

# SENATE BILL REPORT

## SB 6873

As of February 25, 2010

**Title:** An act relating to increasing state revenues to preserve funding for essential public services by preventing abusive tax avoidance transactions, narrowing or eliminating certain tax preferences, and providing equitable tax treatment.

**Brief Description:** Increasing state revenues to preserve funding for essential public services by preventing abusive tax avoidance transactions, narrowing or eliminating certain tax preferences, and providing equitable tax treatment.

**Sponsors:** Senators Murray, Kline, Kohl-Welles, Regala, Ranker, Keiser, Fairley, Oemig, Fraser and Jacobsen.

**Brief History:**

**Committee Activity:** Ways & Means: 2/24/10.

### Brief Summary of Bill

- Establishing minimum nexus standards;
- Limiting: tax avoidance methods, the first mortgage deduction to the first \$100 million in income, the B&O deduction for dues and fees, the bad debt deduction, community solar incentives, and the exemption for machinery used to create electricity from wind;
- Making the nonresident sales tax exemption into a refund program;
- Eliminating: the direct seller B&O exemption, and the tax preference for bullion, and the trade-in allowance;
- Clarifying: the B&O tax on manufacturing of certain agricultural products, the foreclosure exemption from REET, eligibility for the rural county programs, and gross revenue - PUD privilege tax clarification;
- Imposing B&O tax on corporate directors;
- Increasing the aircraft excise tax, and the urban transportation PUT rate to match the motor transportation PUT rate;
- Pursuing uncollected taxes: tax debts - corporate officer liability;

*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.*

- Repealing: the B&O tax job credit for international service activities, the preferential B&O rate for prescription drug resellers, the sales tax exemption for coal, and the B&O exemption for property management salaries;
- Modifying: the sales tax exemption for fertilizers, sprays, and other washes, and the brokered natural gas provisions; and
- Suspending the sales tax exemption for livestock nutrient equipment and facilities.

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## SENATE COMMITTEE ON WAYS & MEANS

**Staff:** Dean Carlson (786-7305)

**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. Revenues are deposited in the state General Fund. A business may have more than one B&O tax rate, depending on the types of activities conducted. There are a number of different rates. The main rates are 0.471 percent for retailing; 0.484 percent for manufacturing, wholesaling, and extracting; and 1.5 percent for professional and personal services, and activities not classified elsewhere.

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 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 Court held that out-of-state businesses must have a physical presence in the state for there to be substantial nexus sufficient under the 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.

The state of 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 tangible personal property 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 which 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 Department of Revenue (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.

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. Washington courts have not used the economic substance 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.

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. The sales tax is imposed by the state, counties, and cities on retail sales of most items of tangible personal property and some services, including construction and repair services. The state sales rate is 6.5 percent and the local rates vary by location. If retail sales taxes were not collected when the property or services were acquired by the user, then use taxes are applied to the value of most tangible personal property and some services when used in this state. Use tax rates are the same as retail sales tax rates. The combined state/local rate is between 7.0 and 9.5 percent, depending on location.

Persons who reside in a state, possession or Canadian province that imposes a sales tax of less than 3.0 percent are exempt from Washington retail sales tax on tangible personal property 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 B&O 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*, 166 Wn.2d 912 (2009), the Washington Supreme Court held that the exemption also applies to out-of-state businesses selling nonconsumer 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.

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.

Preferential B&O Tax Rate for Board of Director Income. The wages of employees is 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 general fund with the remainder going to the aeronautics account.

Foreclosure Real Estate Excise Tax Exemption. 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 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.

The real estate excise tax does not apply to a nonjudicial 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 - Corporate Officer Liability. Currently, business owners can be held personally liable for uncollected but unremitted sales tax only when a corporation or limited liability company goes out of business.

B&O 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.

