

HOUSE BILL REPORT

HB 2034

As Reported by House Committee On: Appropriations

Title: An act relating to funding K-12 basic education and higher education by narrowing or eliminating tax preferences.

Brief Description: Relating to funding K-12 basic education and higher education by narrowing or eliminating tax preferences.

Sponsors: Representatives Ormsby and Reykdal.

Brief History:

Committee Activity:

Appropriations: 6/5/13 [DPS].

Brief Summary of Substitute Bill

- Eliminates the preferential business and occupation (B&O) tax rate of 0.275 percent for travel agents and tour operators.
- Eliminates the preferential B&O tax rate of 0.138 percent for resellers of prescription drugs.
- Repeals the sales and use tax exemption for bottled water.
- Changes the nonresident sales and use tax exemption for tangible personal property into a remittance program.
- Narrows the high technology tax credit for research and development.
- Expires the high technology sales and use tax deferral program on July 1, 2013.
- Narrows the use tax exemption for extracted fuel produced by an extractor or manufacturer during the extracting or manufacturing activity.
- Provides new funding formula allocations to support increased instructional hours for secondary students, for the Transitional Bilingual Instruction Program, and increased staffing for counselors and family engagement coordinators.
- Specifies an implementation schedule for increased instructional hours under Basic Education.

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.

- Directs the State Board of Education to adopt a 24-credit graduation requirement framework to take effect with the graduating class of 2018.
- Appropriates \$168.6 million for K-12 and \$78.7 million for higher education.

HOUSE COMMITTEE ON APPROPRIATIONS

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 18 members: Representatives Hunter, Chair; Ormsby, Vice Chair; Carlyle, Cody, Dunshee, Green, Haigh, Hudgins, Hunt, Jinkins, Kagi, Maxwell, Morrell, Pedersen, Pettigrew, Seaquist, Springer and Sullivan.

Minority Report: Do not pass. Signed by 8 members: Representatives Alexander, Ranking Minority Member; Chandler, Assistant Ranking Minority Member; Buys, Dahlquist, Fagan, Haler, Schmick and Taylor.

Staff: Jessica Harrell (786-7349) and Jeffrey Mitchell (786-7139).

Background:

Sales and Use Tax.

Retail sales taxes are imposed on retail sales of most articles of tangible personal property, digital products, and some services. A retail sale is a sale to the final consumer or end user of the property, digital product, or service. If retail sales taxes were not collected when the user acquired the property, digital products, or services, then use taxes apply to the value of property, digital products, or services when used in this state. The state, most cities, and all counties levy retail sales and use taxes. The state sales and use tax rate is 6.5 percent. Local sales and use tax rates vary from 0.5 percent to 3.0 percent, depending on the location.

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. Businesses must pay the B&O tax even though they may not have any profits or may be operating at a loss. A business may have more than one B&O tax rate, depending on the types of activities conducted. Major tax rates are 0.471 percent for retailing; 0.484 percent for manufacturing, wholesaling, and extracting; and 1.8 percent for services, and activities not classified elsewhere. Several lower rates also apply to specific business activities.

Preferential B&O Tax Rates on Travel Agents, Tour Operators, and Resellers of Prescription Drugs.

Travel agents and tour operators have a preferential B&O tax rate of 0.275 percent on their gross income. Without this preference, travel agents and tour operators would be taxed under the general service and other rate at 1.8 percent.

Prior to court cases in the 1970s, travel agents paid B&O taxes on commissions earned from arranging intrastate travel only because of the court's interpretation of the United States

(U.S.) Commerce Clause. However, in 1970 the Washington Supreme Court upheld the constitutionality of taxing travel agents on commissions for interstate travel arrangements. Because of this, in 1975 the Department of Revenue (DOR) updated tax rules to reflect the court decision. This expanded the B&O tax base for travel agents, including interstate travel arrangement commissions. The Legislature adopted a preferential B&O rate for travel agents, which has since been expanded to allow tour operators to claim the preferential rate.

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

Nonresident Sales Tax Exemption.

