part" in the user's business. "In substantial part" is defined by rule to mean at least 25 percent.

### Foreclosure Exemption.

The REET does not apply to a non-judicial foreclosure sale of real property by a trustee under the terms of a deed of trust or a judicial foreclosure sale order by a court on any mortgage, lien, or deed of trust. This exemption applies regardless of whether the sale is to the lender or a third party.

### Tax Debts.

Upon the termination, dissolution, or abandonment of a corporate or other limited liability business, an officer, member, manager, or other person having control and supervision of retail sales tax funds is personally liable for unpaid sales tax if the person willfully fails to pay the tax. Furthermore, personal liability will only apply in situations where the DOR has determined that there is no reasonable means of collecting the retail sales tax funds directly from the business.

### Business and Occupation Tax Credit for New Employment for International Service Activities.

Firms engaged in certain international services are entitled to a B&O tax credit of \$3,000 for each new job a firm creates. Eligible activities are defined in the statute, which include services such as computer, legal, accounting, engineering, architectural, advertising, and financial services. To qualify the firm must be located in a community empowerment zone or in a city or group of contiguous cities with a population of at least 80,000.

### Sales and Use Tax Exemption for Food and Food Ingredients.



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 are therefore subject to sales and use tax. However, candy and bottled water are included within the definition and are therefore exempt from sales and use tax.

#### Taxes on Cigarettes and Other Tobacco Products.

Tobacco products are subject to various taxes, including state retail sales and use taxes and tobacco taxes that are paid by wholesalers or distributors of the products in the state.

Since July 1, 2009, all collected tobacco taxes have been deposited in the State General Fund, except for approximately 21 percent of cigarette taxes that are deposited in the Education Legacy Trust Account (\$83 million in 2009).

The cigarette tax is added directly to the price of cigarettes before the sales tax is applied. The cigarette tax is due from the first person who sells, uses, consumes, handles, possesses, or distributes the cigarettes in the state. The cigarette tax rate is \$0.10125 per cigarette (\$2.025 per pack of 20 cigarettes).

The taxpayer pays the cigarette tax by purchasing cigarette tax stamps that are placed on cigarette packs.

The tobacco products tax applies to all tobacco products, except cigarettes, which are taxed separately. Examples of tobacco products include cigars, pipe tobacco, snuff, and chewing tobacco. The tobacco products tax is due from the distributor when the distributor brings tobacco products into the state, manufactures tobacco products in the state, or ships tobacco products to retailers in the state.

The tobacco products tax rate is 75 percent of the wholesale price, but for cigars the tax is capped at 50 cents per cigar. Generally, the wholesale price is the actual purchase or selling price charged by the manufacturer or distributor. These tobacco products are not subject to any stamp requirement.

#### Rural County Tax Incentive Programs.

State law provides a state and local retail sales and use tax deferral program for the purchase of labor and materials used in the construction of new or remodeled buildings or equipment where the buildings or equipment will be used for manufacturing or research and development. (Since July 1, 1994, the repayment requirement has been waived as long as program requirements are maintained making the program an outright exemption.) For purposes of the deferral program, the definition of manufacturing, in addition to its regular definition relating to the production of a new, different, or useful substance or article of TPP, specifically includes computer programming, the production of computer software, and other

computer-related services. To qualify, a project must be located in a county with an average population density of no more than 100 persons per square mile or in a designated community empowerment zone. The sales and use tax deferral program is currently scheduled to expire on July 1, 2010.

State law provides a credit against B&O tax liability for gross income derived from manufacturing or research and development activities in rural counties or designated community empowerment zones. For purposes of the credit program, the definition of manufacturing, in addition to its regular definition relating to the production of a new, different, or useful substance or article of tangible personal property, specifically includes computer programming, the production of computer software, and other computer-related services. Rural counties are defined as those with an average population density of less than 100 persons. The amount of the credit is \$2,000 for each new job created, unless the new position is paid wages and benefits of more than \$40,000 annually, in which case the credit is \$4,000. To qualify, the firm must increase its total jobs in an eligible area by at least 15 percent. The total amount of credit is capped at \$7.5 million.

On January 29, 2010, the Thurston County Superior Court, in an oral ruling, partially granted a motion for summary judgment in a suit brought by Yahoo against the DOR. The Court found that Yahoo's data center in Quincy qualified for the rural county sales and use tax deferral program. The DOR's position has been that state law allows a deferral for computer-related services or programming only when those activities lead to a finished tangible product for sale or potential sale.

