

SENATE BILL REPORT

ESSB 6138

As Passed Senate, 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: Ways & Means: 6/25/15, 6/26/15 [DPS, w/oRec].

Third Special Session: Passed Senate: 6/30/15, 35-10.

SENATE COMMITTEE ON WAYS & MEANS

Majority Report: That Substitute Senate Bill No. 6138 be substituted therefor, and the substitute bill do pass.

Signed by Senators Hill, Chair; Braun, Vice Chair; Dammeier, Vice Chair; Honeyford, Vice Chair, Capital Budget Chair; Hargrove, Ranking Member; Keiser, Assistant Ranking Member on the Capital Budget; Bailey, Becker, Billig, Fraser, Hasegawa, Hatfield, Hewitt, Kohl-Welles, O'Ban, Parlette, Schoesler and Warnick.

Minority Report: That it be referred without recommendation.

Signed by Senators Brown and Padden.

Staff: Dean Carlson (786-7305)

Background: PART 1 - Preferential Business & Occupation (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.

PART 2 - 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

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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.)

PART 3 - Manufacturing Machinery Equipment Exemption for Software Manufacturers: In 1995, the legislature enacted legislation that exempted machinery and equipment used by a manufacturer in a manufacturing operation from the retail sales tax. This exemption applies to firms that manufacture software.

Summary of Engrossed Substitute Bill: PART 1 - 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.

PART 2 - Nexus: The "physical presence" standard is eliminated and replaced 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, \$50,000 in payroll, or \$50,000 in property in any calendar year are subject to B&O tax.

For purposes of collecting sales tax and paying the B&O tax, remote sellers are deemed to have nexus in this state if the remote seller enters into an agreement with a Washington resident for a commission or other consideration to directly or indirectly refer potential customers, by a link on an Internet website or other method, to the remote seller. The remote seller must also have at least \$10,000 in sales to this state in the preceding year.

PART 3 - Manufacturing Machinery Equipment Exemption for Software Manufacturers: The manufacturing machinery and equipment exemption does not apply to:

- an affiliated group or member of an affiliated group that was registered to do business in Washington prior to 1981;
- the affiliated group has a combined employment exceeding forty thousand full and part time employees in the state; and

- the business activities of the affiliated group primarily include the development, sales, and licensing of computer software and services.

PART 4 - Late Payment Penalties: The penalties for late payment of excise taxes are increased 4 percent at each level of delinquency. The penalty rates will go from 5 percent, 15 percent, and 25 percent to 9 percent, 19 percent, and 29 percent.

Appropriation: None.

Fiscal Note: Requested on June 24, 2015.

Committee/Commission/Task Force Created: No.

Effective Date: The bill contains several effective dates. Please refer to the bill.

Staff Summary of Public Testimony: CON: Franchising is a thriving business model nationwide and specifically in Washington. It's a driver of economic activity and a major source of jobs for Washingtonians. Franchises employ over 164,000 people in Washington establishments and have over \$15 billion dollars in economic activity. The proposal of tripling the B&O tax rate will only serve to stifle growth and discourage existing franchises from expanding and discourage new franchises from entering Washington. There are about 13,000 restaurants in Washington. Sixty-four hundred of those are considered quick service restaurants. Over 80 percent of these businesses are considered small businesses. They are operating under small margins, almost the lowest in the country at about 4.5 percent. This bill would triple the tax that restaurant chains would pay for the revenue they receive based on operation of franchisees here in Washington. Washington based franchisees struggle to operate every day in Washington's challenging business climate.

The building permits portion of this bill will create another regulatory burden on contractors who are invested in being part of the solution with regard to the underground economy. The home construction industry wants to fight the underground economy. Those who don't follow the rules put a lot of pressure on those in the industry who do follow the rules in terms of price pressure.

The construction industry is required to provide a UBI number and a contractor's registration number at the time we are issued a building permit. We are also required by statute to track and monitor the registration, insurance, and payments to different state agencies of all of our subcontractors, which we do quarterly. These records are kept on file in our office. They are available for audit for any department in Washington at any time. The burden of the extreme penalties for paperwork and other errors are draconian and onerous. These statutory changes may lead to potential delays in closing and funding, potential loss of clients, and ultimately the potential for default of loans. We are with you in seeking a solution to the problem, but the wrong group of people have been targeted.

OTHER: For years we have been trying to curb the underground economy in the roofing industry. It's been driving up our insurance rates among other problems. We need a solution, but this bill is the wrong answer to address this problem. This bill will hurt home owners because few, if any, of the illegal contractors will take out permits before they do

construction work in order to avoid the requirements in this bill. This leaves the home owner with potentially shoddy construction work that is not up to code and likely to present serious hazards including structural and fire with little or no recourse. The consumer will be at risk.

A preferential rate for a B&O tax charged on royalties effect franchise fees. We have two large brokerage companies in Washington in which business models involve a number of franchisees. For one brokerage, about half of the franchises operate in this state and about half outside of the state. The other large brokerage has a majority of its franchisees outside of the state. The result is that the income made outside of Washington but paid to this Washington company would be significantly effected.

With regard to the construction requirements, the county had its concerns ameliorated with an amendment in the house that has to do with the fee that the county is allowed to charge. The bill is not as simple as the counties collecting a bunch of information and sending it out. It will be a very complicated and expensive administrative process at a county level. The \$5 fee allowed in this bill will not allow the county to recoup the costs the bill will have on the counties. This will turn into an underfunded mandate. The \$10,000 penalty would also apply to the county or city if they don't collect or if there is a clerical mistake, which is extreme.

We hoped the list of loophole closures would have been longer so as to raise more sustainable revenue for areas such as education funding.

Persons Testifying: CON: Mark Johnson, Washington Retail Association; Amber Carter, Amber Carter Government Relations, LLC for AWB; David Main, Building Industry Assoc. of Washington Master Builders Ass. of King and Snohomish Counties; Denny Eliason, Washington Restaurant Association; Bill Stauffacher, Building Industry Association of Washington.

OTHER: Gary Smith, Independent Business Association; Sefton Oxford, Roofing Contractors of Washington; Bob Mitchell, Washington REALTORS; Shawn Lewis, Washington Education Association; Joe Kendo, Washington State Labor Council, AFL-CIO; Josh Weiss, Washington State Association of Counties; Nick Federici, Washington United for Fair Revenue.

Persons Signed in to Testify But Not Testifying: No one.