



HOUSE FINANCE COMMITTEE CONSIDERS TAX INCREASES

BRIEFLY

The House Finance chair has proposed \$1.3 billion in new and increased taxes to fund the budget passed by the House earlier this month. In this brief we summarize and review the proposed tax increases, comparing them to the tax plans recommended by Gov. Jay Inslee and former Gov. Chris Gregoire.

As the 2013 legislature heads into the last week of the regular session, finalizing the state budget for the 2013–15 biennium is the major must-do. In two previous briefs, we have discussed the spending plans proposed by the Senate ways and means committee chair (WRC 2013b) and by the House (WRC 2013a). The House budget spends nearly \$1.2 billion more than does the Senate. In this brief we review the tax increases proposed to fund this difference.

In total, the proposal by House finance committee chair, Rep. Reuven Carlyle (D-Seattle) would raise a projected \$1.344 billion during the 2013–15 biennium. House bill (HB) 2038, which contains most elements of the plan, received a hearing before the House finance committee last Friday (April 19). Other elements are in HB 1920 (regarding the estate tax), HB 1971 (telecommunications) and HB 2041 (motor fuel handling losses). HB 1920 and HB 1971 have both passed the House. HB 2041 received a hearing before the House transportation committee on April 19. The table on page 2 compares the House chair's tax proposals to those presented by Gov. Jay Inslee in March and Gov. Christine Gregoire in December.

Details of the proposal

B&O Surcharge. In 2010, the legislature enacted a three-year increase in the business and occupation (B&O) tax rate for most service businesses, from 1.5 percent to 1.8 percent. The 0.3 percent surtax is scheduled to expire June 30. The

finance chair proposes to make the surtax permanent. This is estimated to provide \$534 million in revenue during the 2013–15 biennium. Gov. Inslee and Gov. Gregoire also proposed to extend the services B&O surtax. Gov. Inslee would make the increase permanent; Gov. Gregoire would have allowed it to expire at the end of 2016.

Estate tax. In a ruling known as the “Bracken decision,” the state Supreme Court held that property passing to heirs through a qualified terminable interest property trust (QTIP trust) is not subject to the state's estate tax as it is currently codified. The federal estate tax does apply to these transfers. The House chair's proposal assumes enactment of legislation to assure that these transfers are subject to the state estate tax. A bill to this effect, HB 1920, has passed the House. Gov. Inslee's tax proposal also included this provision, which is expected to add \$160.3 million to 2013–15 revenues. The Bracken decision was not final until after Gov. Gregoire issued her tax proposal.

Residential telephone service. Under current law, traditional residential “landline” phone service is not subject to sales tax, while similar service to businesses is. Cell phones, which have completely replaced landlines for some households, are subject to sales tax. The House has passed a bill, HB 1971, that would make all residential service subject to sales tax. The bill would also end two excise taxes that fund subsidies to low-income residential customers and services to people with hearing or speech

Comparison of Tax Proposals (dollars in millions)

	Carlyle	Inslee	Gregoire
● Extend 0.3% B&O surcharge on services	534.0	534.0	534.0 ¹
● Negate Bracken decision regarding the estate tax	160.3	160.3	
● Apply sales tax to residential landline telephone service	109.9	83.2	
● Apply sales tax to purchases by non-residents (auto sales excluded)	63.7	63.7	
● Apply public utility tax to in-state portion of interstate transport	63.2		
● Extend beer tax surcharge	58.8 ²	127.6 ³	101.0 ⁴
● Apply sales and use tax to investments in high-tech R&D facilities, machinery and equipment	55.5		
● Apply sales tax to bottled water	51.5	51.5	
● Increase B&O rate for insurance agents from 0.484% to 1.8%	46.1		
● Increase B&O rates for travel agents & tour operators, and for stevedoring from 0.275% to 1.8%	42.3		
● Apply use tax to extracted fuel	40.8 ⁵	40.8 ⁵	62.6
● Apply sales tax to purchases of janitorial services.	36.2		
● Increase B&O rate for resellers of prescription drugs from 0.138% to either 0.484% (wholesale transactions) or 0.471% (retail transactions)	29.0	29.0	
● Apply B&O and sales taxes to sales by importers of imported goods	24.1	24.1	
● Narrow high-tech R&D B&O credit.	23.2		
● Eliminate fuel-tax deduction for handling losses	5.2		
● Apply sales tax to trade-in value in excess of \$10,000		94.8	
● Apply sales tax to custom software		78.5	
● Apply B&O tax to long-term rental of commercial real estate		27.8	
● Increase B&O rates from 0.275% to 0.58125% for: travel agent commissions; tour operators; international charter freight brokers; stevedoring; assisted living facilities; and international investment management		24.6	
● Increase B&O rates from 0.484% to 0.783 percent for: warehousing; radio & TV broadcasting; public road construction; government contracting; chemical dependency centers; canned salmon labelers; insurance producers; title insurance agents; surplus line brokers; non-profit R&D; royalties; and childcare		20.8	
● Increase B&O rates from 0.138% to 0.2245% for: manufacturing biological or alcohol fuels; splitting or processing dried peas; slaughter, breaking or processing perishable meats; manufacturing wheat flour; soybean & canola processing; fruit and vegetable processors; manufacturers of dairy products; and manufacturers of seafood products		10.0 ⁶	
● Increase B&O rates from 0.2904% to 0.3388% for: sale of standing timber; extracting timber; manufacturing timber products; processing for hire timber products; wholesaling by manufacturer of timber products; aluminum smelters; and manufacturing solar energy systems		8.9 ⁷	
● Apply sales tax to farm auction purchases		5.6	
● Increase B&O rates from 0.275% to 0.32725% for manufacturing or wholesaling solar energy; and manufacturing semiconductors		0.6 ⁸	
● Increase B&O rate from 0.350% to 0.3835% for newspapers		0.4	
● Impose new tax on wholesale fuel			368.0
● Apply sales tax to candy and gum			68.6
● Impose new tax on carbonated beverages			57.0
Total	1,343.7	1,387.1	1,191.2

