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Policy Brief

PB 10-12
April 19, 2010

THE FINAL LEGISLATIVE TAX PACKAGE

BRIEFLY

This brief describes the legislative tax package, expected to increase general fund revenues by $769.1 million in the current biennium and at least $1.65 billion in the 2011–13 biennium.

The legislature adjourned early in the morning on April 13, the final day allowed for the 30-day special session that began on March 15. Gov. Chris Gregoire had called the special session so that the legislature could finish work on the supplemental budgets for the 2009–11 biennium, saying that the work would be completed in seven days. It was the inability of the House and Senate to agree on a tax package that extended the seven days to thirty (WRC 2010b).

Second Engrossed Substitute Senate Bill 6143 (2ESSB 6143) contains most of the legislative tax hikes. A second bill, Engrossed Substitute House Bill 2493 (ESHB 2493), raises the taxes on cigarettes and other tobacco products . Together these two bills are expected to increase general fund revenues by $769.1 million in the current biennium and by at least $1.65 billion in the 2011–13 biennium.

SECOND ENGROSSED SUBSTITUTE SENATE BILL 6143

Provisions in parts I to XV of 2ESSB 6143 increase 2009–11 revenue by $667.7 million.

Part I. Reform of B&O Tax for Service and Royalty Categories. Effective June 1, 2010, 2ESSB 6143 makes two fundamental changes to B&O taxation of services and royalties. The first of these changes broadens the nexus rule used to determine whether a service or royalty business has sufficient connection to the state to be subject to the B&O tax. Currently (i.e. before 2ESSB 6143's provisions become effective) the state asserts nexus for the B&O tax if the business has a physical presence in the state. 2ESSB 6143 broadens the standard for the service and royalty categories to include not just firms with a physical presence in the state but also those with substantial economic presence, signified by annual receipts exceeding one-quarter million dollars from customers in the state. The relevant language is:

> A person engaging in [service or royalty] business is deemed to have substantial nexus with this state if the person is:
>
> (a) An individual and is a resident or domiciliary of this state;
>
> (b) A business entity and is organized or commercially domiciled in this state; or
>
> (c) A nonresident individual or a business entity that is organized or commercially domiciled outside this state, and in any tax year the person has:
>
> (i) More than fifty thousand dollars of property in this state;
>
> (ii) More than fifty thousand dollars of payroll in this state;

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(iii) More than two hundred fifty thousand dollars of receipts from this state; or

(iv) At least twenty-five percent of the person's total property, total payroll, or total receipts in this state.

The second change involves the apportionment formulas used to determine the shares of multistate businesses' revenues that are subject to Washington's B&O. Currently a multi-state service and royalty business determines the share of its revenues on which it pays B&O either by separate accounting of in-state and out-of-state activities or by apportioning revenue to Washington based on the share of the business's costs that are incurred in Washington. 2ESSB 6143 shifts taxation of service and royalty businesses to a single factor apportionment formula, based on sales. The share of the multi-state business's revenue that is subject to the B&O will equal the share of revenue coming from customers in Washington.

The bill exempts investment conduits and securitization entities from the B&O tax. In addition, interest and fees on loans secured by commercial aircraft are exempt, so long as the lender does not have a physical presence in the state.

2010 Revenue Legislation

	Millions
2ESSB 6143	
Minimum nexus standards	$84.7
Tax avoidance transactions	$8.5
Modifying first mortgage deduction	$3.6
Direct seller B&O exemption	$155.0
B&O tax on manufacturing of certain agricultural products	$4.1
Sales tax exemption for livestock nutrient equipment/facilities	$1.3
B&O tax on corporate directors	$2.1
Corporate officer liability for tax debts	$1.1
Sales and use tax on bottled water	$32.6
Sales tax on candy with job credit	$30.5
PUD privilege tax clarification	$1.2
Temporary B&O tax surcharge on service businesses	$241.9
Limiting the B&O exemption for property management salaries	$6.9
Temporary beer tax increase	$59.0
Temporary tax increase on carbonated beverages	$33.5
Limiting the bad debt deduction	$1.7
ESHB 2493	
Cigarette and other tobacco product tax increases	$101.4
Other Bills	
ESHB 3014, SSB 6504, SHB 2620, SB 6206, SSB 6614, SSB 6339, SSB 6712	($12.3)
Total	$756.8

It is possible that out-of-state businesses will challenge the constitutionality of the 2ESSB 6143 substantial economic presence nexus standard.