#### Public Utility District Privilege Tax.

Public Utility Districts (PUDs) were created to provide water and electricity, and to conserve water and power resources. Currently, there are 28 PUDs: 23 provide electricity services, 14 provide water or water and wastewater service, and 13 offer wholesale broadband telecommunications service. The powers of a PUD are executed by a board of three or five elected commissioners.

The PUDs that generate, transmit, or distribute electricity are subject to the PUD privilege tax. The tax is intended to be in lieu of property tax, since PUDs are governmental entities and do not pay property taxes.

The PUD privilege tax includes three separate tax bases: electricity that is distributed to PUD customers, electricity that is generated by PUDs at hydroelectric and other facilities, and electricity that is generated by thermonuclear facilities on federal lands, which applies specifically to the nuclear generation facility operated on the Hanford reservation by Energy Northwest. On electricity distributed to retail PUD customers, the tax rate is 2.14 percent of the gross revenue received from the retail sales. On electricity that is generated, the tax rate is equal to 5.35 percent of the first 0.4 cents of wholesale value of each kilowatt-hour of electricity. On electricity that is generated by the Energy Northwest's Columbia Generating Station at Hanford, the tax rate is 1.605 percent of the wholesale value of the electricity.

The PUD privilege tax is administered by the DOR. Tax receipts are shared with local governments and are distributed to local governments under a formula that recognizes where

electricity is sold and the location where generating facilities are located. In Fiscal Year 2008, \$23 million was distributed to local governments. The state received \$19 million.

The tax is based on the amount received from the sale of electricity. A recent lower court case has upheld the request for refund of tax by two PUDs that separate their kilowatt-hour charges from the charge to recoup the costs of providing service regardless of whether any electricity is used (e.g. meter reading, billing, and fixed facilities). These PUDs argue that tax should be paid only on the kilowatt-hour charge. It has been the DOR's interpretation that the tax applies to the entire amount received.

#### Business and Occupation Tax for Solar Energy Systems.

Preferential manufacturing B&O tax rates have been provided by the Legislature in recent years for aerospace, semiconductor microchips and materials, biodiesel fuel, aluminum smelting, solar energy systems, and timber/wood products.

In 2005 B&O tax rate reductions were provided for certain types of solar energy manufacturing. A B&O tax rate of 0.2904 percent is provided to businesses that manufacture or sell at wholesale: (1) solar energy systems using photovoltaic modules; or (2) solar grade silicon to be used in the components of a solar energy system. Taxes paid in manufacturing these systems are granted as a B&O tax credit.

In 2009 additional B&O tax rate reductions were provided. Beginning October 1, 2009, a preferential B&O tax rate of 0.275 percent is provided to businesses that manufacture or sell at wholesale either: (1) solar energy systems using photovoltaic modules; or (2) solar grade silicon, silicon solar wafers, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers to be used exclusively in the components of solar energy systems. This lower B&O tax rate expires on June 30, 2014.

#### Cost-Recovery Incentive Payment Program for Renewable Energy Systems.

In 2005 the Legislature created a Cost-recovery Incentive Payment Program to promote renewable energy systems that produce electricity from solar, wind, or anaerobic digesters. An individual, business, or local government purchasing an eligible system may apply for an incentive payment from the electric utility serving the applicant. The incentive provides at least 15 cents for each kilowatt-hour of energy produced, with extra incentives for solar generating systems or wind generating systems that use certain components manufactured in Washington. Payments are capped at \$5,000 annually per applicant.

A utility providing incentive payments is allowed a credit against its public utility tax (PUT) for incentives paid, limited to \$100,000 or 1 percent of its taxable power sales, whichever is greater. If the amount of requests for incentive payments exceeds the amount of funds available for PUT credit to the utility, the incentive payments to applicants must be reduced proportionally.

The Cost-recovery Incentive Payment Program expires June 30, 2020.

#### Community Solar Projects.

In 2009 the Legislature expanded the Cost-recovery Incentive Payment Program to include community solar projects. Community solar projects are defined as either: (1) a solar energy system owned by local individuals, households, or non-utility businesses that is placed on the property owned by their cooperating local government entity; or (2) a utility-owned solar energy system that is voluntarily funded by the utility's ratepayers where, in exchange for their financial support, the utility gives contributors a payment or credit on their utility bill for the value of the electricity produced by the project.

