HOUSE BILL REPORT
HB 2269

As Reported by House Committee On:
Appropriations

Title: An act relating to investing in education and essential public services by modifying and improving the fairness of Washington's tax system.

Brief Description: Relating to investing in education and essential public services by modifying and improving the fairness of Washington's tax system.

Sponsors: Representatives Hunter, Carlyle, Sullivan and Walkinshaw.

Brief History:
Committee Activity:
Appropriations: 6/22/15, 6/23/15 [DPS].

Brief Summary of Substitute Bill

- Eliminates the preferential business and occupation (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 use tax exemption for extracted fuel.
- Eliminates the preferential B&O tax rate of 0.484 percent for royalty income.
- Establishes a nexus standard for out-of-state sellers that derive income from making retail sales into the state through agreements with Washington residents.
- Establishes an economic nexus standard for wholesale transactions attributable to Washington by out-of-state businesses.
- Limits the availability of a real estate foreclosure exemption.
- Requires local governments that issue building permits to supply subcontractor information to the Department of Revenue.
- Increases late payment penalties for state excise taxes.

- Makes appropriations from the Education Legacy Trust Account, the State General Fund, and other funds for K-12, higher education, the Department of Early Learning, the Office of the Secretary of State, the Department of Revenue, and debt service.

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, Hansen, Hudgins, S. Hunt, Jinkins, Kagi, Lytton, Pettigrew, Sawyer, Senn, Springer, Sullivan, Tharinger and Walkinshaw.

Minority Report: Do not pass. Signed by 15 members: Representatives Chandler, Ranking Minority Member; Parker, Assistant Ranking Minority Member; Wilcox, Assistant Ranking Minority Member; Buys, Condotta, Dent, Haler, Harris, G. Hunt, MacEwen, Magendanz, Schmick, Stokesbary, Taylor and Van Werven.

Staff: 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 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 1.5 percent for services, and activities not classified elsewhere. Several lower rates also apply to specific business activities. A B&O tax credit is provided for businesses whose B&O tax liability is below a certain level. The credit varies depending on the amount of B&O tax due (the total of all classifications) after all other B&O tax credits have been taken. The amount of the small business B&O credit for service-related business is $840 per year, which completely exempts a service business with annual B&O gross income below $56,000 and provides a partial reduction in B&O liability for a service business with gross income at or below $112,000.

Preferential B&O Tax Rate 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 is 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, Including Bottled Water.
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 foods, 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.

Preferential B&O Tax Rate for Royalty Income.
Currently, royalty receipts are apportioned using a single factor receipts method and taxed at a rate of 0.484 percent. The 0.484 percent rate was adopted in 1998 (lowered from 1.5 percent) to align software royalty receipts with the rates for software manufacturing. Royalty income is compensation for the use of intangible personal property such as copyrights, patents, licenses, franchises, trademarks, and similar items.

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.

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.

Nexus.
As currently interpreted by the United States Supreme Court, the commerce clause of the United States Constitution prohibits states from imposing sales or use tax collection

obligations on out-of-state businesses unless the business has a substantial nexus with the taxing state. Under the Court's decision in *Quill Corp. v. North Dakota* (1992), a substantial nexus for sales and use tax collection purposes requires that the taxpayer have a physical presence in the taxing state. Physical presence can be established through a taxpayer's own activities in the taxing state, or indirectly, through independent contractors, agents, or other representatives that act on behalf of the taxpayer in the taxing state.

Currently, Washington cannot impose wholesaling B&O tax on sales of goods that originate outside the state unless the goods are:

- received by the purchaser in this state; and
- the out-of-state seller has physical presence nexus (i.e., the same physical nexus requirement that is used for sales tax purposes).

Both the criteria must be met for the seller to be subject to Washington B&O taxation. In 2010 Washington adopted an economic presence test for nexus with respect to service-related activities but not wholesaling or retailing activities. For these classifications, a business does not need to have a physical presence to have nexus and be subject to Washington tax. Economic nexus is established by having sales in excess of $267,000 to Washington customers. (The threshold is adjusted from year-to-year based on inflation.)