A sales tax exemption is allowed to a resident of a state, possession, or Canadian province that does not impose a retail sales tax, use tax, value added tax, gross receipts tax, or similar generally applicable tax of 3 percent or more on purchases of goods for use outside the state. The exemption does not apply to items or services consumed in the state such as hotel stays or meals at restaurants. Retailers are not required to make tax exempt sales to qualifying nonresidents. A vendor may choose to collect sales tax on purchases made by qualifying nonresidents or to sell merchandise tax free.

Tax Credit for High Technology Research and Development.

Current law provides a B&O tax credit for qualified Research and Development (R&D) spending through July 1, 2015. To qualify, R&D must be conducted in the fields of:

- advanced computing;
- advanced materials;
- biotechnology;
- electronic device technology; or
- environmental technology.

The credit for each taxpayer may not exceed \$2 million or the amount of tax liability for the calendar year, whichever is less. Taxpayers taking the credit must submit an annual survey to the DOR.

High Technology Sales and Use Tax Deferral Program.

In order to qualify for the high technology R&D sales and use tax deferral/waiver, a business or nonprofit must invest in a new R&D facility or expand, renovate, or equip an existing facility.

Beneficiaries are required to submit an application to the DOR prior to beginning construction of a facility or acquiring machinery and equipment. As long as the facility or machinery and equipment continues to qualify for the intended purpose, the deferred sales and use taxes do not need to be repaid. Beneficiaries must submit an annual survey each year

and continue the qualified use of the facility for eight years. The deferral program expires July 1, 2015.

Use Tax Exemption for Extracted Fuel.

Fuel consumed by manufacturers or extractors is exempt from use tax when the fuel is used in the process of manufacturing or extracting at the same plant. The fuels for which the exemption generally applies are to wood by-products, also referred to as "hog fuel," and to refinery fuel gas.

A court decision made shortly before the Legislature created the preference in 1949 dealt with the taxability of a wood product manufacturer, the initial primary user of the exemption. There were no refineries operating in Washington when this preference was enacted in 1949. There are currently five active refineries in Washington.

Deposit of Sales and B&O Taxes.

Almost all revenues derived from sales and B&O taxes are deposited into the State General Fund. The Education Legacy Trust Account (ELTA) was created in 2005. Currently, the Washington estate tax is the sole source of revenue for the ELTA. Money in the ELTA can only be used for kindergarten through grade 12 (K-12) and higher education.

State Expenditure Limit.

First enacted in 1993 by Initiative 601, the state expenditure limit allows expenditure from the State General Fund to grow each fiscal year by the fiscal growth factor, which is the average annual growth in state personal income over the prior 10 fiscal years. Whenever the cost of any state program or function is shifted from the State General Fund or moneys are transferred from the State General Fund to another fund or account, the state expenditure limit must be lowered to reflect the shift or transfer.

State Debt Limit.

The state Constitution limits the issuance of state general obligation debt. The State Treasurer may not issue a general obligation bond if the amount of interest and principal payments in any year, along with debt payments for existing bonds, would exceed 9 percent of the average of the annual general state revenue collections for the previous six fiscal years. The constitutional debt limit is reduced over time from 9 percent to 8 percent by July 1, 2034. It is set at 8.5 percent starting July 1, 2014; 8.25 percent starting July 1, 2016; and 8 percent starting July 1, 2034. The definition of general state revenues includes the state property tax because it is deposited in the State General Fund.

Prototypical School Funding Formula.

The prototypical school funding formula provides the statutory framework for the state's allocation of funds to support the instructional program of Basic Education, including allocations for categorical programs such as the Transitional Bilingual Instruction Program (TBIP) and for materials, supplies and operating costs (MSOC). The formula includes allocations for various categories of staff based on an assumed school grade level and size, districtwide staff, and administration. For most categorical programs, the allocation is based on assumed hours of supplemental instruction per week.

The TBIP provides instructional support for students whose level of English language proficiency is determined to be sufficiently deficient to impair learning. Students exit the TBIP based on results from a statewide assessment administered each spring.

Phased-in Implementation of Basic Education Changes.