¹ Expires 12/31/16.

² 25¢/gal. large brewers, 15¢/gal. small brewers; permanent.

³ 50¢/gallon all brewers; permanent.

⁴ 50¢/gallon large brewers; expires 12/31/16.

⁵ "Hog fuel" (wood waste generated by sawmills) not taxed.

⁶ Fruit & vegetable, dairy and seafood rates 0% thru 1/30/15.

⁷ Aluminum and solar excluded from subtotal, included in column total.

⁸ Semiconductor revenue excluded from subtotal, included in column total.

impairments. These subsidies and services would in the future be funded from the general fund. The bill also creates a universal services fund to subsidize services of small high cost rural providers. This bill has broad support within the telecommunications industry. The House finance chair's proposal counts on \$109.9 million from the sales tax on residential phone service. This gain would be offset in part by costs of funding the various subsidies and the loss of money from audits related to residential services provided by cable companies over the internet.

Gov. Inslee's tax proposal included revenue from taxing residential landlines; Gov. Gregoire's proposal did not.

Purchases by non-residents. State law currently provides an exemption from sales tax for purchases by residents of states with sales taxes rates less than 3 percent for goods that are to be consumed outside of Washington. This exemption is used primarily by residents of the states of Oregon, Alaska, Montana and the Canadian province of Alberta. The House finance chair would eliminate this exemption for all goods other than motor vehicles, boats and trailers to be licensed in other states, estimating a gain of \$63.7 million for the 2013–15 biennium. Gov. Inslee included this provision. Gov. Gregoire did not.

Washington retailers with locations near to the Oregon border believe that the loss of this exemption would significantly impact their sales. The 2002 report of the Tax Structure Study Committee (the "Gates Committee") supports that view. The committee found:

The combination of Washington's high sales tax and the absence of a sales tax in Oregon causes retail trade and consequently sales tax revenues in the counties bordering Oregon and Idaho to be very sensitive to changes in tax rates. Sales and revenues in the 14 counties bordering Oregon and Idaho would increase by an estimated 22 percent if the sales tax differential were eliminated.

Without the non-resident exemption Washington's retail sales disadvantage would be even greater.

Public utility tax. The state currently collects public utility tax on the transportation of goods by truck, train or water if both the origin and the destination of the movement are within the state. When either the origin or the destination is out of state, the movement is not taxed. The finance chair proposes to apply the public utility tax to the in-state portion of these movements. The estimated revenue gain for 2013–15 is \$63.2 million.

Beer tax. In 2010, the tax on beer was raised for three years by \$15.50 per 31 gallon barrel for large brewers (those producing more than 60,000 barrels per year). This surtax is scheduled to expire on June 30. The finance chair proposes to impose permanent beer surtaxes of \$7.75 per barrel on large brewers and \$4.65 per gallon on small brewers. The estimated revenue gain is \$58.8 million for the 2013–15 biennium.

With these surtaxes, the overall beer tax would be \$15.83 per barrel for large brewers and \$9.43 per barrel for small brewers. Beer is also subject to the sales tax. Oregon's beer tax is \$2.60 per barrel. Idaho's rate is \$4.65 per gallon if the alcohol content is 4 percent or less by weight and \$13.95 if the alcohol content exceeds 4 percent by weight (5 percent by volume).