The state's ability to assert nexus is constrained by the U.S. Constitution's Due Process and Commerce Clauses, as interpreted by the federal courts. Some states do apply similar nexus standards for their corporate income taxes, and these standards have been upheld in federal district and appeals courts. However, the U.S. Supreme Court has thus far refused to review any of these lower court decisions. With respect to sales and use taxes, the U.S. Supreme Court held in the case Quill Corporation v. North Dakota, 504 U.S. 298 (1992), that physical presence was the correct standard. The key question would seem to be whether the B&O is an income tax or a sales tax. Since a business's tax obligation is based on revenue without any deductions for costs, one might argue that the B&O is more akin to a sales tax than an income tax. And, in fact, the Census Bureau's government finance statistics program does classify the B&O as a sales tax.

2ESSB 6143 provides that if the nexus standard is ruled to be unconstitutional all other reforms that the bill makes to the B&O taxation of services and royalties are void.

Altogether these reforms to the service and royalty B&O tax are expected to increase revenue by $84.7 million for 2009-11 and $395.0 million for 2011–13.

Part II. Tax Avoidance

Controversial legislation introduced early in the session at Gov. Chris Gregoire's behest would have granted to the Department of Revenue very broad powers to disregard for tax purposes any "abusive tax avoidance transaction," which was defined to be a transaction, plan, or arrangement that reduced taxes owed to the state but otherwise lacked economic substance. Rather than granting such broad powers, the provisions on tax avoidance ultimately adopted in 2ESSB 6143 instruct DOR to disregard three specific types of transaction:

> (a) Arrangements that are, in form, a joint venture or similar arrangement between a construction contractor and the owner or developer of a construction project but that are, in substance, substantially guaranteed payments for the purchase of construction services characterized by a failure of the parties' agreement to provide for the contractor to share substantial profits and bear significant risk of loss in the venture;
>
> (b) Arrangements through which a taxpayer attempts to avoid [B&O tax] by disguising income received, or otherwise avoiding tax on income, from a person that is not affiliated with the taxpayer from business activities that would be taxable in Washington by moving that income to another entity that would not be taxable in Washington; and
>
> (c) Arrangements through which a taxpayer attempts to avoid [sales or use tax] by engaging in a transaction to disguise its purchase or use of tangible personal property by vesting legal title or other ownership interest in another entity over which the taxpayer exercises control in such a manner as to effectively retain control of the tangible personal property.

The bill also addresses two specific strategies that have been used to avoid paying real estate excise tax (REET). The first of these strategies involves the use of options. Under current law, REET is collected on the transfer or acquisition of a controlling interest in an entity that owns real property in the state. In determining whether a controlling interest has been transferred, all transactions within a 12 month window are aggregated. Options have been used to stagger the transfer of interest in a real estate holding entity so that no REET is due. The bill stipulates that the date the option agreement was executed rather than the date the option was exercised is to be used for purposes of determining whether REET is due.

Under the second REET avoidance strategy, real estate is formally owned by a subsidiary of a corporation: the subsidiary sells the real estate and transfers the proceeds to the parent corporation; the parent then dissolves the subsidiary before any REET is paid. In such instances, the bill makes the parent corporation liable for the REET.

Finally, the bill clarifies that the use tax must be paid on tangible personal property "acquired by the user in any manner."

Altogether the tax avoidance provisions are expected to increase 2009-11 revenue by $8.5 million.

Part III. First Mortgage Interest Deduction

Currently, banks and other financial businesses are allowed a deduction for interest earned on loans secured by first mortgages on residential properties located in Washington State when calculating their B&O tax liability. In its 2009 ruling on the HomeStreet Bank case, Washington Supreme Court found that the portions of interest retained as servicing fees by lenders after the loan is sold on the secondary market qualify for this mortgage interest deduction.

2ESSB 6143 narrows the definition of interest that qualifies for deduction to exclude fees that are not "recognized over the life of the loan as an adjustment to yield in the taxpayer's books and records according to generally accepted accounting principles." Fees received for servicing securitized loans remain deductible only if the servicer is also the originator of the loans.

