HOUSE BILL REPORT
ESSB 6138

As Passed House:
June 30, 2015

Title: An act relating to increasing state revenue through improved compliance methods and eliminating tax preferences for royalties and certain manufacturing equipment.

Brief Description: Increasing state revenue through improved compliance methods and eliminating tax preferences for royalties and certain manufacturing equipment.

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

Brief History:
Committee Activity:
None.
Third Special Session
Floor Activity:
Passed House: 6/30/15, 60-38.

Brief Summary of Engrossed Substitute Bill

- Eliminates the preferential Business and Occupation tax rate (B&O) of 0.484 percent for royalty income.
- Authorizes additional methods of establishing nexus for purposes of collecting B&O and retail sales taxes.
- Clarifies the sales and use tax exemption for manufacturing machinery and equipment to include prewritten software that is delivered electronically.
- Eliminates the sales and use tax exemption for manufacturing machinery and equipment for certain individuals.
- Increases the penalties for late tax payments by four percent.

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Background:

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.

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 3.1 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.

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.

Nexus.
As currently interpreted by the Untied State 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).

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.)

Manufacturing Machinery Equipment Sales Tax Exemption.
In 1995, the legislature enacted legislation that exempted machinery and equipment (M&E) used by a manufacturer in a manufacturing operation from the retail sales tax. The production of prewritten computer software contained on a disc or other tangible storage media provided to the buyer is considered a manufacturing activity. Prewritten computer-software developers have historically qualified for the retail sales and use tax exemptions M&E. Today, the software industry delivers most prewritten software to buyers electronically rather than by tangible storage media. This change has called into question whether software developers continue to be eligible for the M&E exemptions.

Late Payment Penalties.
Taxpayers who submit late 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; or
- 25 percent penalty from the first day of the third month and thereafter.

Summary of Bill:

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.

Nexus.
Nexus standards are modified to include remote sellers who:
- 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;
- 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 Department of Revenue 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.

Economic nexus standards are extended 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 business will be required to remit wholesaling B&O tax at the rate of 0.484 percent.

Manufacturing Machinery Equipment Sales Tax Exemption.
The definition of "manufacturer" is clarified to include those engaged in the development of prewritten computer software that is not transferred to purchasers by means of tangible

storage media rather electronically, and excludes an "ineligible person" from taking the M&E sales and use tax exemption. An "ineligible person" is all members of an affiliated group of two or more entities where:

- at least one member was registered with the Department on or before July 1, 1981, and
- the group has a combined full and part-time employment of 40,000 as of August 1, 2015.

The group's business activities must also be primarily development, sales, and licensing of computer software and services.

Late Payment Penalties.
The penalties for late tax returns are increased by four percent to:

- 9 percent from one day after the due date to the last day of the month following the due date;
- 19 percent from the first day of the second month following the due date to the last day of that month; or
- 29 percent from the first day of the third month to the last day of that month.

Appropriation: None.

Fiscal Note: Available. New fiscal note requested on June 28, 2015.

Effective Date: The bill has an emergency clause and takes effect August 1, 2015, except for Part II, which takes effect September 1, 2015.