Preferential B&O Rate for Resellers of Prescription Drugs. In 1998 the Legislature authorized a preferential B&O tax rate for resellers of prescription drugs that are registered with the Federal Drug Enforcement Administration and licensed by the State Board of Pharmacies. The lowered tax rate is 0.138 percent, compared with the 0.484 percent rate for wholesalers and 0.471 percent for retailers. Drug resellers typically purchase drugs from the manufacturer and sell them directly to a retailer or health care provider.

Rural Job Credit and Deferral Program. A credit against the state B&O tax is provided for manufacturing, research and development, or computer service firms that create new jobs in rural counties or community empowerment zones (CEZs).

Rural counties are defined as those with an average population density of less than 100 persons per square mile. Currently, of the state's 39 counties, only seven (Clark, King, Kitsap, Pierce, Snohomish, Spokane and Thurston) do not meet this definition. CEZs have been established in King, Kitsap, Pierce, and Spokane Counties.

The amount of the credit is \$2,000 for each new job created, unless the new position is paid wages (including benefits) of more than \$40,000 annually, in which case the credit is \$4,000. To qualify, a firm must increase its total employment in rural counties or community empowerment zones by at least 15 percent. The amount of credit is capped at \$7.5 million annually for all firms. The 15 percent job increase percentage is calculated by comparing employment in the four full calendar quarters after employees are hired to employment in the four full calendar quarters before employees were hired.

The Rural County Sales/Use Tax Deferral Program grants a deferral of sales/use tax for manufacturing, and computer-related businesses, research and development laboratories, and commercial testing facilities (excluding light and power businesses) locating in rural counties, CEZ, or a county containing a CEZ. The sales and/or use taxes on qualified construction and equipment costs for such businesses located in these specific geographic areas are waived when all program requirements have been met and verified.

Motor and Urban Classifications in the Public Utility Tax. The Public Utility Tax (PUT) is assessed on public service businesses, including businesses that engage in transportation, communications, and the supply of energy, natural gas, and water. The tax is in lieu of the B&O tax.

Under current law, the motor transportation classification imposes tax at a rate of 1.8 percent (1.926 percent including the surcharge). The urban transportation classification imposes tax at a rate of 0.6 percent (0.642 percent with the surcharge).

Motor and urban transportation include the operation of motor driven vehicles used in transporting persons or property on a for-hire basis. The urban classification applies when the origination and destination: (1) is within the same city; (2) extends no more than five miles beyond the same city; or (3) is between cities that are no more than five miles apart. Other for-hire transportation is reported under the motor classification.

The Sales Tax Exemption for Fertilizers, Sprays, and Other Washes. Sales of fertilizer, spray materials (including pesticides) and chemical sprays and washes for the post-harvest treatment of fruit are excluded from the definition of retail sale, if they are used in the commercial production of any agricultural commodity. The same statute exempts fertilizer and spray sold to landowners that participate in specified federal conservation and habitat protection programs or a cooperative habitat agreement with the Washington State Department of Fish and Wildlife.

B&O Deduction for Dues and Fees. B&O tax deduction is allowed for amounts received by a business for which no goods or services are received and only give the payee the right to be a member (aka bona fide initiation fees and dues).

B&O Deduction for Bad Debts. A credit or refund against current sales tax liability is allowed for retail sales taxes previously remitted to the state on debts that are deductible as worthless for federal income tax purposes.

Taxation of Brokered Natural Gas. Washington imposes a separate and distinct use tax on the use of natural gas or manufactured gas, referred to as the brokered natural gas (BNG) use tax. Cities may impose a local version of the BNG use tax. The purpose of BNG use taxes is to eliminate differential tax treatment for natural gas purchased from gas companies, which is subject to state and local utility taxes, and gas purchased directly from producers by large, commercial users, which is not subject to utility taxes. The BNG use tax rates are identical to state and local utility tax rates.