This limitation on the mortgage interest deduction is expected to increase 2009-11 revenue by $3.6 million and 2011–13 revenue by $7.9 million.

Part IV. Direct Seller's Exemption

State law currently provides an exemption from the B&O tax for businesses who sell consumer products in Washington exclusively through direct seller's representatives. The companies must have no presence in the state other than the representatives, who pay B&O on the commissions they receive.

DOR has interpreted this exemption narrowly as applying to companies whose representatives sell consumer products door-to-door to retail customers. (Avon and Mary Kay Cosmetics are examples.) The Washington State Supreme Court, however, ruled in the Dot Foods case that the exemption applies more broadly. DOR fears that a number of out of state firms that currently pay B&O on their sales into the state will reorganize their activities to qualify for the exemption.

2ESSB 6143 retroactively conforms the direct seller exemption to DOR's narrow interpretation and totally eliminates the exemption beginning May 1, 2010. These changes are expected to increase revenue by $155.0 million for 2009-11 and $199.4 million for 2011–13.

Part V. Tax Preferences for Perishable Meat, Fruit and Vegetable Products

State law provides a preferential B&O rate of 0.138 percent (rather than the standard 0.484 percent manufacturing rate) to processors and wholesalers of perishable meat products. In addition, state law currently provides a B&O tax exemption for processors of fresh fruits or vegetables. This exemption is scheduled to expire on July 1, 2012, after which fruit or vegetable processors will pay the preferential 0.138 percent rate.

A 2005 decision by the Washington State Supreme Court in the Agrilink Foods case broadened the interpretation of the perishable meat exemption to include manufacturing or wholesaling non-perishable products that contain only a small amount of processed meat, such as a can of chili. DOR believes that the same rationale would broaden the fruit and vegetable preferences to products containing only a small amount of fruit or vegetable.

Effective June 1, 2ESSB 6143 narrows the meat preference so that it only applies to end products that are perishable, or are primarily composed of animal carcass, or are a meat by-product. It also limits the fruit and vegetable preference to products that are at least 50 percent fruit or vegetable by weight or volume.

Narrowing the perishable meat, fruit and vegetable preferences is expected to increase 2009-11 revenue by $4.1 million and 2011-13 revenue by $8.8 million.

Part VI. Livestock Nutrient Equipment and Facilities Exemption

Livestock nutrient equipment and facilities are currently exempt from the sales and use taxes. 2ESSB 6143 suspends this exemption for three years, from July 1, 2010 to June 30, 2013. This is expected to increase 2009-11 revenue by $3.1 million and 2011–13 revenue by $2.8 million.

Part VII. B&O Tax on Corporate Directors

Income earned as an employee is exempt from the B&O tax while income earned as an independent contractor is subject to the B&O at the 1.5 percent service rate. Existing statutes do not specify whether corporate directors qualify for the employee exemption or are independent contractors.

Effective July 1, 2010, 2ESSB 6143 makes explicit that corporate directors are independent contractors who are subject to the B&O tax. The bill exempts director's compensation received before July 1, 2010 from the B&O. However, it explicitly does not authorize refunds of B&O taxes already paid by corporate directors, citing the state constitution's prohibition on the giving or loaning of state credit (Article VIII, Section 5).

Taxing corporate directors is expected to increase 2009-11 revenue by $2.1 million and 2011–13 revenue by $4.6 million.

Part VIII. Tax Debt Liability of Corporate Officers

2ESSB 6143 makes the chief executive and chief financial officers of a limited liability business entity (e.g. corporations, limited liability companies and limited liability partnerships) personally liable for any unpaid state and local sales taxes when the entity is terminated, dissolved or abandoned, or is insolvent. This liability is very broad, applying "regardless of fault or whether the individual was or should have been aware of the unpaid tax liability of the limited liability business entity."

Strict liability of chief executive and chief financial officers for unpaid sales taxes is expected to increase 2009-11 revenue by $1.1 million.

Part IX. Sales Tax on Bottled Water and Candy.