Community solar projects are eligible to receive incentives of 30 cents for each kilowatt-hour of energy produced, unless the amount of requests for incentive payments exceeds the amount authorized for credit to utility, in which case the incentive payments to applicants must be reduced proportionally. Payments to a community solar project are capped at \$5,000 annually per applicant.

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Incentive payments to participants in a utility-owned community solar project may only account for up to 25 percent of the total allowable credit.

#### Tax Relief for Aluminum Smelters.

In 2004 the aluminum manufacturing industry received a package of incentives designed to keep it operating during a period of high energy costs and falling aluminum prices. The incentives were scheduled to expire on January 1, 2007, but were renewed by the 2006 Legislature. Tax incentives for the aluminum industry are: a reduced business and occupation (B&O) rate from 0.484 percent to 0.2904 percent for manufacturers of aluminum; a B&O tax credit for the amount of property taxes paid on an aluminum smelter; a sales and use tax credit against the state portion of the tax for personal property, construction materials, and labor and services performed on buildings and property at an aluminum smelter; and an exemption from the brokered natural gas use tax on gas delivered through a pipeline. The exemptions provide about \$3.5 million per year of tax relief for the participants. The excise tax preferences expire January 1, 2012, and the B&O credit for property taxes ends with property taxes paid in calendar year 2011.

The Citizen Commission for Performance Measurement of Tax Preferences (Commission) was established by the 2006 Legislature (EHB 1069). The seven-member Commission is made up of five appointees: two appointed by the House of Representatives, two appointed by the Senate, one appointed by the Governor, and two non-voting members: the State Auditor and the Chair of the Joint Legislative Audit and Review Committee (JLARC). The Commission develops a schedule to review nearly all tax preferences at least once every 10 years. The Commission also schedules preferences with expiration dates for reviews two years before the tax preference expires.

Tax preference reviews are conducted by the JLARC according to the schedule established by the Commission. For each tax preference, the JLARC provides recommendations to continue, modify, schedule for future review, or terminate the preference. The Commission reviews and comments on the JLARC report.

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he aluminum tax incentives were reviewed in 2009. The JLARC recommended that the Legislature should extend the expiration date for the aluminum smelter tax preferences because the public policy goal of preserving family wage jobs is being maintained, and because the high energy prices that brought about the tax preference are higher and more volatile than when the incentives were originally enacted.

The Commission endorsed the recommendation to extend the expiration date, and further recommended that the Legislature should consider establishing a final expiration date. In addition, the Legislature should explore other alternative means of achieving family wage jobs in rural communities.

#### Federal Aviation Regulation part 145 Aircraft Repair Stations.

In 2003 the Legislature reduced the business and occupation (B&O) tax rate from 0.484 percent to 0.275 percent for firms that repair equipment used in interstate or foreign commerce. The exemption was limited to firms classified by the Federal Aviation Administration (FAA) as a Federal Aviation Regulation (FAR) part 145 certified repair stations with airframe and instrument ratings and limited ratings for nondestructive testing, radio, class three accessory, and specialized services. The lower rate was scheduled to end July 1, 2006. In 2006 the reduced B&O tax rate for FAA certified repair stations was extended to July 1, 2011, and the tax rate was changed from 0.275 percent to 0.2904 percent. In 2008 the lower B&O rate was extended to all repair stations that engage in the repair of equipment used in interstate or foreign commerce.

#### B&O Tax Reductions for Publically Owned Zoos and Aquariums.

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. Nonprofit organizations are generally subject to the B&O tax. However, nonprofit artistic and cultural organizations are not taxed on income from business activities and income received from governments.

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

##### Nexus.

For purposes of imposing the state B&O tax on service activities and the activity of receiving royalty income, a business or individual will have substantial nexus with the state if the individual or business meets one of the following requirements: (1) an individual is a resident or domiciled in the state; (2) a business entity is organized or commercially domiciled in this state; or (3) the individual or business is organized or domiciled outside the state but has more than \$50,000 of property in the state, more than \$50,000 of payroll in the state, more than \$500,000 of receipts from this state, or at least 25 percent of the individual's or business's total property, total payroll, or total receipts in this state. This nexus standard only applies to service activities and the activity of receiving royalty income. A business or individual with substantial nexus in any tax year is deemed to have substantial nexus with the state for the following four tax years.

