

HOUSE BILL REPORT

ESSB 5882

As Passed House:
June 28, 2013

Title: An act relating to creating, expanding, or extending tax preferences.

Brief Description: Creating, expanding, or extending tax preferences.

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

Brief History:

Committee Activity:

None.

Second Special Session

Floor Activity:

Passed House: 6/28/13, 66-25.

Brief Summary of Engrossed Substitute Bill

- Provides a business and occupation (B&O) tax exemption for amounts received by a business that provides payroll and related human resource services to an affiliated company.
- Provides a temporary B&O tax exemption for the sale of dairy products to purchasers who use the dairy product as an ingredient in the manufacturing of another dairy product.
- Provides a temporary sales and use tax exemption for honey bee food sold to honey beekeepers and extends the expiration date for the honey bee B&O exemptions for wholesale sales of honey bee products and pollination services.
- Provides a temporary sales and use tax exemption for clay targets purchased for use in clay target shooting at nonprofit gun clubs.
- Provides a temporary sales and use tax exemption for products that impart flavor during the cooking process for restaurants.
- Provides a temporary B&O exemption for amounts received by a cooperative finance organization from rural electric cooperatives or other nonprofit or governmental providers of utility services.

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.

- Provides a temporary sales and use tax exemption for standard financial information sold to a qualifying international investment management company.
- Provides a temporary sales and use tax exemption for cover charges at establishments that provide an opportunity to dance.
- Extends the expiration date for the preferential B&O tax rate for manufacturers and wholesalers of specific parts of solar energy systems.
- Extends the sales and use tax exemption for hog fuel.
- Provides a temporary sales and use tax exemption for labor and services for repairing, cleaning, altering, or improving large private aircraft owned by a nonresident.
- Provides a temporary B&O exemption for qualifying blood banks and expands the definition of a qualifying blood bank to include testing or processing of blood.
- Provides a temporary sales and use tax exemption for the purchase of propane or natural gas used to distill mint oil on a farm.
- Provides a use tax exemption for any article of personal property, valued at \$10,000 or less, purchased or received as a prize from a nonprofit organization or library as a fundraising activity.
- Extends the sales and use tax exemption for machinery and equipment used in facilities that generate electricity from renewable energy.
- Extends the sales and use tax exemption for machinery and equipment used to generate 10 kilowatts of electricity or less from solar energy systems.
- Requires intent language, expiration dates, and a tax preference performance statement for new tax preferences.
- Requires taxpayers to report the amount of tax preference to the Department of Revenue (DOR) for new tax preferences.
- Requires a task force, by January 1, 2014, to provide recommendations to the legislature on appropriate metrics that can be included in a tax preference performance statement.
- Requires DOR and Joint Legislative Audit and Review Committee to make recommendations, by December 1, 2013, to the Legislature on ways to improve the annual tax incentive reports and surveys.

Staff: Dominique Meyers (786-7150).

Background:

Part I: Pursuant to Washington Administrative Code (WAC) 458-20-111, an exclusion is allowed from the measure of tax amounts representing money or credits received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of the taxpayer's business or profession. The rule states that the words advance and reimbursement apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability, either primarily or secondarily, other than as agent for the customer or client.

Part II: Until July 1, 2015, a business and occupation (B&O) tax exemption is provided for dairy product manufacturing and for wholesale sales to purchasers who transport the goods outside of the state in the ordinary course of business. When the B&O tax exemption expires on July 1, 2015, dairy products will again be subject to a B&O tax rate of 0.138 percent.

Part III: In 2008 due to concerns over the occurrences of colony collapse disorder, the Legislature enacted the following exemptions relating to honey beekeepers:

- the income received from the wholesale sale of honeybee products by those individuals who do not otherwise qualify as farmers is exempt from the B&O tax;
- the income received from pollination services to a farmer by an eligible beekeeper is exempt from the B&O tax; and
- the sale of bees to an eligible apiarist is exempt from the sales and use tax.

The exemptions established in 2008 expire July 1, 2013.

Part IV: A retail sale is a sale to the final consumer or end user of the property, digital product, or service. Tangible personal property that is consumed by a business in order to provide a service is subject to the retail sales tax.