Community Solar Incentives. In 2009 the Legislature enacted ESSB 6170, which provided additional incentives for renewable energy systems cost recovery program, extending the cost-recovery incentive program for renewable energy systems to include community solar projects. As a result, community solar projects are now eligible to receive cost recovery incentive payments from participating light and power businesses at a base incentive rate of \$0.30 for each economic development kilowatt-hour of energy produced. Incentive payments for all other renewable energy systems remain at a base rate of \$0.15 for each economic development kilowatt-hour of energy produced.

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.

B&O Exemption for Property Management Salaries. B&O tax exemption is allowed for amounts received by a property management company, if the payments are received from a property management trust account for payment of wages and benefits to on-site personnel.

Tax Preferences for Bullion. Prior to 1985 sales of precious metal bullion and monetized bullion were subject to retail sales tax and state B&O tax. Retailers collected state sales tax, plus applicable local sales taxes, from purchasers while sellers were subject to B&O tax on the gross receipts of such transactions. However, in 1985 an exemption from the retail sales tax was created for the sale of precious metals and monetized bullion. The sellers of precious metals and monetized bullion are taxed at the 1.5 percent service rate on their commissions.

Precious metal bullion are metals refined or smelted into a form where the value is attributable to the content of the product rather than its form. Examples of metal bullion specified in the statute include gold, silver, platinum, rhodium, and palladium. Monetized bullion means coins and other metals used as a medium of exchange. The exemption does not apply to precious metal or monetized bullion that is used to produce jewelry or artwork, for which the value does depend upon the form of the product.

PUD 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 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 public utility districts are governmental entities and do not pay property taxes.

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 department's interpretation that the tax applies to the entire amount received.

Sales Tax Exemption for Coal. Purchases of coal used at a thermal electric generating facility placed in operation after 1969 and before July 1, 1997, are exempt from retail sales/use tax. The exemption is contingent upon owners of the plant demonstrating to the Department of Ecology that progress is being made to install the necessary air pollution



control devices and that the facility has emitted no more than 10,000 tons of sulfur dioxide during the previous 12 months.

Exemption for Machinery Used to Generate Electricity from Wind. Effective July 1, 2009, through June 30, 2013, purchases and installation of machinery and equipment that will be used directly in a facility that generates no more than ten kilowatts of electricity using solar energy are exempt from sales/use tax. In addition, purchases and installation of machinery and equipment used directly in generating electricity using fuel cells, sun, wind, biomass energy, tidal and wave energy, geothermal resources, anaerobic digestion, technology that converts otherwise lost energy from exhaust, or landfill gas in a facility that generates no less than one kilowatt of electricity are exempt from sales/use tax subject to the following: (1) from July 1, 2009, through June 30, 2011, the exemption is 100 percent of the sales or use tax paid; and (2) July 1, 2011, through June 30, 2013, the exemption is in the form of a refund from the DOR of 75 percent of sales or use tax paid.

Trade-In Sales Tax Exemption. The definition of selling price for purchases subject to retail sales tax may exclude the value of trade-ins. To qualify, the used items must be accepted by the vendor and be of like-kind.

**Summary of Bill:** Part 1: Economic Nexus and Apportionment. For purposes of imposing the 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.

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; and
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; and
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.

#### Part 2: Economic Substance and Tax Avoidance.

The economic substance doctrine is adopted. Accordingly, DOR may disregard abusive tax avoidance transactions for tax periods on or after January 1, 2006. An abusive tax avoidance

transaction is defined to mean a transaction, plan, or arrangement that lacks economic substance. A transaction is deemed to have economic substance only if: (1) the transaction changes the taxpayer's economic position in a meaningful way, apart from the transaction's tax effects; (2) the taxpayer has a substantial nontax purpose for entering into the transaction; and (3) the transaction is an objectively reasonable means of accomplishing the substantial nontax purpose.

DOR has the burden of establishing that a transaction does not have economic substance.

