HOUSE BILL REPORT
HB 2996

As Reported by House Committee On:
Finance

Title: An act relating to investing in a well-qualified and sufficient K-12 public education workforce by narrowing or eliminating tax preferences.

Brief Description: Investing in a well-qualified and sufficient K-12 public education workforce by narrowing or eliminating tax preferences.

Sponsors: Representatives Lytton, Reykdal and Santos.

Brief History:
Committee Activity:
Finance: 2/26/16, 2/29/16 [DP].

Brief Summary of Bill

- Eliminates the preferential business and occupation tax (B&O) tax rate for travel agents and tour operators.
- Eliminates the preferential B&O tax rate for resellers of prescription drugs.
- Eliminates the sales and use tax exemption for bottled water.
- Converts the nonresident sales tax exemption to a remittance program.
- Narrows a real estate excise tax exemption related to transfers made in foreclosure proceedings or through enforcement of a judgment.
- Eliminates the preferential B&O tax rate for international investment management services.
- Deposits the additional revenues into the Education Legacy Trust Account.

HOUSE COMMITTEE ON FINANCE

Majority Report: Do pass. Signed by 8 members: Representatives Lytton, Chair; Robinson, Vice Chair; Frame, Pollet, Reykdal, Ryu, Springer and Wylie.

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.

Minority Report: Do not pass. Signed by 6 members: Representatives Nealey, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Manweller, Stokesbary, Vick and Wilcox.

Minority Report: Without recommendation. Signed by 1 member: Representative Condotta.

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 3.0 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 1.5 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 tax 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 tax liability for a service business with gross income at or below $112,000.

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 United States Supreme 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.

In 2010 Washington adopted an economic presence test for nexus with respect to service-related 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.

Until 2015 Washington could not impose the wholesaling B&O tax on sales of goods that originated outside the state unless the goods were:

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

In 2015 Engrossed Second Substitute Bill 6138 extended economic nexus standards to out-of-state businesses with no physical presence in Washington, but who make wholesale sales into Washington. If these businesses have more than $267,000 of receipts from this state, then economic nexus standards with Washington will apply and these businesses will be required to remit the wholesaling B&O tax at the rate of 0.484 percent.

<u>Preferential Business and Occupation Tax Rate for Travel Agents and Tour Operators</u>. 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 rates at 1.5 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 tax rate for travel agents, which has since been expanded to allow tour operators to claim the preferential rate.

<u>Preferential Business and Occupation Tax Rate for Resellers of Prescription Drugs</u>. 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.

<u>Sales and Use Tax Exemption for Food and Food Ingredients, Including Bottled Water</u>. 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.

Real Estate Excise Tax Foreclosure Exemption.

The Real Estate Excise Tax (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.

Preferential Business and Occupation Tax Rate for International Investment Management Services.

A preferential B&O tax rate of 0.275 percent is provided for a business providing international investment management services if the firm meets two requirements:

1. it primarily provides investment management services; and
2. at least 10 percent of its gross income is derived from providing these services to either:
    - persons or collective investment funds residing outside the U.S.; or
    - persons or collective investment funds with at least 10 percent of their investments located outside the U.S.

In 2010 the adoption of an economic nexus standard for service related income affected businesses that provide IIMS. Therefore, out-of-state businesses that have no physical presence in Washington may owe B&O taxes on income derived from IIMS services provided to Washington residents. Conversely, in-state businesses may apportion income out of Washington that was previously taxed, if the income is derived from IIMS services provided to out-of-state customers.

Deposit of Sales and Business and Occupation 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 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 Washington 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.

Summary of Bill:

Preferential Business and Occupation Tax Rate on Travel Agents and Tour Operators.
The preferential rate of 0.275 percent for travel agents and tour operators is repealed. Travel agents and tour operators are subject to the service and other tax rate of 1.5 percent.

Preferential Business and Occupation Tax Rate for Resellers of Prescription Drugs.
The preferential tax rate of 0.138 percent for resellers of prescription drugs is eliminated. 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.

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 amount of the remittance claim must exceed $25.

Real Estate Excise Tax Foreclosure Exemption.
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; or
- 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 U.S, or to this state or its instrumentalities, as the lender or creditor, in a foreclosure proceeding or by enforcing a judgment.

<u>Preferential B&O Tax Rate for International Investment Management Services</u>.
The preferential B&O tax rate of 0.275 percent is eliminated thereby imposing the general service rate of 1.5 percent on these services.

<u>Deposit of Additional Tax Revenues</u>.
The additional B&O revenues are deposited directly into the ELTA. Because many of the 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 State General Fund to the ELTA.