Part V: The sales and use tax does not apply to sales of food and food ingredients that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. This does not include alcohol, tobacco, prepared food, soft drinks, or dietary supplements. However, a meal purchased at a restaurant is a retail sale. Restaurants are exempt from paying sales tax on the food they purchase for resale. These purchases are exempt in statute as an ingredient of the final product sold to customers at retail. Items purchased by restaurants to aid in the cooking process and impart flavor to food are not defined as an ingredient of the final product sold; therefore, restaurants must pay sales tax on these items.

Part VI: The B&O tax is imposed on the gross receipts, income, or sales of a business operating in Washington. The tax rate varies depending on the classification of the business activity.

Rural electric cooperatives and mutual electric utilities are nonprofit, member-owned electric utilities that provide retail electric service to their members. Electric cooperatives and mutuals in Washington are entitled to the same federal preference power as municipal utilities and public utility districts.

The National Rural Utilities Cooperative Finance Corporation (CFC) was incorporated in 1969 as a member-owned, nonprofit, cooperative financing organization. It raises and loans

funds to supplement the loan programs for electric cooperatives and mutuals offered by the federal Rural Utilities Service. According to the CFC, its outstanding loans and guarantees totaled \$20.2 billion as of May 31, 2012, for all cooperatives nationwide. And according to the Washington Rural Electric Cooperative Association, electric cooperatives in Washington have approximately \$160 million in outstanding loans with the CFC as of May 31, 2012.

Part VII: In 2007 the Legislature directed the Department of Revenue (DOR) to conduct a study of the taxation of electronically delivered products and to prepare a final report for the Legislature by September 1, 2008. The legislation required the DOR to conduct the study in consultation with a committee consisting of four legislative members, as well as additional members representing the industry and government. The report's conclusion stated that legislation implementing tax policy on digital products is necessary in 2009 to: (1) protect the sales and use tax base; (2) establish certainty in the tax code; (3) maintain conformity with the Streamlined Sales and Use Tax Agreement (SSUTA); and (4) encourage economic development. The committee was not able to reach consensus on a specific tax policy proposal because of the differing views on certain fundamental issues surrounding the taxation of digital products. However, the committee did agree that legislation adopting a broad, general imposition approach for digital products would be possible only if the legislation: (1) contains meaningful and easily administered broad-based exemptions for business inputs; (2) provides sales and use tax amnesty to taxpayers who failed to collect tax on digital products for prior periods; (3) maintains conformity with the SSUTA; and (4) protects and promotes the location of server farms and data centers in Washington.

In 2009 the Legislature made numerous amendments to the retail sales and use taxes statutes. The terms digital good, digital automated service, and digital code were defined and, with limited exceptions, sales and use taxes were imposed on the sale of such products. The Legislature provided certain exemptions from the retail sales and use tax including an exemption for standard digital information purchased solely for business purposes. Standard digital information is defined as a digital good consisting primarily of data, facts, or information that is not generated for a specific client or customer.

Part VIII: A retail sale includes the sale of or charge made for services received by persons involved in business activities such as amusement and recreation services. Amusement and recreation services include, but are not limited to, golf, pool, billiards, skating, bowling, ski lifts and tows, day trips for sightseeing purposes, and others, when provided to consumers. This also includes cover charges for providing the opportunity to dance, which are subject to the retailing B&O tax classification and the retail sales tax.

Part IX: Beginning in 2005 manufacturers and wholesalers of solar systems using photovoltaic modules paid a B&O tax at the rate of 0.294 percent. The reduced B&O tax rate was set to expire June 30, 2014. Over the years, several amendments to this section have taken place. Currently, manufacturers and wholesalers of solar energy systems using photovoltaic modules or stirling converters, or of solar grade silicon, silicon solar wafers, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers are taxed at the rate of 0.275 percent.