Under current law, food and food ingredients are generally exempt from the sales tax, although the exemption does not apply to prepared foods, soft drinks and dietary supplements. 2ESSB 6143 makes bottled water and candy subject to the sales tax effective June 1, 2010. For candy the sales tax exemption is permanently ended. Under the terms of 2ESSB 6143, bottled water's sales tax exemption is suspended until July 1, 2013. However, under the provisions of another bill passed by the legislature, EHB 2561, voters in November will decide whether to keep bottled water taxable with the proceeds to be used for debt service on bonds issued to fund energy-related improvements to schools, colleges and universities, and other public facilities.

Water purchased for use by human patients under a medical professional's prescription remain exempt from the sales tax, as do sales to individuals who do not otherwise have a source of potable water.

2ESSB 6143 provides this definition of candy:

> "Candy" means a preparation of sugar, honey, or other natural or artificial sweeteners in combination with chocolate, fruits, nuts, or other ingredients or flavorings in the form of bars, drops, or pieces. "Candy" does not include any preparation containing flour and does not require refrigeration.

To cushion the impact of the tax on in-state candy manufacturers, 2ESSB 6143 provides a $1,000 per employee B&O tax credit to these manufacturers for the period August 1, 2010 to July 31, 2012. The total value of the credit any manufacturer may claim is capped at the amount of sales tax collected on its candy.

Extending the sales tax to bottled water is expected to increase 2009-11 revenue by $32.6 million and 2011–13 revenue by $69.2 million, while extending the tax to candy is expected to increase 2009-11 revenue by $30.5 million and 2011–13 revenue by $62.4 million.

Part X. PUD Privilege Tax Clarification

Public utility districts (PUDs) that generate electricity are subject to the PUD privilege tax, which is levied in lieu of the property tax. The tax is based on the revenue received from the sale of electricity. A recent court decision granted two PUDs that charge customers separately for electricity used and for various fixed costs of providing electric service (e.g. meter reading, billing and fixed facilities) refunds for taxes paid on the fixed charges. 2ESSB 6143 clarifies that the PUD privilege tax applies to all fees that PUDs receive from their customers related to supplying electricity.

This clarification expected to increase 2009-11 revenue by $1.2 million and 2011–13 revenue by $2.2 million.

Part XI. B&O Temporary Surcharge on Services

For a period of 38 months, beginning May 1, 2010 and ending June 30, 2013, 2ESSB 6143 increases the B&O tax rate for the services category from 1.5 percent to 1.8 percent. Hospitals and research and development services are exempted from this increase.

For businesses in the service category, the small business tax credit is permanently increased from $35 per month to $70 per month. For service businesses paying the 1.8 percent rate, the small business tax credit will now completely eliminate B&O obligations if monthly revenue is less than $3,889. For service businesses paying the 1.5 percent rate (all services after June 30, 2013), the credit will completely eliminate the B&O tax if monthly revenue is less than $4,667.

The increase in the B&O rate on services is expected to increase 2009-11 revenue by $241.9 million and 2011–13 revenue by $491.1 million.

Part XII. B&O Exemption for Property Management Salaries

Currently revenues received by property management businesses from property owners are exempt from the B&O tax to the extent that the moneys are deposited into property management trust accounts for the payment of wages and benefits of on-site personnel. 2ESSB 6143 narrows the exemption so that it only applies if either the property management business is not-for-profit or the property owner is a city or county housing authority.

Narrowing this exemption is expected to increase 2009-11 revenue by $6.9 million and 2011–13 revenue by $14.8 million.

Part XIII. Temporary Beer Tax Increase

Currently beer is subject to a tax of $8.08 per 31 gallon barrel (a bit more than 26 cents per gallon). Small brewers (those brewers who produce less than 2 million barrels per year) pay a preferential rate of $4.782 on the first 60,000 barrels produced in a year. 2ESSB temporarily raises the beer tax by $15.50 per barrel ($0.50 per gallon) for the period beginning June 1, 2010 and ending June 30, 2013. This will bring the total beer tax rate to $23.58 per barrel. For small brewers, the tax on the first 60,000 barrels will remain $4.782 per barrel.

This increase in the tax on beer is expected to increase 2009-11 revenue by $59.0 million and 2011–13 revenue by $106.8 million.

Part XIV. Carbonated Beverages Tax

As noted above, soda pop is subject to the state and local sales taxes.