Property counting toward the thresholds is the average value of the taxpayer's property owned or rented in the state during the tax year. Other than loans and credit card receivables, property is generally valued at its cost basis. Loans and credit card receivables are generally valued at their outstanding principal balance. Rented property is valued at eight times the annual rental rate, less any amounts received for subrentals. Receipts counting towards the thresholds are the amounts included in the numerator for purposes of apportioning income to the state as described below.

Payroll counting towards the thresholds is the total amount paid by the business for compensation in this state. Compensation is paid in this state if the compensation is reportable to this state for unemployment compensation tax purposes. The property, payroll, and receipts thresholds are adjusted annually for changes in the consumer price index (CPI) if the change in the CPI is 5 percent or more since the last adjustment. The DOR reviews the CPI every December, and an adjustment applies to any tax period that begins after the adjustment is made.

#### Apportionment.

Income derived from service activities and royalties is apportioned to Washington based on a receipts factor. The receipts factor is a fraction of which the numerator is the total gross income of the business attributable to this state for the activity and the denominator is the worldwide gross income of the business for the activity. The total worldwide gross income from the activity is multiplied by the receipts factor to determine the amount of income apportioned to Washington for purposes of the B&O tax. Apportionment using the receipts factor would replace the three-factor apportionment formula for financial institutions and the cost apportionment formula for other businesses providing services.

Except for financial institutions, gross income is attributable to this state based on the following series of hierarchical rules:

1. Income is attributable to this state if the customer received the benefit of the service in this state or used the business's intangible property in this state.
2. If the customer received the benefit of the service or used the intangible property in more than one state, income is attributable to the state where the service was primarily received or where the intangible property is primarily used.
3. If income cannot be attributed under the foregoing, then the income is attributable to the state where the customer ordered the service or where the royalty agreement was negotiated.
4. If income cannot be attributed under the foregoing, then the income is attributable to the state to which the billing statements or invoices are sent to the customer.
5. If income cannot be attributed under the foregoing, then the income is attributable to the state from which the customer sends payment to the business.
6. If income cannot be attributed under the foregoing, then the income is attributable to the state where the customer is located.
7. If income cannot be attributed under the foregoing, then the income is attributable to the state where the business is domiciled.

For financial institutions, gross income is attributable to this state as follows:

1. Interest, fees, and penalties on credit card receivables and net gains from the sale of credit card receivables, are attributable to this state if the billing address of the cardholder is in this state.
2. Interest, fees, and penalties on secured loans are attributable to this state if the property securing the loan is located within this state.
3. Interest, fees, and penalties on unsecured loans are attributable to this state if the borrower is located in the state.
4. Net gains on the sale of loans and loan servicing fees are attributable to this state in the same manner as provided in two or three for secured and unsecured loans.
5. Interest, dividends, net gains, and other income from investment assets and activities and from trading assets and activities are attributable to this state if the income is properly assigned to a regular place of business of the financial institution within this state. This would apply to income from investment securities, trading account assets, federal funds, futures contracts, forward contracts, swaps, and foreign currency transactions.

#### Tax Avoidance Transactions.

Unless otherwise specifically provided in statute, the DOR must respect the form of a transaction, except where the form is adopted for the purpose of: disguising income or otherwise avoiding tax on income; disguising the purchase or sale of property or services; or avoiding use tax on property used in the state by an entity organized outside the state.

The DOR must adopt rules, as resources allow, to assist taxpayers in determining when the form of a transaction will be disregarded. Rules adopted by the DOR must include examples. In adopting rules, the DOR may consider the following judicial doctrines: the sham transaction doctrine; the economic substance doctrine; the business purpose doctrine; the step transaction doctrine; and the assignment of income doctrine.

The DOR may not disregard any transaction, plan, or arrangement initiated before April 1, 2010, if the taxpayer reported its tax liability in conformance with specific written instructions by the DOR, a determination by the DOR, or any other document published by the DOR.

If a tax deficiency is deemed to be a result of a disregarded transaction, the DOR may assess a 35 percent penalty; however, the DOR may not assess the penalty if the taxpayer discloses its participation in the transaction before the DOR discovers it.

