SENATE BILL REPORT
SB 6635

As of April 6, 2012

Title: An act relating to improving revenue and budget sustainability by repealing, modifying, or revising tax preferences.

Brief Description: Improving revenue and budget sustainability by repealing, modifying, or revising tax preferences.

Sponsors: Senators Murray and Kline.

Brief History:
Committee Activity: Ways & Means: 4/06/12.

SENATE COMMITTEE ON WAYS & MEANS

Staff: Dianne Criswell (786-7433)

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 1.8 percent for professional and personal services, interest earned on loans by financial institutions, and activities not classified elsewhere.

Citizen Commission for Performance Measurement of Tax Preferences. Legislation enacted in 2006 requires a periodic review of most excise and property tax preferences to determine if their continued existence or modification serves the public interest. The enabling legislation assigns specific roles in the review process to two different entities. The job of scheduling tax preferences, holding public hearings, and commenting on the reviews is assigned to the Citizen Commission for Performance Measurement of Tax Preferences (Commission). The responsibility for conducting the reviews is assigned to the staff of the Joint Legislative Audit and Review Committee (JLARC). The commission develops a schedule to accomplish a review by JLARC of each tax preference at least once every ten years.

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.

B&O Tax Deduction for First Mortgage Interest. A B&O tax deduction is available to financial institutions for interest earnings on loans secured by first mortgages or deeds of trust on residential properties. An originating lender that sells mortgage loans onto the secondary market, but continues to service the loans, may deduct the fees for servicing these loans.

B&O Tax Exemption for Manufacturers of Certain Agricultural Products. B&O tax exemptions are provided for manufacturing of fruits or vegetables, dairy, and seafood. These exemptions expire July 1, 2012, and are replaced by a preferential B&O tax rate of 0.138 percent.

Sales and Use Tax Exemption for Eligible Server Equipment. In 2010 ESSB 6789 provided a sales and use tax exemption for eligible server equipment and power infrastructure for eligible computer data centers. The exemption expires on April 1, 2018. In order to qualify a data center must:

- be located in a rural county;
- have at least 20,000 square feet dedicated to housing servers; and
- have commenced construction between April 1, 2010, and before July 1, 2011.

Additionally, within six years of construction a qualifying business must have created 35 family wage employment positions or three family wage jobs per 20,000 square feet of space.

Commencement of construction means the date that a building permit is issued under the building code for construction of a computer data center. Construction of a data center includes the expansion, renovation, or other improvements made to existing facilities, including leased or rented space.

Eligible server equipment is the original server equipment installed in an eligible data center after April 1, 2010, and replacement server equipment which replaces servers originally exempt under this law and is installed prior to April 1, 2018.

B&O Taxation of Newspapers. The printing and publishing of newspapers is subject to the B&O tax at a rate of 0.2904 percent. (The Legislature, in 2009, lowered the tax rate from 0.484 percent to 0.2904 percent, effective July 1, 2009.) The tax applies to the gross receipts of the business, including subscription sales, newsstand sales, advertising income, and other income. In recent years newspapers have begun to post materials from their hard-copy editions to the Internet. Until July 1, 2008, income derived from this activity did not constitute printing or publishing. Thus, advertising income received by newspapers for their web-based materials was subject to B&O tax under the service classification at a rate of 1.5 percent – currently the rate is 1.8 percent until July 1, 2013.

In 2008 the Legislature amended the definition of newspaper for B&O tax purposes to include any newspaper-labeled supplement and the Internet-based version of printed newspapers. As a result, income from publishing newspaper supplements and advertising income related to Internet-based newspaper material is subject to the 0.2904 percent printing and publishing newspaper tax rate, instead of the 1.8 percent service rate. However, the reduced tax rate was only applicable for a three-year period, from July 1, 2008, until June 30, 2011.

Sales Tax Exemption for Certain Phone Services. Under current law, an exemption from retail sales tax is allowed for local calls made by residential telephone customers, calls made from coin-operated payphones, and calls made from cell phones by a customer whose primary place of use is outside the state.