Since 1989, soda pop has been taxed through a tax on the syrups used to make the beverage. The syrup tax rate is $1 per gallon. Currently, however, the syrup tax is effectively eliminated through a credit against the B&O tax for syrup tax paid.

2ESSB 6143 imposes a temporary new tax on carbonated beverages at the rate of 2 cents per 12 ounces. The tax will be collected for the period beginning July 1, 2010 and ending June 30, 2013.

This tax does not apply to carbonated water.

In January, Gov. Gregoire proposed a 5 cent per gallon tax on carbonated beverages. As justification, she pointed to "growing public health issues" associated with the consumption of soda pop, "including childhood obesity and diabetes" (WRC 2010a).

The soda pop tax is expected to increase 2009-11 revenue by $33.5 million and 2011–13 revenue by $82.4 million.

Part XV. Limitation of the Bad Debt Deduction

Currently sellers are entitled to a credit or refund for sales taxes paid to the state to the extent that the taxed sale results in a "bad debt." 2ESSB 6143 limits the bad debt credit/refund to the limitation of the bad debt B&O deduction to the original seller of the good and only if that seller has not assigned the debt to a third party (i.e. if the debt has been sold or assigned, neither the original seller nor the assignee is eligible for the bad debt credit/refund).

Limiting the bad debt deduction is expected to increase 2009-11 revenue by $1.7 million and 2011–13 revenue by $4.1 million.

Engrossed Substitute House Bill 2493

The state tax rate on cigarettes is currently $2.025. Of the tax, $1.596 is deposited to the general fund, and $0.429 is deposited into the education legacy trust account.

Effective May 1, 2010, ESHB 2493 increases the state tax rate on a pack of 20 cigarettes by $1, to $3.025. Of this, $2.509 is to be deposited into the general fund and $0.516 into the education legacy trust account. The increase in the per pack education legacy trust account deposit is intended to compensate that account for the decreased sales of cigarettes due to the higher tax.

The current tax on tobacco products other than cigarettes is 75 percent of wholesale value. ESHB 2493 increases this to 95 percent of wholesale value with some exceptions: The tax on a small cigar will equal the tax on a single cigarette ($0.15125). The tax on a large cigar will be the lesser of 95 percent of wholesale value or 65 cents. The tax on a 1.2 ounce unit of moist snuff will be the greater of 95 percent of wholesale value or 83.5 percent of the tax on a pack of cigarettes.

Increasing taxes on cigarettes and other tobacco products is expected to increase 2009-11 revenue by $101.4 million and 2011–13 revenue by $198.3 million.

Other Legislation.

Seven other bills altogether reduce 2009–11 revenue by $12.3 million.

Of the seven, the bill with the largest impact is ESHB 3014, which extends and modifies the sales and use tax deferral program for investment projects in rural counties. This reduces 2009–11 revenue by $7.8 million. SSB 6504 diverts $2.7 million from the general fund to a new crime victims' compensation account. SHB 2620 clarifies ambiguities in the taxation of digital goods, reducing 2009–11 revenue by $1.0 million.

SB 6206 allows a 90-day extension of the due dates for filing tax incentive accountability reports, while SSB 6614 exempts from the B&O tax credits or funds received by utilities from the Bonneville Power Administration for the purposes of implementing energy conservation or demand-side management programs. Each of these bills is expected to reduce 2009–11 revenue by $300,000.

SSB 6339 provides a sales tax exemption for wax and ceramic materials used to make molds for creating ferrous and nonferrous investment castings used in industrial applications, while SSB 6712 extended tax incentives for the manufacturers of biofuels, for purchasers of motor vehicles powered by clean fuels, and for Federal Aviation Administration certified repair facilities. Each of these bills is expected to reduce 2009-11 revenues by $200,000.

Observations

Of the $769.1 million in additional revenue that 2ESSB 6143 and ESHB 2493 raise in 2009–11, $402.1 million (52 percent) is from permanent tax increases.

Even with the $1.65 billion in additional revenues that these bills provide for the 2011–13 biennium, legislators will face a multi billion dollar gap next year when they return to Olympia to write a budget for 2001-13 (WRC 2010a).

References

Washington Research Council (WRC). 2010a. Governor Gregoire's Tax Package. Policy Brief, PB 10–06. February 23. http://www.researchcouncil.org

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