<u>State Expenditure Limit</u>.
The transfers from the State General Fund to the ELTA are exempted from the requirement to lower the state expenditure limit.

<u>State Debt Limit</u>.
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: Available.

Effective Date: The bill takes effect July 1, 2016.

Staff Summary of Public Testimony:

(In support) In the age of *McCleary*, the Legislature has some major decisions to make next session. There has been some emergent issues come up over the past six to 12 months, including our teacher shortage. The teacher shortage is a crisis in our state. Closing these tax preferences is something to look at to address this issue. Everybody looks at tax preferences differently, but this is a conversation that needs to keep happening. Schools are facing shortages of educators statewide. One of the top priorities is to address recruitment, preparation, and retention of full-time and substitute teachers. This bill would help do that. If the Legislature is caught between closing tax preferences and a paramount duty to fund education, it is the hope that the Legislature would land on the side of the students. A starting salary of $35,000 makes it hard to compete with neighboring states.

(Opposed) The fiscal challenges facing the state are understood; however, differential rates are an essential element of the B&O tax because these rates are often designed to address low-margin industries. An increase in the rate would have to be passed directly to customers. For the prescription drug resellers, the increase in this bill represents a 250 percent increase for this industry. The Joint Legislative Audit and Review Committee reviewed this tax preference several years ago and recommended retaining this tax preference. It has been implied that this preferential rate benefits out-of-state firms; however, Washington employers and facilities benefit. The drug wholesale industry is not pharmaceutical companies. The drug wholesale industry would love to have the profit margin of pharmaceutical companies but they do not. The prescription drug tax preference is not a loophole. Competition is based on a basis point margin. There are all sorts of competition and profit margins are extremely tight. It is important for Russell Investments to keep their 800 jobs in the state, which maintains the state tax revenues these jobs generate. Despite the current preferential B&O tax rate, Washington's tax liability is high compared with other states because a majority of other states have a net income tax. Because of federal law, this industry has to be structured using separate business entities which can create multiple layers of B&O taxation. Under current law, if our financial investment company was headquartered in California, they would pay about the same amount of tax as they do in Washington. If the preferential rate goes away, the company would pay 77 percent less in California. The Association of Washington Business supports the broad goal of the bill to adequately fund K-12 education, but they do not support the way in which the bill goes about achieving that goal. Eliminating the nonresident sales tax exemption would erode an important incentive for nonresident buyers to shop in Washington, especially along our borders. This would hurt jobs and be especially detrimental in small communities. A sales tax on bottled water will discourage purchases. Increasing the price of bottled water will discourage a healthy habit. Taxing bottled water pushes people back towards soda pop. The tax does not have a definite impact on bottled water sales. Bottled water is a food product so making it subject to sales tax unfairly singles it out. The tax will have an especially large impact on small bottlers. This bill represents a tax increase of 545 percent on travel agents and tour operators. In places that have a gross receipts tax such as Nevada, Ohio, and the City of San Francisco, the rate is often half of what it currently is in Washington. Expedia pays better than average wage. The current tax rate on travel agents provides a very stable environment in which to grow Expedia. Under current law, financial institutions do pay the REET when they sell foreclosed properties. When a financial institution forecloses on property, it is also in a loss position–it is not just the borrower. This legislation would make Expedia pay twice. During the economic crisis, this industry agreed to fully fund the Foreclosure Fairness Act. Banks already have a significant tax burden in Washington. Banks already contribute about $450 million per biennium.

(Other) There is an assumption that if a financial institution acquires property through the foreclosure process, the institution will absorb the cost of the additional REET. Nothing is further from the truth. These institutions will have to add it to the sales price of the property to recover the cost. A lot of time this session has been spent talking about housing affordability. Eliminating the REET foreclosure exemption does not help housing affordability. Every 1 percent increase in the price of property eliminates hundreds of potential buyers.

Persons Testifying: (In support) Julie Salvi, Washington Education Association; and Jerry Bender, Association of Washington School Principals.

(Opposed) Cindi Holmstrom, Washington Whole Drug Association and Russell Investments; Rob Makin, Washington Wholesale Drug Association; Erik Strom, Russell Investment; Eric Lohnes, Association of Washington Business; Tim Dougherty, Northwest Bottled Water Association; Bruce Tornquist, Competetive Edge Marketing, Incorporated; Joanie Deutsch, Washington Retail Association; Tom Pucci, Expedia; Steve Gano, Expedia; Denny Eliason, Washington Bankers Association; and Jim Hedrick, City of Spokane.

(Other) Bob Mitchell, Washington Realtors.

Persons Signed In To Testify But Not Testifying: None.