Gov. Inslee recommended making the current \$15.50 surtax on large brewers permanent and extending the surtax to small brewers. Gov. Gregoire recommended extending the surtax on large brewers through the end of 2016.

Research and development.

The state provides two tax incentives to locate high tech R&D activities. The first of these incentives waives sales taxes on building, expanding, renovating and equipping qualified high tech R&D facilities. The second is a B&O tax credit for qualified high tech R&D expenditures. Both of these incentives are scheduled to expire on June 30, 2015. The

finance chair proposes to end the sales tax waiver on June 30 of this year and to narrow the range of firms that qualify for the B&O credit. His proposal limits the credit to firms with less than \$10 million annual income. Together these changes are expected to provide \$78.7 million in additional revenue during the 2013–15 biennium. Gov. Inslee and Gov. Gregoire did not recommend ending or narrowing either of these incentives.

As we have previously noted, incentives for R&D are justified by the positive R&D externality. Knowledge created through one firm's R&D flows to nearby companies. Because companies fail to capture the full benefits of their R&D, they underinvest. The tax incentives partially offset this market failure (WRC 2013c). Over the period these incentives have been in place, the industries that benefit from them have accounted for a substantial share of the growth of the Washington economy (WRC 2012).

Bottled water. The finance chair would apply the sales tax to bottled water. This is expected to add \$51.5 million to state revenues during the 2013–15 biennium. Gov. Inslee recommended taxing bottled water; Gov. Gregoire did not.

The 2010 legislature imposed a temporary sales tax on bottled water that was repealed by Initiative 1107, which was supported by 60.4 percent of the voters at the November 2010 general election

Insurance agents. The finance chair proposes to raise the B&O rate on insurance agent commissions from 0.275 percent to 1.8 percent. The estimated revenue gain is \$46.1 million during the 2013–15 biennium. The sale of insurance involves a considerable amount of pyramiding. The commission on a particular policy will be taxed twice in cases where an independent subagent works under an agent. Insurance premiums, from which the commissions are paid, are subject to the state's 2 percent insurance premiums tax. Gov. Inslee recommended that the B&O rate on insurance agent commissions be increased from 0.484 percent to 0.783 percent. Gov. Gregoire did not recommend an increase in insurance pre-

mium rates.

Travel agents, tour operators and stevedoring. The finance chair would increase the B&O rates for travel agents and tour operators, and for stevedoring from 0.275 percent to 1.8 percent. These rate increases are expected to increase revenue by \$42.3 million during 2013–15. Gov. Inslee recommended that the rates for these businesses be increased to 0.58125 percent. Gov. Gregoire did not recommend an increase.

Still gas ("extracted fuel"). Under current Washington law, the "use of fuel by the extractor or manufacturer thereof when used directly in the operation of the particular extractive operation or manufacturing plant which produced or manufactured the same" is not subject to the use tax. Wood product manufacturers and petroleum refiners are thought to be the largest beneficiaries of this provision. The finance chair proposes to make refiners pay use tax on their self-produced fuel, which is commonly known as still gas. Taxing this still gas is expected to provide \$40.8 million in the 2013–15 biennium. Gov. Inslee also proposed to tax refiner still gas. Gov. Gregoire proposed to tax both still gas and wood products manufacturers' "hog fuel" (wood by-products from the manufacturing process).

In the majority of western states, still gas is not subject to sales or use taxes (WRC 2013d).

Janitorial services. The finance chair proposes to apply the sales tax to janitorial services and reduce the B&O rate for providers of these services from 1.8 percent to 0.471 percent. This is expected to raise \$36.2 million during the 2013–15 biennium. Neither Gov. Inslee nor Gov. Gregoire recommended this tax.

Resale of prescription drugs. The B&O rate for resellers of prescription drugs is currently 0.138 percent. The finance chair proposes to raise the rate to 0.484 percent for retail transactions and 0.484 for wholesale transactions. This is expected to raise \$29.0 million during the 2013–15 biennium. Gov. Inslee recom-

mended increasing tax rates on these transactions; Gov. Gregoire did not.

Import transactions. The finance chair proposes to apply the B&O tax and sales tax to certain import transactions. This is expected to raise \$24.1 million during the 2013–15 biennium. Gov. Inslee recommended taxing these transactions; Gov. Gregoire did not.

Fuel tax. Fuel suppliers, distributors and importers of gasoline are allowed a small handling loss deduction (0.25–0.31 percent) when calculating their motor fuel tax obligations. The finance chair proposes to eliminate this deduction. This proposal is expected to increase revenues to the motor vehicle account by \$5.1 million during the 2013–15 biennium. Neither Gov. Inslee nor Gov. Gregoire recommended eliminating this deduction.

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