If DOR determines that a transaction lacks economic substance, DOR may take reasonable steps necessary to deny the tax benefit resulting from the abusive tax avoidance transaction. These steps may include: re-characterizing the nature of income; disregarding the form of a corporate or other business entity; treating a transaction according to its underlying economic substance rather than form; treating a series of formally separate steps as a single transaction; and imputing income to a taxpayer who provides services to a related person and the consideration does not reflect the fair market value of the service.

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

The statutory language describing how the acquisition of tangible personal property (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.

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.

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 DOR.

Part 3: First Mortgage Deduction. The first mortgage deduction is limited to \$100 million per year for each financial business. Also included is a prospective clarification that only the holders of the loan may take the deduction.

Part 4: Nonresident Tax Exemption in the Form of a Refund. The existing nonresident sales tax exemption at the point of sale is changed to an exemption in the form of a refund.

Applications for sales tax refunds would be made electronically once a one year. The minimum refund request is \$25. Applications for refund would be accepted between January 1 and December 31 of each year for purchases made within the preceding calendar year.

Part 5: Direct Seller B&O Exemption. The B&O exemption for firms that sell into Washington using direct seller's representatives is eliminated. For periods prior to April 1, 2010, the exemption is retriactively limited to consumer products.

Part 6: Preferential B&O Tax Rate for Manufacturing Certain Agricultural Products. The B&O preferential tax rate (0.138 percent) for meat processing to the manufacturing of perishable meat products, dehydrated, cured, or smoked meat products, and hides, tallow, and other meat by-products is expressly limited to those activities creating a final product which is at least 50 percent fruit and vegetables to qualify for the preferential tax rate.

The preferential rate 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.

Part 7: B&O Tax on Amounts Paid to Corporate Directors. 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. After July 1, 2010, fees paid to members of corporate boards of directors would not be exempt under the exemption for wages and salaries for employees.

Part 8: Aircraft Excise Tax. The existing aircraft excise tax is replaced with a tax of 0.5 percent of the depreciated value of the aircraft.

Part 9: Foreclosure Exemption from REET. The REET exemption for transfers made pursuant to foreclosure is narrowed. Sales of the property to a third party would be subject to tax. For sales involving judicial or nonjudicial foreclosure or enforcement of a judgment, the tax is imposed on the beneficiary of the deed of trust, mortgagee, or judgment creditor.

Part 10: Tax Debts - Corporate Officer Liability. DOR is allowed to pursue uncollected taxes of a terminated or insolvent limited liability business from the chief executive or chief financial officer, or other persons responsible for paying the taxes.

Part 11: The B&O Tax Job Credit for International Service Activities. The B&O tax credit for international service activities is repealed.

Part 12: Repealing the Preferential B&O Rate for Prescription Drug Resellers. The preferential B&O tax rate (0.138 percent) for resellers of prescription drugs is repealed

These firms will pay under the wholesaling (0.484 percent) or retailing (0.471 percent) classifications.

Part 13: Eligibility for the Rural County Programs. A business claiming the sales and use tax deferral under chapter 82.60 RCW and B&O credits under chapter 82.62 RCW in the Rural County Job Credit and Deferral Programs are eligible for the incentives for computer programming, but only when it is used to create a new item for sale.

Part 14: Increasing the Urban PUT to the Motor PUT Rate. The PUT rate for urban transportation is increased from 0.6 percent to 1.8 percent (same rate as Motor PUT).

Part 15: Modifying the Sales Tax Exemption for Fertilizers, Sprays, and Other Washes. The current sales tax exemption for fertilizers, sprays, and other washes used in the commercial production of any agricultural commodity is narrowed; only organic products used in commercial agriculture production are exempt.

Part 16: Limiting the B&O Deduction for Dues and Fees. The B&O tax deduction for dues and initiation fees is allowed certain nonprofit organizations exempt under certain federal income tax provisions in U.S.C. section 501(c).

Part 17: Limiting the Bad Debt Deduction. The deduction is expressly limited to the seller.