Part X: In 2009 the Legislature enacted a sales and use tax exemption for hog fuel used to produce electricity, steam, heat, or biofuel. The exemption expires on June 30, 2013. Hog

fuel is a waste product of wood that is ground, a process known as hogging, for use as a commercial energy source. As such, it is a kind of biofuel. Hog fuel is typically used as a fuel supply for boilers and electric power generation at mills that produce the material as a manufacturing byproduct. It is also purchased for use as a fuel source at these mills. Hog fuel is more fibrous and less uniform in size than clean wood chips.

Part XI: Aircraft used in Washington for longer than 90 days must be registered and a fee of \$15 is due to the Department of Transportation. Certain aircraft are exempt from the \$15 registration fee, such as un-airworthy aircraft and commercial aircraft engaged principally in commercial flying constituting an act of interstate or foreign commerce. The aircraft excise tax varies by type of aircraft and ranges from \$20 for a home-built aircraft up to \$125 for a turbojet multi-engine fixed wing plane and currently does not apply to commercial aircraft engaged principally in commercial flying that constitutes interstate or foreign commerce.

Generally, large private airplanes are subject to state sales or use tax, as is any modification or repair work to the aircraft.

In addition to the \$15 registration fee, private aircraft in the state for longer than 90 days, if not subject to the aircraft excise tax, are subject to state personal property taxes.

Part XII: In 2004 the Legislature reenacted exemptions for nonprofit blood, bone, and tissue banks. A qualifying blood bank must have a primary business purpose of collecting, preparing, and processing blood. A qualifying tissue bank must have a primary business purpose of recovering, processing, storing, labeling, packaging, or distributing human bone tissue, ligament tissue and similar musculoskeletal tissues, skin tissue, heart valve tissue, or human eye tissue. A qualifying blood and tissue bank must have a primary business purpose of collecting, preparing, and processing blood. All of the qualifying banks must be considered, under federal law as it existed on June 10, 2004, exempt nonprofit organizations and registered pursuant to federal law. These qualifying banks are exempt from the B&O tax, retail sales and use taxes, and property taxes.

Part XIII: Farmers are exempt from the B&O tax for the sale of any agricultural product at wholesale and for growing, raising, or producing agricultural products owned by others. This exemption does not apply to any person who sells such products at retail or to any person who sells manufactured substances or articles. Mint growers do not fall within this exemption because they must further process mint into mint oil, which is considered a manufactured substance.

Mint growers and processors use propane or natural gas to distill mint oil. Propane and natural gas are considered tangible personal property. Therefore, mint growers and processors must pay retail sales or use taxes for the purchase or use of propane and natural gas.

Part XIV: Amounts received from fundraising activities by nonprofit organizations and libraries are exempt from the B&O tax. Similarly, sales made by nonprofit organizations or libraries are exempt from the sales tax. However, those who purchase or receive as a prize an article of personal property from a nonprofit organization or library for a fundraising activity owe use taxes to the state.

Part XV: A sales and use tax exemption in the form of a refund is allowed for 75 percent of the sales tax paid on machinery and equipment used directly in generating electricity from wind, sun, fuel cells, biomass, tidal or wave energy, geothermal resources, anaerobic digestion, and technology that converts otherwise lost energy from exhaust or landfill gas into electricity. In addition, the exemption applies to the labor and services rendered in respect to installing exempt machinery and equipment. The facility using the machinery and equipment must generate at least 1,000 watts of electricity to qualify for the exemption.

Part XVI: A sales and use tax exemption is allowed for machinery and equipment used directly in generating electricity using solar energy. In addition, the exemption applies to the labor and services rendered in respect to installing exempt machinery and equipment. The facility using the machinery and equipment must generate no more than 10 kilowatts of electricity to qualify for the exemption. The exemption expires July 1, 2013.

Washington derives most of its revenue from various excise taxes and property tax. The major excise taxes are the state sales and use tax and the B&O tax. Washington law also provides numerous reductions in these various taxes through tax exemptions, deductions, credits, deferrals, and preferential tax rates. Collectively, these tax reductions are referred to as tax preferences.

State law 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 the review of tax preferences, holding public hearings, and commenting on the reviews is assigned to the Citizen Commission for Performance Measurement of Tax Preferences (Commission). The analysis and reviews are assigned to the staff of the Joint Legislative Audit and Review Committee (JLARC).