The tax avoidance provisions expire July 1, 2011.

#### Use Tax.

The statutory language describing how the acquisition TPP occurs (lease, gift, bailment, etc.) is eliminated. Therefore, the acquisition of TPP in any manner is subject to use tax unless some other provision specifically exempts the transaction.

#### Real Estate Excise Tax.

For the purpose of determining whether the sale of a controlling interest has occurred within a 12-month period, an option to purchase real estate is also included in the determination. The date the option agreement is executed is used as the relevant date.

The DOR may, at its option, enforce the collection of REET for the sale of a controlling interest in a business by pursuing the buyer of a controlling interest, seller of a controlling interest, or the business entity itself of which a controlling interest is transferred.

The law is clarified that a lien for payment of REET attaches to each parcel of property owned by an entity in which a controlling interest has been transferred.

A parent corporation of a wholly-owned subsidiary is responsible for REET if the subsidiary transfers real property to a third party and then dissolves before payment of the tax.

Buyers are no longer absolved from REET liability by simply providing notice of a real estate sale to the DOR.

#### First Mortgage Deduction.

An annual \$100 million cap is placed on the deduction. Therefore, a financial business may not deduct more than \$100 million in any calendar year for amounts derived from interest. Interest income is clarified to mean the portion of fees charged to borrowers, including points and origination fees, that are recognized over the life of the loan as an adjustment to yield using generally accepted accounting principles.

#### Nonresident Sales Tax Exemption.

The nonresident sales tax exemption is eliminated. The exemption for motor vehicles, boats and trailers to be licensed in another state is retained.

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

The direct sellers representatives (DSR) B&O tax exemption is eliminated beginning April 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 April 1, 2010.

#### Tax Preferences for Manufacturers of 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.

#### Sales and Use Tax Exemption for Livestock Nutrient Management Equipment and Facilities.

The sales and use tax exemption for livestock nutrient management equipment and facilities is suspended for three years.

#### Preferential Business and Occupation Tax Rate for Board of Director Income.

The fees paid to members of corporate boards of directors are explicitly subject to tax under the "service and other" classification at the 1.5 percent tax rate. Therefore, fees paid to members of corporate boards of directors would not be exempt under the exemption for wages and salaries for employees.

#### Aircraft Excise Tax.

Starting January 1, 2011, the existing aircraft excise tax, which imposes an annual fixed charge, is replaced with a tax assessed on the taxable value of the aircraft. The taxable value is the fair market value of the aircraft, which is the most recent purchase price of the aircraft depreciated based on a schedule prepared at least once a year by the DOR. The tax rate is 0.5 percent. The tax on aircraft manufactured before 1971 is capped at an amount equal to twice the tax under the current schedule. The tax applies to the same aircraft subject to the current aircraft excise tax and is imposed annually. All of the revenue from the tax is deposited into the State General Fund.

#### Use Tax Exemption for Certain Motor Vehicles and Trailers Used in Interstate Commerce.

The requirement that motor vehicles or trailers be used at least 25 percent of the time to qualify for the use tax exemption is changed to a 50 percent threshold.

#### Foreclosure REET Exemption.

The REET foreclosure exemption is limited to only transfers made to a beneficiary under a non-judicial trustee's sale or a mortgagee, lien holder, or beneficiary under a court-ordered sale. In other words, the sale of property to third parties would be subject to REET even if the sale is pursuant to a foreclosure sale. The beneficiary is responsible for payment of the REET.

#### Tax Debts.

When the DOR issues a tax warrant for unpaid tax from a limited liability business entity (i.e., corporation, limited liability company, limited liability partnership, etc.) that has been terminated, dissolved, abandoned, or is otherwise insolvent, the DOR may pursue the

collection of unpaid taxes from a responsible individual. A responsible individual means any current or former officer, manager, member, partner, or trustee of a limited liability business entity. Personal liability extends to unpaid state and local sales taxes. Personal liability for unpaid taxes extends to current or former chief executive officers or chief financial officers regardless of fault or whether the individual was or should have been aware of the unpaid tax liability. For other individuals, personal liability applies only if the individual willfully failed to pay the tax.

#### Business and Occupation Tax Credit for New Employment for International Service Activities.

The B&O tax credit for new employment for international service activities is repealed.