Part 18: Brokered Natural Gas. The brokered natural gas use tax is imposed at the location where the gas is burned by the taxpayer or stored in a facility of the taxpayer for later consumption. This change does not affect the state, but increases revenues to local governments imposing the tax.

Part 19: Limiting Community Solar Incentives. For community solar projects, the renewable cost recovery program is limited to those community solar projects generating no more than 100 kilowatts of electricity.

Part 20: Sales Tax Exemption for Livestock Nutrient Equipment and Facilities. The sales and use tax exemption for equipment and facilities used for handling livestock nutrients at dairies and livestock feeding operations is suspended for three years.

Part 21: Tax Preference for Bullion. The B&O tax treatment for the wholesaling or retailing of metal bullion or monetized bullion is changed from 1.5 percent of commissions to 0.484 percent (wholesaling) or 0.471 percent (retailing) of the selling price. The sales tax exemption for bullion is retained.

Part 22: PUD Privilege Tax. Gross revenue for purpose of the PUD privilege tax applies to all charges for electricity including recurring charges as a condition of receiving the electricity.

Part 23: Repealing the Sales Tax Exemption for Coal. The sales and use tax exemption for coal used at a coal-fired thermal electric generation facility is repealed.

Part 24: Eliminating the Trade-In Allowance. The sales tax exemption for the value of trade-ins is repealed.

Part 25: Machinery Used to Create Electricity from Wind. In order to qualify for the exemption for machinery and equipment used to create energy from wind, a producer must either be a local utility or someone contracting with a local utility for the sale of power.

Part 26: Repeal of B&O Exemption for Property Management Salaries. The B&O exemption for amounts received by a property management company from the owner of a property for gross wages and benefits paid to on-site personnel is repealed.

**Appropriation:** None.

**Fiscal Note:** Requested on February 24, 2010.  
[OFM requested ten-year cost projection pursuant to I-960.]

**Committee/Commission/Task Force Created:** No.

**Effective Date:** Various dates are provided, please refer to dates in Part 27 (Miscellaneous Provisions) of the bill.

**Staff Summary of Public Testimony:** PRO: Economic nexus will level the playing field for in-state businesses. Furthermore, the apportionment changes will encourage fairness. Businesses which set up structures for the sole purpose of avoiding taxes raises concerns. Tax avoidance changes interacts with economic nexus provisions of this bill to encourage businesses not to restructure in-state businesses out-of-state for the sole purpose of tax avoidance. The tax avoidance provision addresses the disappearing taxpayer scenario or the subsidiary set up out of state for the sole purpose of avoiding tax. This package is a better option than a sales tax increase. We are glad to see a proposal to raise revenue, but we would still like to see additional revenue to support programs for homecare programs and services. An all-cuts budget takes away necessary services. Corporations and businesses should pay their fair share. Looking at the public value of tax preferences is good public policy. State spending has a multiplier effect, as does private sector spending; thus, the 2009 reductions in state spending has impacted our economy. While increasing taxes may impact jobs, the factor is smaller than cutting state spending; raising revenue to support state programs saves jobs. Washington's tax structure is outdated, as it was developed in the 1930s. The tax base should be broadened. The federal government deregulated this industry in the 1980s; the Washington Legislature put in a use tax to address this. If the utility tax is paid, the use tax is not. The brokered natural gas change is equitable, and it is prospective. The use tax on brokered natural gas is constitutional, is fair by treating all consumers of natural gas the same, and reasserts the existing practice of local taxes on natural gas. This is good policy and also helps local governments, which are also struggling to fund essential government services, which is why this proposal fits under the title. The two-year budget contemplates \$4 billion in reductions to \$1 billion in new revenues; those reductions have hit some populations harder than others, such as children, the poor, the elderly, and the disabled. This proposal helps share the burden and some of us would support a tax increase. Despite the clean-up efforts, the coal plant in Centralia continues to pollute. The exemption for coal is in contrast with other pollution control and reduction efforts. The agreement with Trans Alta is

complicated, but was not contingent upon clean air standards. Revenues resulting from the repeal of the coal exemption should be redirected into related programs.