Leasehold Excise Tax. Government-owned property is exempt from property tax. However, private lessees of that property may be subject to a leasehold excise tax (LET), levied at 12.84 percent of the rent. Historically, pursuant to a 1979 determination by the state Department of Revenue (DOR), port districts have not been required to collect the LET from port tenants leasing wharf facilities on a non-exclusive, preferential use basis. Recently, DOR determined that preferential use leases provided substantial possession, use, and control of the property to these tenants. Thus, DOR concluded that these types of leasehold interests were subject to LET, since they provided substantial control of the property.

Summary of Bill: The bill as referred to committee not considered.

Summary of Bill (Proposed Substitute): B&O Tax Deduction for First Mortgage Interest. A financial business that is located in more than ten states may not deduct from B&O tax amounts derived from interest earnings on loans secured by first mortgages or deeds of trust on residential properties. The JLARC is directed to review the first mortgage deduction by June 30, 2015, as part of its tax preference review process.

B&O Tax Exemption Manufacturers of Certain Agricultural Products. The B&O tax exemptions for manufacturing of fruits or vegetables, dairy, and seafood are extended to July 1, 2017, and are then replaced by a preferential B&O tax rate of 0.138 percent.

Sales and Use Tax Exemption for Eligible Server Equipment. The time is extended for eligible data centers and qualifying tenants of data centers to qualify for the sales and use tax exemption on server equipment and power infrastructure, to those that commenced construction between April 1, 2012, and July 1, 2015. The exemption time is extended for eligible replacement server equipment placed in new data centers and for qualifying tenants until April 1, 2020. Qualifying businesses that are already using the exemption may still receive the exemption until 2018. The requirement that a lessee lease 20,000 square feet of space is eliminated. The definition of server equipment is modified for clarity and a definition for qualifying tenants is provided.

B&O Taxation of Newspapers. The definition of a newspaper is amended to permanently include the Internet version of printed newspapers and newspaper supplements. The effect of this is to tax advertising revenue from the online versions of newspapers and newspaper supplements at the same rate as the traditional newspaper. The B&O tax rate for printing and publishing a newspaper, or both, is increased from 0.2904 percent to 0.365 percent until June 30, 2013, and 0.35 percent thereafter.

Sales Tax Exemption for Certain Phone Services. The sales tax exemption for local calls made by residential telephone customers, calls made from coin-operated payphones, and calls made from cell phones by a customer whose primary place of use is outside the state is repealed. For services affected by this repeal that cover a billing period starting before and ending after the July 1, 2012, sales tax will apply to the first billing period starting on or after July 1, 2012.

<u>Leasehold Excise Tax.</u> Leasehold interests subject to LET do not include the preferential use of publicly-owned cargo cranes and docks and associated areas used in loading and discharging of cargo at a port district marine facility. Preferential use means use by a private party under a written agreement with the public owner in which the public owner or a third party maintains a right to use the property when it is not being used by the private party.

Appropriation: None.

Fiscal Note: Requested on April 4, 2012.
[OFM requested ten-year cost projection pursuant to I-960.]

Committee/Commission/Task Force Created: No.

Effective Date: The bill contains an emergency clause and takes effect on July 1, 2012, except for Part III (data centers) which takes effect immediately.