#### Sales Taxes on Certain Products and Services.

State and local sales and use taxes are extended to bottled water and candy by removing these items from the exemption for food and food ingredients. Exemptions are provided for bottled water dispensed by a prescription or for persons for which potable water is not readily available. The Department of Revenue is directed to develop an alternative definition of candy and petition the streamline sales and use tax agreement governing body for a change in the definition of candy.

State and local sales and use taxes are imposed on cosmetic medical services, and custom software services including the customization of prewritten computer software.

#### Cosmetic Medical Services.

Generally, "cosmetic medical service" means any medical procedure that is directed at improving the individual's appearance and that is not medically necessary to promote the proper function of the body or prevent or treat physical illness or disease. Examples of cosmetic medical services would include cosmetic surgery, hair transplants, cosmetic tissue fillers, laser hair removal, laser skin resurfacing, and chemical peels.

#### Custom Software Services and Customization of Prewritten Computer Software.

Generally, "custom software services" is the development of computer software for a specific person. "Customization of prewritten computer software" means any alteration, modification, or development of applications using or incorporating prewritten computer software for a specific person.

#### Taxes on Cigarettes and Other Tobacco Products.

Beginning April 1, 2010, the cigarette tax rate is increased from \$0.10125 to \$0.15125 per cigarette (from \$2.025 to \$3.025 per pack of 20 cigarettes). The additional cigarette taxes are deposited in the State General Fund. The amount of cigarette taxes deposited into the Education Legacy Trust Account is adjusted to 14 percent of the total cigarette tax to reflect its approximate share of the new total cigarette tax.

Beginning October 1, 2010, the tobacco products tax is increased from 75 percent to 95 percent of the taxable sales price, with some exceptions.

*Large Cigars.* The tobacco products tax rate on large cigars is the greater of 95 percent of the taxable sales price with a per cigar cap of \$0.65.

*Little Cigars.* The tobacco products tax rate on little cigars is a per cigar tax that is the same as the per cigarette tax.

*Moist Snuff.* The tobacco products tax rate on moist snuff is based on a single unit package. The tax rate is 20 times the per cigarette tax (\$3.025). For units larger than 1.2 ounces, the tax rate is increased proportionally based on the package size.

Beginning July 1, 2011, tobacco product distributors must begin providing the DOR information regarding their purchases of other tobacco products. This information may include product descriptions, brands, number of packages, purchase prices, and other information.

Within one year of the date that the federal government requires a tobacco code to track tobacco products, all individual packages must contain the code that would verify if taxes have been paid on the product. If the federal government does not implement a tobacco code by July 1, 2011, the DOR must, by July 1, 2014, recommend to the Legislature a method of determining whether tax has been paid on a product.

#### Rural County Tax Incentive Programs.

The Rural County Sales and Use Tax Exemption/Deferral Program (Program) is extended to July 1, 2020. Beginning July 1, 2010, the Program is changed to include only projects located in distressed counties and inside community empowerment zones.

For purposes of the Program and the rural county B&O tax credit, the following changes are made to the definitions of "manufacturing" and "research and development:"

- Until July 1, 2010, the definition of "manufacturing" is changed to include only computer programming, production of computer software, and other computer-related services that contribute to the production of a new, different, or useful substance or article of tangible personal property. Beginning July 1, 2010, activities related to computer programming, production of computer software, and other computer-related services are excluded from the definition of "manufacturing."
- The definition of "research and development" is modified to apply only to activities that are intended to ultimately result in the production of a new, different, or useful substance or article of TPP.

The changes are made retroactive, as well as prospective.

#### Public Utility District Privilege Tax.

The PUD privilege tax applies to all charges for sale of electricity including any recurring charges that are billed to consumers as a condition for receiving electricity.

#### Business and Occupation Surtax on Certain Services.

A temporary B&O surtax of 0.5 percent is imposed on the following service categories: accounting; legal; business support services; computer systems design; data processing; facilities support services; investment advice services; management, scientific, and technical consulting services; administrative management and general management services; human resources consulting services; marketing consulting services; process, physical distribution, and logistics consulting services; environmental consulting services; marketing research and public opinion polling services; office administrative services; parking lot management services; promotion services for performing arts, sporting, and similar events; public relations services; scientific research and development services including research and development in the physical, engineering, and life sciences; and other professional, scientific, and technical services. The surtax ends on June 30, 2013.