The Commission develops a schedule to accomplish a review of tax preferences at least once every 10 years. The Commission is authorized to omit certain tax preferences from the schedule, such as: those required by constitutional law; the sales and use tax exemptions for machinery, equipment, and food; the small business credit for the B&O tax; the property tax relief program for retired persons; and tax preferences that the Commission determines are a critical part of the tax structure.

Tax preferences that have a statutory expiration date are scheduled for review before the preference expires. When reviewing tax preferences, JLARC considers a number of factors including the following: (1) the public policy objectives of the exemption; (2) whether terminating the tax preference may have negative effects on the category of taxpayers that currently benefit from the tax preference; (3) the extent to which resulting higher taxes may have negative effects on employment and the economy; and (4) the economic impact of the tax preference compared to the economic impact of government activities funded at the same level of expenditure as the tax preference.

Each year JLARC prepares a final report containing analysis of the tax preference and recommendations for the Legislature to consider regarding the continuation of the preference. In general, the JLARC recommendation categories are as follows: continue without

modification; clarify or modify; and terminate. The Commission then reviews the JLARC recommendations and includes final comments in the report and can either endorse, endorse with additional comments, or not endorse JLARC recommendation. The fiscal committees of the Legislature must jointly hold a public hearing to consider the final report.

Summary of Bill:

Part I: A B&O tax exemption is provided for amounts received by a business, that is considered a qualified employer of record, that provides payroll and related human resource services to an affiliated company. The exemption is for amounts received by the business for an affiliate's employee costs. Employee costs means wages and salaries, benefits, or other assessments paid to or on behalf of the employee. Affiliated is defined to mean under common control.

There is no exclusion for the B&O tax for employee costs if the employer of record has a contractual obligation to provide services other than paymaster services to the affiliated business.

Part II: An additional type of sale of dairy products is temporarily exempt from the B&O tax until July 1, 2015. These are sales of dairy products to purchasers who use the dairy products as an ingredient or component in the manufacturing of a dairy product. Once the exemption expires, a preferential B&O tax rate of 0.138 percent will apply until July 1, 2023.

Dairy products are defined by reference to the Code of Federal Regulations and include byproducts such as whey and casein, and products comprised of not less than 70 percent dairy products by weight or volume.

Part III: A legislative finding is made that in 2013, colony collapse disorder is still a significant problem for the apiary (honey beekeeper) industry. It is stated that the Legislature's intent is that tax relief provided by this act will not be extended when data indicates that honey bee colony survivorship has improved as provided in the colony collapse disorder progress report published annually by the United State Department of Agriculture, and data provided by the Washington State Department of Agriculture (WSDA) to the JLARC.

The WSDA is required to create a honey bee workgroup to develop a report that outlines solutions that bolster the use of Washington honey bee colonies. The workgroup includes: (1) two members from the Washington state beekeepers association; (2) one apiarist with no less than 1,000 hives; (3) one apiarist with no more than 25 hives; (4) one member from the Washington State University apiary lab; (5) one member from the WSDA; (6) one member from the tree fruit industry; and (7) one member from the seed industry. The workgroup may include or seek input from other agencies, organizations, and stakeholders. By December 31, 2014, the workgroup must submit a report to the Legislature that includes the following:

- proposed changes to the industry's tax structure to increase competitiveness with out-of-state beekeepers for pollination contracts;
- analytics and metrics to measure the value of the proposed tax structure changes;
- proposed additional resources needed to continue applied and basic research to support commercial beekeepers in the state and to recover colony losses;

- colony levels needed to meet the pollination demands of the state's agricultural industry;
- other policy changes that would increase competitiveness of the state's beekeepers;
- other industry needs that would increase the market share of pollination contracts awarded to state beekeepers; and
- metrics needed to provide accountability for state resources invested in the honey bee industry.

The three temporary tax exemptions provided in 2008 are extended through July 1, 2017. Additionally, feed used by an eligible apiarist in the raising of a bee colony used to make honey bee products is exempt from the sales and use tax. This exemption also expires on July 1, 2017.