Legislation enacted in 2009 and 2010 provided for phased-in implementation of changes in both the Basic Education program and the funding to support it. A schedule for increasing the minimum instructional hours provided for students has not yet been adopted, although 2011 legislation declared that the increase may not occur before the 2014-15 school year.

Graduation Requirements.

The revised definition of Basic Education requires that school districts provide students with the opportunity to complete 24 credits for high school graduation, based on courses specified by the State Board of Education (SBE). The increase to 24 credits is also subject to an implementation schedule to be adopted by the Legislature.

Changes in graduation requirements proposed by the SBE must be submitted for legislative review before they are adopted. Changes that are found to have a fiscal impact on school districts take effect only if formally authorized and funded by the Legislature. In November 2010 the SBE adopted a resolution proposing a Career and College Ready framework for the 24 credits. In 2011 the SBE implemented changes from the proposed framework that had been identified as not having a fiscal impact, to take effect with the graduating class of 2016. The remaining changes have not yet been authorized or funded by the Legislature.

Summary of Substitute Bill:

Preferential B&O Tax Rate on Travel Agents, Tour Operators, and Resellers of Prescription Drugs.

The preferential rates for travel agents, tour operators, and resellers of prescription drugs are repealed. These businesses are subject to the service and other tax rate of 1.8 percent and qualify for the increased small business credit if at least 50 percent of their income is reported under the service and other classification.

Sales Taxes on Bottled Water.

State and local sales and use taxes are extended to bottled water by removing bottled water from the food and food ingredients sales tax exemption.

Exemptions are provided for bottled water dispensed by a prescription and for persons whose primary source of drinking water is unsafe. Generally, sales tax must be paid at the time of purchase of the bottled water. However, the person can seek a refund if the total amount paid in state and local sales taxes exceeds \$25.

Nonresident Sales Tax Exemption.

The nonresident sales tax exemption is converted to a remittance program. Out-of-state residents will owe sales tax initially, but may apply to the DOR for a remittance of

Washington sales taxes paid in the prior calendar year. The person may seek a remittance of both state and local sales tax. The amount of the remittance claim must exceed \$25.

Narrow the Tax Credit for High Technology Research and Development.

The legislation limits the availability of the high technology B&O tax credit to businesses with an annual gross income of \$10 million or less. Businesses that do not qualify for the credit in 2013 are not required to repay any credit claimed prior to the effective date of the change.

Repeal the High Technology Sales and Use Tax Deferral Program.

The high technology sales and use tax deferral program is terminated on July 1, 2013. The DOR may not issue any new deferral certificates after this date. It would grandfather in businesses already in the deferral program as long as current law requirements continue to be met.

Repeal the Use Tax Exemption for Extracted Fuel.

The legislation repeals the use tax exemption for fuel produced by an extractor or manufacturer when the fuel is directly used in the same extracting or manufacturing activity that produced the fuel; however, the exemption for biomass fuel is retained.

For refinery fuel gas, the value of the extracted fuel for purposes of use tax is based on the wellhead price, as published by the U.S. Energy Information Administration.

Deposit of Additional Tax Revenues.

New revenues in the bill cannot be directly tracked, therefore, these additional amounts are estimated twice a year by the DOR and transferred from the State General Fund to the ELTA.

State Expenditure Limit.

The transfers from the State General Fund to the ELTA are exempted from the requirement to lower the state expenditure limit.

State Debt Limit.

New tax revenues initially deposited in the State General Fund are explicitly excluded from the calculation of general state revenues for purposes of the state debt limit determination.

Prototypical School Funding Formula.

A new allocation is established to support increased instructional hours starting in the 2014-15 school year, based on students in grades 7 through 12 and using the general education class size, to be increased in equal annual increments until an allocation of 2.2222 hours per week is achieved in the 2017-18 school year.

A new TBIP allocation is established based on students who have exited the TBIP within the previous two years.

The staffing allocations for counselors in middle and high schools and family engagement coordinators in elementary schools are each increased by 0.167 full-time equivalent staff.

Implementation of Basic Education Changes.