Staff Summary of Public Testimony on Proposed Substitute: PRO: <u>Part I (B&O Tax Deduction for First Mortgage Interest) and Part V (Sales Tax Exemption for Certain Phone Services).</u> The positive net revenue outweighs the negative impacts in this bill. Some tax preferences in this bill have expiration dates or require study or accountability; these measures should be applied to all tax preferences in this bill. There are a lot of people who never believed that they would need state assistance that are now relying on the safety net. Closing tax loopholes is a good way to fund necessary state services. <u>Part II (B&O Tax Exemption Manufacturers of Certain Agricultural Products).</u> Washington state fruit and vegetable processors are the third largest manufacturing employer in Washington. This exemption, including the exemption for out-of-state wholesales, has helped ameliorate the impact of the poor economy. The tax exemption has allowed us to retain more jobs, and, in some cases, increase jobs. Darigold is a unique organization, a cooperative of dairy farmers. Dairies are growing in Washington and need more investment. Washington, with its temperate climate, is a good location for dairies. As dairy farmers and manufacturers are looking to locate farms and facilities, this incentive is a chief consideration. Margins are thin in these types of manufacturing, but these activities create jobs and are good for communities. For purposes of this tax preference, wine is a fruit. Washington winemakers export throughout the world, and current economic times are challenging. The market for premium wines is very competitive and these incentives help Washington winemakers compete nationally and globally.
<u>Part III (Sales and Use Tax Exemption for Eligible Server Equipment).</u> The current data center sales tax exemption has been a successful tax incentive that has increased investments and employment. In the 18 month window, seven projects were approved. The extension of the data center incentive will reinvigorate construction and bring permanent jobs to these communities. This is responsible tax policy, with a proven track-record and an expiration date. There will be increased stales and B&O tax revenues in the near term and on-going increases from the property tax. The cloud computing trend is continuing, and we have lost data centers to Oregon after the first incentive construction window closed. This equipment will need to be replaced within the term of the exemption (expires in 2020), so there will be

on-going jobs, including jobs for electricians. Part VI (Leasehold Excise Tax). Washington is a trade dependent state. Washington benefits from being the closest major port to Asia. A lot of cargo in Washington's marine terminals is discretionary and, thus, could be routed through other ports in the United States, Canada, or even Central America. We have never collected LET on these leases until now. Collecting LET will increase costs, and may make Washington less competitive.

CON: Part I (B&O Tax Deduction for First Mortgage Interest). We appreciate that the PSSB 6635 reflects negotiated language. However, in 2010 we worked with the Legislature to make the economic nexus changes to the state tax code, which doubled the Washington tax burden for some financial institutions. That change, along with the temporary increase in the B&O service and other category, has been challenging. Adding to the tax liability by removing this deduction from financial institutions in more than ten states is problematic. With the other tax changes, Washington moves from one of the best states for banking to one of the worst. Policy makers should be concerned about the impact of this legislation on the handful of national banks which provide the majority of capital for Washington borrowers; the availability of loans could be impacted. Part V (Sales Tax Exemption for Certain Phone Services). This repeal will impact a class of service that is relied on by many seniors, low-income persons, and people in rural areas. This exemption makes a highly regulated telephone service more affordable. We are concerned that the revenue impact on the fiscal note is too high.

OTHER: All Parts. We appreciate the tax preferences extended or created by this proposal. However, we are concerned about Parts I and V of the bill, limiting or repealing tax preferences. This is a difficult economic period in which to increase taxes on businesses. This is a highly competitive market. Specifically, limiting the B&O tax deduction for first mortgage interest to financial institutions located in ten or fewer states creates a subcategory of an industry. This is not good tax policy. Tax preferences should be broad-based and industry-wide. Part V (Sales Tax Exemption for Certain Phone Services). During the November 2011 session, there was legislation introduced, but not enacted, that would have bifurcated this exemption. We have concerns about any proposal which would create two types of residential service, differentiated by technology. There are many small, Washington-based businesses in the telecommunication sector. Imposing another tax on these land-line based services is a burden on consumers. Instead of this proposed repeal, there should be a comprehensive look at the whole context of taxes and fees on telecommunications services.

Persons Testifying: PRO: Dave Myers, Washington State Building and Construction Trades Council; Rebecca Johnson, Washington State Labor Council; Nicole Grant, Certified Electrical Workers of Washington; Nick Federici, Rebuilding our Economic Future Coalition; Celeste Gazarek, National Frozen Foods Corporation; Steven Rowe, Darigold; Jean Leonard, Washington Wine Institute; Eric Johnson, Washington Public Ports Association.

CON: Denny Eliason, Washington Bankers Association; Tom Walker, Century Link.

OTHER: Amber Carter, Association of Washington Business; Ron Main, Broadband Cable Association of Washington; Betty Buckley, Washington Independent Telephone Association.