Part IV: Nonprofit gun clubs are provided a sales and use tax exemption for the clay targets they purchase for use in clay target shooting for which a fee is charged. The buyer must provide the seller with an exemption certificate from the DOR. This exemption expires on July 1, 2017.

Part V: A sales and use tax exemption is provided for products sold to restaurants that impart flavor to food during the cooking process. The product must be completely or substantially consumed during the cooking process, which includes items such as wood chips, charcoal, briquettes, and grapevines, or the product must support the food during the cooking process and be entirely comprised of wood, such as grilling planks. This exemption expires on July 1, 2017.

Part VI: The B&O tax does not apply to amounts received by a cooperative finance organization where the amounts are derived from loans to rural electric cooperatives or other nonprofit or governmental providers of utility services organized under the laws of Washington.

Cooperative finance organization means a nonprofit organization with the primary purpose of providing, securing, or otherwise arranging financing for rural electric cooperatives. Rural electric cooperative means a nonprofit, customer-owned organization that provides utility services to rural areas. This provision expires July 1, 2017.

Part VII: A retail sales and use tax exemption is created for the sale of Standard Financial Information (SFI) to Qualifying International Investment Management Companies (QIIMC). The SFI is defined as financial data, facts or information, or financial information services, that is developed for more than one single customer. The SFI includes, but is not limited to, financial market data, bond ratings, credit ratings, and deposit, loan, or mortgage reports. A QIIMC is defined as a person who is primarily engaged in the business of providing investment management services with at least 10 percent of the gross income derived from such services to persons or collective investment funds outside of the United States, or collective investment funds with at least 10 percent of their investments positioned outside of the United States. The amount of deductible purchases are limited to \$24 million per year.

The SFI may be provided in hard copy, in a storage medium, or as a digital product transferred electronically. To receive the tax exemption the seller must obtain an exemption

certificate from the buyer or maintain relevant data of sale as authorized by the SSUTA. This provision expires July 1, 2021.

Part VIII: Amusement and recreation services do not include the opportunity to dance provided by an establishment in exchange for a cover charge. A cover charge is a charge to enter an establishment or added to the purchaser's bill in exchange for the purchaser having the opportunity to dance. An opportunity to dance means that an establishment provides a designated physical space where customers are allowed to dance and the establishment makes customers aware that this area for dancing exists. The result of this change is that cover charges provided for the opportunity to dance are no longer subject to the retail sales tax. These cover charges will also no longer be subject to the retailing classification of the B&O tax, but will be subject to the services and other activities classification currently taxed at 1.8 percent. This exemption expires on July 1, 2017.

Part IX: The expiration date for the B&O tax rate on manufacturers and wholesalers of solar energy systems using photovoltaic modules or stirling converters, or of solar grade silicon, silicon solar wafers, silicon solar cells, thin film solar devices, or compound semiconductor solar wafers, is extended until June 30, 2017.

Part X: The expiration date for the existing sales and use tax exemption for hog fuel is delayed by 11 years, from June 30, 2013, until June 30, 2024. The DOR must declare any hog fuel sales tax exemption claimed within the previous two calendar years to be immediately due and payable to DOR, if the taxpayer who claimed the exemption closes a facility resulting in the loss of jobs in Washington.

Taxpayers claiming the hog fuel exemption must file a complete annual survey with the DOR. The survey includes the amount of tax preference claimed and employment, wage, and benefit information for each of the facilities in Washington at which the exemption is claimed. The DOR must provide annual survey information to JLARC. The Employment Security Department and other agencies, upon request, must cooperate with JLARC by providing information about the average wage of employment in counties where the exemption is claimed. The JLARC must review the performance of the tax preference with respect to its impact on jobs, wages, benefits, and the goal of retention of 75 percent of employment at the facilities at which the exemption was claimed. The JLARC must report its findings to the Legislature by October 31, 2019.

Part XI: When sold to nonresidents of Washington, large private aircraft are exempt from state sales and use tax. Labor and services for repairing, cleaning, altering, or improving large private aircraft owned by a nonresident are exempt from sales and use tax. The tax exemption expires July 1, 2021.