CON: Part 1: Economic Nexus and Apportionment. This proposal is overbroad and a significant change to Washington's tax system. This change would create a lack of certainty. This will create litigation costs to the state. This should be a study (economic nexus and apportionment). This is on a fast-track and should be slowed down for stakeholder work. We are concerned that the local governments will impose economic nexus, which will be impossible. This is a big change. Apportionment changes could help some in-state businesses in the high tech sector. The financial services industry would be impacted. This could make capital less available; this could impact economic recovery. This could make credit less available, and could hurt consumers and businesses. Community banks will also be impacted; they work with national banks. Out-of-state credit card companies will be impacted, and these costs will impact Washington consumers and businesses. This could also disincentivize securitizing loans. For the national banks, this will lead to pyramiding taxation on their affiliates as funds are transferred, per federal regulation. This could discourage small business lending. Economic nexus will increase Alaska Airline's costs.

Part 2: Tax Avoidance. This creates an unreasonable expansion of authority to DOR (Part 2 – Tax Avoidance). This takes the Legislature's authority away. These powers are not needed. DOR allowed this treatment for years, and these changes may be applied retroactively. Recharacterizing bank contracts by DOR is a concern. This change creates uncertainty for businesses; they will not know what their tax liability would be until an audit was over. There may be reasons why property is maintained and owned outside of Washington. There is authority under current law to pursue some of these schemes. This should be studied, rather than adopted outright.

Part 3: Mortgage Deduction. Any origination fees will now be treated differently. Residential mortgages are narrow-margin loans; this deduction encourages such mortgages. Servicing loans keeps banks, jobs, and connections to the customer in Washington.

Part 4: Nonresident Sales Tax Exemption. A lot of sales of yachts are for nonresidents, and this refund mechanism will drive sales out of Washington.

Part 5: Direct Sellers. There are direct sellers who qualified under the exemption as it was intended when it was enacted; narrow the preference to its intended beneficiaries. There is a high-turnover industry, and complicating these transactions is going to make this a lot more difficult for the direct sellers, many of whom are women making a supplemental income for themselves and families.

Part 6: Ag Products Manufacturing. We have concerns about the fiscal estimates; we believe the benefit to agricultural producers is small.

Part 7: Corporate fees. This will affect banks' actions to get qualified persons on the boards; banks are required to have boards.

Part 8: Aircraft Excise Tax. This could lead to aircraft being sold, because of the increased tax burden. We would like to work with the Legislature on other proposals, because restructuring the aircraft excise tax would harm this industry. There are many small airfields and airports that will be impacted, because the high-value aircraft will move out of state. Further, this increase will impact border areas in Washington, because it would be very easy to move aircraft to another state. The aviation industry has been hit hard; this proposal will hurt this sector's recovery. This industry supports family-wage jobs and has invested a lot in the sector. This restructuring is an excessive increase. There may be other approaches which make more sense.

Part 9: REET Foreclosure. This will disadvantage banks which have already lost revenue on foreclosed property.

Part 10: Corporate Officer Liability. We should not make corporate officers liable for unpaid excise taxes; this removes personal liability when a business fails which may be outside the control of corporate officers. This proposal is overbroad, because some corporate officers have no part of the financial operations. There is a distinct difference between the sales tax held in trust and other excise taxes. Businesses retaining sales taxes are stealing from the state; a business' excise tax liability is different.

Part 12: Prescription Drug. Prescription drug resellers operate on a low margin. The industry stayed in Washington and brought family wage jobs after the preferential rate was enacted.