#### Incentives for Renewable Energy Systems Using Stirling Converters.

Businesses that manufacture stirling converters are eligible to receive a B&O tax rate of 0.275 percent. Individuals, businesses, or local governments that generate electricity from a stirling converter manufactured in Washington are eligible to receive an incentive payment for each kilowatt-hour produced. The incentive payment is 15 cents per kilowatt-hour multiplied by a factor of 2.4. A "stirling converter" is defined as a device that produces electricity by converting heat from a solar source using a stirling engine. The definition of "customer-generated electricity" is revised to clarify that the exclusion of electricity generated by utilities does not apply to utility-owned community solar projects. The definition of "solar inverter" is expanded to include any device that converts direct current (DC) into alternating current (AC) in a solar energy system.

#### Sales and Use Tax Exemption for Investment Castings.

A sales tax exemption is provided for wax and ceramic materials used to make molds for creating ferrous and nonferrous investment castings used in industrial applications. The exemption also applies to labor or services used to create wax patterns and ceramic shells for ferrous and nonferrous investment castings.

#### Tax Relief for Aluminum Smelters.

The aluminum tax incentives set to expire in 2012 are extended for five years. The following tax incentives are extended until January 1, 2017: the reduced B&O rate from 0.484 percent to 0.2904 percent for manufacturers of aluminum; the sales and use tax credit against the state portion of the tax for personal property, construction materials, and labor and services performed on buildings and property at an aluminum smelter; and the exemption from the brokered natural gas use tax on gas delivered through a pipeline. The B&O tax credit for the amount of property taxes paid on an aluminum smelter is extended through 2017 property taxes.

Reports on the effectiveness of the tax incentives by the fiscal committees of the House of Representatives and Senate are eliminated and replaced by the JLARC tax preference review process.

FAR part 145 Aircraft Repair Stations.

The expiration date for FAR part 145 certified repair stations is extended from July 1, 2011, to July 1, 2024.

B&O Tax Reductions for Publically Owned Zoos and Aquariums.

Metropolitan park districts and nonprofit organizations that operate publically-owned zoological facilities that are accredited by the Association of Zoos and Aquariums are exempt from the B&O tax on income received from business activities at the zoo. They are also exempt from tax on income received from governments to support zoological exhibitions, presentations, performances, and education programs.

The value of articles manufactured by a nonprofit organization or metropolitan park district operating a zoo for use in displaying or presenting zoological exhibitions, presentations, performances, or educational programs is exempt from the B&O tax.

Sales and Use Tax Deferral for Performing Arts Centers.

A state and local sales and use tax deferral is provided for the construction of a performing arts center. To be eligible, the facility must be owned and operated by a nonprofit organization, used primarily as a performing arts center with a seating capacity of at least 1,700, and located in a city with a population between 115,000 and 150,000 at the time construction of the facility is initiated.

To receive the deferral, the governing board of the organization must apply and include information about the facility's location, the expected or actual costs of the facility, the time schedules for completion, and other information required by the DOR. The DOR must rule on the application within 60 days. Applications must be submitted by December 31, 2012.

Sales and use taxes eligible for deferral are taxes imposed on: labor and materials related to the construction of the facility, acquisition and installation of fixtures, and site preparation. The deferral only applies to taxable activity occurring on or after July 1, 2011.

Sales and use taxes must be repaid beginning in the fifth year after the facility is operationally complete. Ten percent of the tax liability is due each year for 10 years. No interest is due on the deferral. The DOR may authorize an accelerated deferral at the request of the organization.

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**Appropriation:** None.

**Fiscal Note:** Requested 3/9/10.

**Effective Date:** The bill contains an emergency clause and takes effect April 1, 2010, except Part 1, relating to minimum nexus standards, Part 2, relating to tax avoidance transactions, and Part 3, relating to modifying and placing a cap on the first mortgage interest deduction which take effect July 1, 2010; section 902, relating to the aircraft excise tax, which takes effect January 1, 2011; sections 1701, 1702, and 1704 through 1708, relating to rural county tax incentives, which take effect July 1, 2010; sections 1709 and 1710, relating to tax preference accountability surveys, which take effect July 1, 2010 if the Legislature does not adopt SHB 1597 by July 1, 2010; and section 606 which reinstates prior law related to the expiration of the part 145 FAR aircraft repair station tax exemption and takes effect July 1, 2011.