Large private airplanes that are in Washington longer than 90 days, but are here either for storage of longer than a year, or repairs, alterations, or reconstruction are exempt from the state's \$15 registration fee. Large private airplanes are defined as weighing more than 41,000 pounds and not used primarily in interstate commerce or used by a government entity, and also as being assigned a weight designation applied to aircraft over 41,000 pounds by the Federal Aviation Authority.

Commercial aircraft engaged principally in commercial flying that constitutes interstate or foreign commerce, that are in Washington State longer than one year for the purpose of continual storage, are subject to the aircraft excise tax, which automatically makes them not subject to personal property tax.

Part XII: The definitions of qualifying blood bank and qualifying blood and tissue bank are expanded to include testing or processing of blood, on behalf of itself or another qualifying blood bank or qualifying blood and tissue bank. These expanded activities will be exempt from the B&O tax, retail sales and use taxes, and property taxes. These exemptions expire July 1, 2016.

Part XIII: Mint growers and processors are exempt from the sales and use taxes for the purchase of propane or natural gas used to distill mint oil on a farm. The buyer must provide the seller with an exemption certificate in a form and manner prescribed by the DOR in order to benefit from the exemption. This exemption expires on July 1, 2017.

Part XIV: Any article of personal property, valued at \$10,000 or less, purchased or received as a prize in a game of chance from a nonprofit organization or library for a fundraising activity is exempt from the use tax. This exemption expires on July 1, 2017.

Part XV: The expiration date for the sales and use tax exemption for machinery and equipment used in facilities that generate electricity from renewable energy is extended to January 1, 2020. Individuals that utilize the tax incentive must submit an annual report to the DOR.

The JLARC is required to include additional information in their tax preference review, with specific reference to the intent and performance milestones established in the legislative intent.

Part XVI: The expiration date for the sales and use tax exemption for machinery and equipment used in facilities that generate electricity from solar energy is extended by five years to June 30, 2018.

Machinery and equipment used to produce thermal heat using solar energy also qualifies for a sales and use tax exemption. The facility using exempt machinery and equipment cannot produce more than three million British thermal units per day.

Part XVII: A default expiration date of 10 years for new tax preferences is required, unless the legislation specifies an alternate date. All new tax preference legislation must include a "tax preference performance statement", i.e. legislative intent language.

The performance statement must indicate at least one of following general legislative purposes of the tax preference:

- induce certain designated behavior;
- improve industry competitiveness;
- create or retain jobs;
- reduce structural inefficiencies in the state tax structure;
- provide tax relief for certain businesses or individuals; or

- a purpose not otherwise listed above.

The tax preference performance statement must include additional legislative intent, ascertainable metrics, and data requirements to measure the effectiveness of the preference as it pertains to the statement. Taxpayers must report the amount of tax preference claimed to the DOR. Generally, this will not be a new requirement since taxpayers are already required to report tax credits and deductions on the excise tax return. Taxpayers that claim less than \$1,000 per calendar year or are annual filers are not required to report the amount of tax preference to the DOR for tax preferences that are not normally reported.

The amount of the tax preference claimed by a taxpayer is subject to public disclosure, with the following exceptions:

- the DOR may waive disclosure for any taxpayer for good cause (good cause is demonstrated by a reasonable showing of economic harm to the taxpayer); or
- a taxpayer may request nondisclosure for any calendar year where the amount of the tax preference claimed by the taxpayer is less than \$10,000.

If new tax preference legislation does not include a tax preference statement, JLARC is not required to include the preference in the tax performance review report, and it is assumed that the legislative intent is to allow the tax preference to expire. A five-person task force is established, overseen by the legislative auditor, to make recommendations by January 1, 2014, on the data and metrics to include in tax preference performance statements.

Part XVIII: The DOR, in consultation with JLARC, must make recommendations to the Legislature by December 1, 2013, on ways to improve the tax preference annual reports and surveys.

Appropriation: None.

Fiscal Note: Not requested.

Effective Date: The bill takes effect on October 1, 2013, except for section 203, which takes effect July 1, 2015, parts III, X, XV, and XVI, which contain an emergency clause and take effect July 1, 2013, and part XI, which takes effect January 1, 2014.