School districts must provide a minimum of 1,000 instructional hours, districtwide, for students in each of grades 1 through 6 beginning in the 2017-18 school year. For students in each of grades 7 through 12, districts must increase instructional hours districtwide as follows:

- 1,020 hours in 2014-15;
- 1,040 hours in 2015-16;
- 1,060 hours in 2016-17; and
- 1,080 hours in 2017-18 and thereafter.

School districts must make a program of instructional support available for up to two years immediately after students exit the TBIP for those who need assistance in reaching grade-level performance in other academic subjects.

Graduation Requirements.

School districts must provide students the opportunity to complete 24 credits for high school graduation beginning with students in the graduating class of 2018. The SBE must adopt rules to implement the Career and College Ready framework that was adopted by resolution on November 10, 2010. The provisions of the bill constitute the legislative authorization required under current law to change graduation requirements.

Kindergarten-12 Appropriations.

A total of \$168.6 million is appropriated from the ELTA for the program of K-12 public education. The following allocations are provided for enhancing the prototypical school formula:

- \$13.0 million for the Transitional Bilingual program:
 - Bilingual instructional hours for the prototypical middle school is increased from 4.7780 to 5.1853.
 - Bilingual instructional hours for the prototypical high school is increased from 4.7780 to 5.8520.
 - Additional instructional hours totaling 1,000 hour per week is provided for students transitioning out of the program of Basic Education.
- \$24.6 million for counseling support staff:
 - Prototypical middle and high school guidance counselor allocations are increased by 0.167 full-time equivalents.
 - Parent engagement coordinators in the elementary school are added, increasing the formula by 0.167 full-time equivalent equivalents.
- \$23.1 million for full-day kindergarten:
 - Allocations for full-day kindergarten are increased from 48 percent of the kindergarten full-time equivalent students to 53 percent.
- \$48.2 million for MSOC:
 - Allocations for MSOC are increased from \$784.31 in school year 2013-14 and \$797.64 in school year 2014-15 to \$808.91 in school year 2013-14 and \$822.66 in school year 2014-15.
- \$24.1 million for increased instructional hours:
 - Twenty additional hours of instruction are provided for grades 7 through 12.

Higher Education Appropriations.

A total of \$78,700,000 is appropriated from the ELTA for higher education. This includes:

- \$5 million to the Student Achievement Council for the Opportunity Scholarship Program;
- \$9.72 million to the University of Washington to increase base funding;
- \$24.868 million to the University of Washington to expand computer science and engineering enrollments;
- \$5.007 million to the Washington State University to increase base funding;
- \$17.628 million to the Washington State University to expand computer science and engineering enrollments;
- \$1.351 million to the Eastern Washington University to increase base funding;
- \$2.018 million to the Central Washington University to increase base funding;
- \$752 thousand to The Evergreen State College to increase base funding;
- \$5.024 million to the Western Washington University to increase base funding;
- \$4.868 million to the Western Washington University to expand computer science and engineering enrollments; and
- \$2.5 million to the State Board of Community and Technical Colleges for the Student Achievement Initiative.

Substitute Bill Compared to Original Bill:

The original bill is a title only bill, which was completely replaced by the provisions described in the summary of the substitute.

Appropriation: The sum of \$247.3 million from the ELTA.

Fiscal Note: Not requested.

Effective Date of Substitute Bill: The bill contains an emergency clause and takes effect on July 1, 2013, except for sections 101, 103 through 109, 112, and 113 relating to tax preferences, which contain an emergency clause and take effect August 1, 2013; sections 209 through 214 relating to K-12 funding formulas, which contain an emergency clause and take effect September 1, 2013; and section 102 relating to B&O taxes, which takes effect July 1, 2015.