<u>Real Estate Excise Tax (REET) Foreclosure Exemption</u>.
The REET is imposed on each sale of real property, including transfers of ownership and transfers of controlling interests in entities that own property in the state. Real property includes any interest in land or anything affixed to land. The state tax rate is 1.28 percent. Additional local rates are allowed. The combined state and local rate in most areas is 1.78 percent.

The REET does not apply to transfers made in foreclosure proceedings or through enforcement of a judgment, including foreclosures that occur through auction without court oversight. The REET also does not apply to a deed given in lieu of foreclosure to satisfy a mortgage or deed of trust.

<u>Local Government Data with Respect to Building Permits</u>.
Building permit applicants must provide information to a local government in which a building permit is sought regarding the general contractor, but not subcontractors. This information is not shared by all localities with state agencies.

<u>Late Payment Penalties</u>.
Under current law, late excise tax returns receive a penalty of:

- 5 percent from one day after the due date to the last day of the month following the due date;
- 15 percent from the first day of the second month following the due date to the last day of that month; and
- 25 percent from the first day of the third month and thereafter.

<u>Deposit of Sales and B&O Taxes</u>.
Almost all revenues derived from sales and B&O taxes are deposited into the State General Fund (GFS). 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 GFS 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 GFS or moneys are transferred from the GFS 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 (GSR) 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 the GSR includes the state property tax because it is deposited in the GFS.

Summary of Substitute Bill:

Preferential B&O Tax Rate for Prescription Drug Resellers.
The preferential rate for resellers of prescription drugs is repealed. Resellers of prescription drugs are subject to the 0.484 percent wholesaling rate.

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.

Preferential B&O Tax Rate for Royalty Income.
The preferential B&O tax rate for royalty income is eliminated. This income is subject to the 1.5 percent B&O tax rate and would qualify for the increased small business credit.

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 Department of Revenue (DOR) for a remittance of Washington state sales taxes paid in the prior calendar year. The amount of the remittance claim must exceed $25.

Nexus.
Nexus standards are modified to include remote sellers who: (1) enter into agreements with Washington residents who, for a commission or other consideration, refer potential customers

to the remote seller such as by a link on a website; and (2) generate more than $10,000 in gross receipts during the prior calendar year under such agreements from sales into this state. This type of nexus is referred to as "click-through" nexus.

This change in nexus standards will require these remote sellers to collect and remit Washington sales tax for sales made into the state. Remote sellers that collect and remit retail sales tax will also be required to pay B&O tax on their Washington sales. Remote sellers have the ability to rebut a determination by the DOR that they have established click-through nexus with the state. Any provision of the click-through nexus standards that conflict with any future change in federal law will expire.

This proposal eliminates the "physical presence" standard and replaces it with an "economic nexus" standard for wholesaling activities. Wholesale businesses that lack physical nexus but gross $267,000 or more in sales to Washington customers in any calendar year will become subject to B&O tax.

<u>Real Estate Excise Tax (REET) Foreclosure Exemption</u>.
This proposal would require that REET be paid if:
- a lender or creditor receives property through a foreclosure proceeding or by enforcing a judgment;
- property is sold at a foreclosure or sheriff's auction; and
- property is transferred by order of the court in a foreclosure or a judgment enforcement proceeding.

The following would remain exempt:
- transfers to a lender or creditor to avoid the foreclosure process ("deed in lieu of foreclosure");
- if the selling price is greater than the lien or security interest on the property, transfers by sale at a foreclosure or sheriff's auction; and
- transfers to the United States, or to this state or its instrumentalities, as the lender or creditor, in a foreclosure proceeding or by enforcing a judgment.

<u>Repeal the Use Tax Exemption for Extracted Fuel</u>.
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 tax is based on the wellhead price, as published by the United States Energy Information Administration. The refinery fuel is subject to a rate of 3.852 percent.

<u>Local Government Data with Respect to Building Permits.</u>
Local governments that issue building permits are required to obtain at the time of final inspection the names, contractor registration numbers, and unified business identifier numbers, of any subcontractors performing work on the project.