Part 14: Urban PUT. The increase of the urban PUT would be a blow to the state's economy. The trucking industry has been impacted by the poor economy. This is not a loophole. This would do more harm than good. Cargo shipped through our ports is trucked to warehouses in the area. Washington ports are in competition with other ports in the U.S. and Canada. This will not only impact jobs on the waterfront, but jobs throughout the state, including farmers. Ports should be part of the solution; we are the most trade dependent state. We will lose business and cargo if this tax is increased, as have other ports in the U.S. This will affect exports as well, including agricultural products. This will fundamentally increase the cost of moving goods in Washington.

Part 15: Sprays and Fertilizers. We provide healthy food, jobs, and tax revenues. This will jeopardize our competitiveness. This is also a policy debate about organic inputs. Agricultural producers are price takers, not price makers; we have little control over inputs, markets, and prices. Eliminating these exemptions will affect businesses' viability. This is a cyclical industry; market forces could change quickly. The organics input regulation is very complicated, changing this exemption should be carefully considered before we make any changes. Agricultural producers have little control over growing conditions and the inputs related to these conditions; any inputs come out of the producer's bottom line.

Part 16: Dues and Fees. While club membership is discretionary, clubs do support jobs and revenue. This sector is already impacted, because membership is discretionary. An additional tax could be counterproductive. AAA services or community service programs are funded, in part, through these membership fees. DOR reviews this preference every four years (in its Tax Exemption Study) and has concluded that any savings are unlikely.

Part 18: BNG. Brokered natural gas use for local tax is going to cost the state money and is unconstitutional. Shifting the tax incidence from first use to consumption is going to complicate the taxing of brokered natural gas. Having different tax incidence for the same product is poor tax policy. Concern about whether this fits in the title.

Part 13: Rural County. This is currently in litigation, so any proposals should wait. Yahoo has invested in these areas and is entitled to the tax preferences.

Part 21: Bullion. Bullion is a small margin business, the markup is only 2 to 5 percent. These businesses will have to close, due to the tax increase proposed, and jobs and tax revenue will be lost. Bullion is recognized in Washington and under the federal IRS code as an investment. Bullion businesses are paying our fair share, similar to other investment professionals. We cannot pass this on to our customers, because bullion is for investment.

Part 22: PUD Privilege. This provision should be prospective only.

Part 23: Coal Exemption. Repealing the exemption for coal will impact jobs at Trans Alta. Washington will lose more than it gains from this repeal. The exemption was part of a bargain to clean up this industry's environmental impact, and to pull them back now is



unfair. Trans Alta has invested a large amount of money in the plant and pollution control devices, and supports jobs in the Centralia area. The Centralia area needs the family-wage jobs and revenues which Trans Alta brings. Trans Alta has a commitment to a cleaner Washington, and will continue to reduce emissions. Energy provision is essential, but often taken for granted.

Part 24: Trade-in. Trade-in exemption is important to the agricultural producer and rural communities. This would hurt boat sales and impact revenues. This will greatly increase the amount of tax the customer will pay and will increase debt. Vehicle sales are essential to economic recovery. Luxury tax proposals are a problem, when this is a consumer led recovery. Boat owners are already paying a vehicle excise tax and other taxes and fees; they are paying their fair share.

Part 25: Wind Energy Narrowing. This incentive should be retained to encourage wind generated electricity. Wind energy should not be treated any differently than other renewable energy generators in Washington. This is an economic investment in our state, creating jobs and revenues. Members of the environmental community support the current law and its encouragement of renewable generators. Other tax preferences should be narrowed or eliminated; this incentive should be retained.

Part 26: Property Management. This change will increase taxes and will lead to job cuts at property management companies, which is a low-margin business. In this marketplace, the commercial real estate market is very weak; property management is likewise affected. The cost of this increase will be passed on, either to property owners or by reducing jobs. We are not employment agencies, we are a pass through.

General. We should look to more cuts, not tax increases.

**Persons Testifying:** Contact committee staff for list of names. There were 14 pro; 60 con.