Staff Summary of Public Testimony:

(In support) Our state cannot meet its obligations to fully fund education without revenue. A responsible budget requires revenues and this bill is a step in the right direction. It is time the state matches an improving education policy with improving tax policy and closing loopholes for needed revenue to fund education. The state cannot move forward one piece at a time; the revenue bill will start to put the state on the right path towards funding education without cutting the safety net. The programs this bill is funding are not excessive. They are essential education programs the state is obligated to fund, and closing the tax loopholes that are excessive is a thoughtful way to get there. This is a simple choice: kids versus tax breaks. Eliminating seven out of 640 tax breaks is a great place to start. Funding class size reductions, increased instructional hours, etc., are all parts of Basic Education and require additional funding. The state needs more resources to prepare our children for a 21st century

economy. We would like to see the redefinition of Basic Education paid for and we think this bill begins to do that. The state's paramount duty to educate kids is more important than tax breaks. The tax exemption for extracted fuel was enacted before the first refinery was even in the state. Of the 45 other states that impose a use tax, 29 of them have refineries and only one of the 29 offers a similar use tax exemption. The \$40 million redirect to education is good public policy that outweighs any economic harm to refiners. This is a modest revenue proposal, which will maintain the safety net. By closing a few tax loopholes, we can make a down payment on *McCleary*. We applaud the investment in education, but are disappointed that it does not include the B&O expansion. The programs maintained in this bill are not excessive. This bill does a surgically good job of making tough Hobson's choices. The priorities evinced in this bill are in the right order. This bill responds to tough decisions with the right choices. The Superintendent of Public Instruction supports additional resources to ensure our students succeed and preserve our advantage in a global economy.

(Opposed) Repealing the R&D incentives will result in a loss of jobs. To attract high technology businesses, states need a financial strategy and a talent strategy. Eliminating the tax incentives for R&D will negatively impact the financial strategy Washington has in place. Washington is one of two states that imposes a sales tax on labor. Washington has 191,000 technology workers. The average wage in this industry is \$110,000. The sales tax deferral offsets added costs that allow high-tech businesses to concentrate on job growth. These jobs are easy to move to other states. Eliminating preferences for high-tech industries will drive these businesses out of state. Repealing or narrowing tax preferences before their expiration date is breaking a promise to the businesses that rely on the preferences as part of their business plan. Eliminating the tax exemption for extracted fuel is inconsistent with conversation and recycling efforts. It will encourage additional consumption of fossil fuels. The bill picks geographic winners and losers. Eliminating the extracted fuel exemption negatively impacts the economic job engine of Skagit and Whatcom counties. Refiners contribute significantly in taxes paid to schools. The Joint Legislative Audit & Review Committee (JLARC) report did not look at an accurate timeframe for the high-technology industry. The report should have also looked at jobs retained. It should be pointed out that JLARC's recommendation was to review and clarify. It is hard to prepare for a title only bill. It is really unfair to release a tax bill 30 minutes before the hearing. Eliminating these tax breaks will disrupt commerce and break promises. Having an authentic dialogue about the R&D tax breaks will not happen if this bill is passed. Expedia has over 2,000 employees. They are a major employer in our state. Eliminating the preferential tax rate for travel agents will have a negative impact on small businesses. Ninety-three percent of these businesses have fewer than 10 employees.

(Other) The B&O surtax has been taken off the table; however, we hope to continue to work on sound tax policy that does not pick winners and losers.

Persons Testifying: (In support) Loni Todd, Service Employees International Union 905; Shawn Lewis, Washington Education Association; Elizabeth Richer, League of Education Voters; Lonnie Johns-Brown, Washington State Association of Head Start and Early Childhood Education and Assistance Program; Sarah Francis, Moms Rising; Steve Leahy, Americas Edge; Ramona Hattendorf, Washington State Parent Teacher Association; Jen Estroff, Children's Alliance; Miguel Perez-Gibson, Climate Solutions; Dennis Eagle, Washington Federation of State Employees; Teresa Mosqueda, Washington State Labor

Council AFL-CIO; Sherry Burkey, Western Washington University; and Ken Kanikeberg, Office of the Superintendent of Public Instruction.

(Opposed) Lew McMurrin, Washington Technical Industry Association; Tom McBride, TechAmerica; Greg Hanon, Western States Petroleum Association; Vicki Christopherson, Washington Biotechnology and Biomedical Association; Brad Boswell, Washington Beverage Association; Amber Carter, Association of Washington Business; and Steve Gano, Expedia and Shell Oil.

(Other) Patrick Connor, National Federation of Independent Business.

Persons Signed In To Testify But Not Testifying: None.