Cities, towns, and counties are required to provide information to the state that would identify unregistered contractors that are not paying taxes. The DOR would share this information with the Department of Labor and Industries and the Employment Security Department.

These requirements only apply to residential construction projects.

The local government may charge a fee on permit applicants to defray the cost of collecting and remitting contractor data to the DOR.

Late Payment Penalties.
Penalties are increased on late excise tax returns as follows:
- 5 to 8 percent from one day after the due date to the last day of the month following the due date;
- 15 to 18 percent from the first day of the second month following the due date to the last day of that month; and
- 25 to 28 percent from the first day of the third month to the last day of that month.

Deposit of Additional Tax Revenues.
Because new B&O and sales tax revenues in the bill cannot be directly tracked, these additional amounts are estimated twice a year by the DOR and transferred from the GFS to the ELTA.

State Expenditure Limit.
The transfers from the GFS to the ELTA are exempted from the requirement to lower the state expenditure limit.

State Debt Limit.
New tax revenues initially deposited in the GFS are explicitly excluded from the calculation of GSR for purposes of the state debt limit determination.

Substitute Bill Compared to Original Bill:

The substitute bill adds the following provisions:
- 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 use tax exemption for extracted fuel;
- eliminates the preferential B&O tax rate of 0.484 percent for royalty income;
- establishes a nexus standard for out-of-state sellers that derive income from making retail sales into the state through agreements with Washington residents;
- establishes an economic nexus standard for wholesale transactions attributable to Washington by out-of-state businesses;
- limits the availability of a real estate foreclosure exemption;
- requires local governments that issue building permits to supply subcontractor information to the DOR;
- increases late payment penalties for state excise taxes; and

- makes appropriations from the ELTA, the GFS, and other funds for K-12, higher education, the Department of Early Learning (DEL), the Office of the Secretary of State, the DOR, and debt service.

Appropriation: Appropriations are made for the 2015-17 fiscal biennium.

- A total of $12.9 million from the GFS for the Office of the Secretary of State and the DOR.
- A total of $159.2 million from the ELTA for K-12 programs and compensation.
- A total of $103.6 million from the ELTA for higher education institutions and financial aid.
- A total of $32.0 million from the Building Construction fund for the University of Washington.
- A total of $28.3 million for the DEL.
- A total of $37.2 million from various funds for debt service.

Fiscal Note: Not requested.

Effective Date of Substitute Bill: The bill contains an emergency clause and takes effect August 1, 2015, except section 1004 and Part XI, relating to the Education Legacy Trust Account and appropriations from it and other accounts, which take effect July 1, 2015, and Parts I, VI, and VII, relating to excise taxes, which take effect September 1, 2015.

Staff Summary of Public Testimony:

(In support) We support the additional funding. The money for the salary increase is already gone. It is going towards health insurance premiums, which are increasing 8 percent next year. It is great to close unproductive, antiquated tax loopholes. There may have been a time when these tax loopholes were justified and represented good public policy, but now we need the revenue. Closing tax loopholes is the next best thing to a capital gains tax, but it still doesn't fix the structural deficit in our tax system. We will probably be back in two years talking about the next *McCleary* investment. This is a tepid revenue proposal so we are offering our tepid support. There are so many holes that have been punched in our tax structure that smaller, marginal businesses actually pay higher taxes than larger, profitable businesses. Closing loopholes does not make the most regressive tax system in the nation even more regressive. We are still only putting a Band-Aid on a gaping wound. Our tax structure is still barely able to keep up with the economy. We still don't fully fund K-12 education and the safety net. We will be in a perpetual budget quagmire until we address the structural budget deficit.

(In support with concerns) The click-through nexus provisions will help level the playing field between brick-and-mortar businesses and online retailers. We continue to support a national solution. We oppose the converting the nonresident sales tax exemption into a remittance program because it will act as a disincentive for nonresidents to shop in Washington. We oppose the sales tax on bottled water. Bottled water is a healthy and essential food item. The bottled water industry is an important and growing force in Washington. We also oppose the increase in the tax rate on royalties. This will impact over

14,000 franchisees in Washington and will keep new franchisees from entering the market. We also oppose the increase in the late payment penalties. Struggling businesses do not need to incur further costs.

