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**Finance Committee**

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**HB 2796**

**Brief Description:** Investing in education by narrowing or eliminating certain tax preferences.

**Sponsors:** Representatives Carlyle, Hunter, Freeman, Walkinshaw, Ryu, Tarleton, Jinkins, Tharinger, Fey, Pollet, Ormsby, Van De Wege, Roberts, S. Hunt, Riccelli, Moscoso and Farrell.

**Brief Summary of Bill**

- Eliminates the preferential business and occupation tax rate 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 use tax exemption for extracted fuel produced by an extractor or manufacturer during the extracting or manufacturing activity.

**Hearing Date:** 2/28/14

**Staff:** Jeff 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.

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*This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.*

### 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 1.5 percent for services, and activities not classified elsewhere. Several lower rates also apply to specific business activities.

### Preferential B&O Tax Rates for Resellers of Prescription Drugs.

A preferential B&O tax rate of 0.138 percent is provided to persons that warehouse and resell prescription drugs to retailers, hospitals, clinics, health care providers, or other providers of health care services. This tax preference was enacted to help Washington wholesalers that compete with out-of-state firms that are not subject to B&O tax due to a lack of sufficient nexus with the state. The state was unable to restrict the preferential rate only to companies with in-state warehouses. Therefore, out-of-state wholesalers with nexus in Washington also qualify for the preferential B&O tax rate. Without the preferential B&O tax rate, these businesses would pay the wholesaling B&O tax rate of 0.484 percent.

### 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 for 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.

### 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.

### 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 K-12 and higher education.

State Expenditure Limit.

First enacted in 1993 by Initiative 601, the state expenditure limit allows expenditures 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 ten 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 9.0 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 9.0 percent to 8.0 percent by July 1, 2034. It is set at 8.5 percent starting July 1, 2014; 8.25 percent starting July 1, 2016; and 8.0 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.

**Summary of Bill:**

Preferential B&O Tax Rate for Resellers of Prescription Drugs.

The preferential B&O tax rate for resellers of prescription drugs is repealed. Prescription drug resellers would pay the general wholesaling rate of 0.484 percent.

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.

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.

The additional taxes from repealing the extracted fuel tax exemption and eliminating the preferential B&O tax rate for resellers of prescription drugs are deposited directly into the ELTA. Because other new tax revenues in the bill cannot be directly tracked, 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.

**Appropriation:** None.

**Fiscal Note:** Requested on 2/26/14.

**Effective Date:** The bill contains an emergency clause and takes effect on June 1, 2014.