(With concerns) We appreciate the emphasis on new revenue. This has been a key point all session. We also appreciate the funding of the enhanced K-12 cost-of-living-adjustment (COLA). However, there is a significant drawback to the COLA. The underfunding of basic education will result in an increased use of local levy funding. It exacerbates the problem.

(Opposed) We disagree with the characterization of the extracted fuel exemption as a tax loophole when it is consistent with the very policies the state is advocating with respect to energy reduction and energy efficiency practices. As an example, the Pierce County waste water treatment facility plant is using the gas byproducts it produces to run the facility. The bio-solids created at the facility are then used to fertilize Chamber's Bay. The Department of Ecology recently recognized an auto dealership for reusing waste engine oil in a boiler. Refiners can obtain 60 percent of their energy needs by recycling their refinery fuel gas, which is a waste byproduct. We believe the narrowing of the real estate excise tax foreclosure exemption would interfere with certain foreclosure strategies such as cash for keys. Therefore, the language may inadvertently tax distressed homeowners. There are several reasons why part IX of the bill, which relates to increased contractor and subcontractor data reporting from cities and counties to the DOR, is being opposed: (1) it creates a new level of bureaucracy, which will slow down the process of getting final approval of projects; (2) the penalties for not providing accurate information are excessive; and (3) the bill fails to get at the real problem, which is homeowners using unregistered contractors for small and mid-size projects. We have opposed most of the components in this bill for several years and continue to oppose these provisions. We oppose closing or narrowing tax preferences because of the negative impact on our economic recovery, competitiveness, and job creation. Some of the items in the bill, such as bottled water, have been before the voters and were rejected. Taxes on royalties will hurt innovation and commerce opportunities. Changing the nonresident exemption into a refund mechanism will create ill will towards our state when nonresidents try to go through the bureaucracy of collecting a refund. We supported the click-thru nexus provisions in a different bill that contained some other favorable changes to digital policy; however, we can't support click-through nexus in this bill.

(Other) We support the funding mechanisms in the bill, which would address Washington's unfair and regressive tax system. This is an excellent start in closing or narrowing unproductive tax preferences. We believe many of the concerns that you are hearing from businesses could be addressed by a progressive capital gains tax. A capital gains tax would also provide more funding and impact fewer taxpayers. The changes to the real estate foreclosure exemption are unfair to banks. It taxes them twice on what these businesses consider to be a single transaction. When a bank acquires property in foreclosure, it often has to make a significant investment in the property before it can be resold. This tax would be imposed at a very sensitive time and should not be applied twice. This bill acknowledges Washington's limited tax and revenue structure and seeks to address it. We don't have specific comments on the specific tax components in this legislation, but because it dedicates revenue to higher education, we believe it is an important and critical effort toward providing viable and dedicated funding for higher education. The investments provide critical backfill of the higher education tuition freeze in 2017, fund expansion of high-demand computer science enrollment capacity, as well as provide construction funding for a new computer science building, which would allow us to double our computer science degrees production each year and expand residencies in family medicine.

(Information only) New York's highest court upheld click-through nexus. The Supreme Court of the United States did not grant review of the decision.

Persons Testifying: (In support) Doug Nelson, Public School Employees Service Employees International Union Local 1948; Joe Kendo, Washington State Labor Council; and Dennis Eagle, Washington Federation of State Employees.

(In support with concerns) Mark Johnson, Washington Retail Association.

(With concerns) Mitch Denning, Alliance of Educational Associations.

(Opposed) Greg Hanon, Western States Petroleum Association; Bill Clarke, Washington Realtors; Bill Stauffacher, Building Industry Association of Washington; and Amber Carter, Association of Washington Business.

(Other) Susie Tracy, Family Medicine Residency Network; Nick Federici, Washington United for Fair Revenue; Brad Tower, Community Bankers of Washington; and Genesee Adkins, University of Washington.

(Information only) Drew Shirk, Department of Revenue.

Persons Signed In To Testify But Not Testifying: None.