



PB 10-06
February 23, 2010

GOVERNOR GREGOIRE'S TAX PACKAGE

BRIEFLY

Governor Gregoire's tax package would increase general fund–state revenues by \$759 million in the current biennium and \$1.67 billion in 2011–13

In December, Governor Chris Gregoire presented a plan to close what was then figured to be a \$2.6 billion shortfall in the enacted 2009–11 budget. (The shortfall is now calculated to be \$2.8 billion.) State law required that this supplemental budget proposal be balanced under current revenue. The December proposal cut \$1.6 billion from the enacted spending plan. The remainder of the \$2.6 billion gap was closed by transferring \$650 million to the general fund–state (GF-S) from other state accounts (including \$229 million from the budget stabilization account) and accepting a lower projected general fund ending balance (WRC 2009b). Governor Gregoire disavowed the plan even as she presented it, saying that it did not reflect her values, and promised to present an alternative proposal in January that would tap additional resources to restore some of the cuts in the initial plan.

Governor Gregoire presented her alternative, *Book 2*, budget proposal on January 12. The January proposal (which we refer to as *Book 2.0*) restored \$779 million of the cuts proposed in December. To partially pay for restoring these cuts, the governor identified changes to the state's revenue system projected to increase tax collections for the 2009–11 by \$105 million beyond the amount forecast by the Economic and Revenue Forecast Council in November. Additional details would await the February update to the general fund revenue forecast (WRC 2010a)

The revenue forecast update came on February 12, and the governor updated her supplemental proposal on February 17. The revised proposal (which we refer to as *Book 2.1*) puts a value of \$769 million on the restored program cuts, proposes legislation that would raise \$759 million in additional revenue, and assumes an additional \$435 million in federal stimulus funds.

2009–11 BALANCE SHEET

The table on page 2 presents general fund–state (GF-S) balance sheets for the 2009–11 and 2011–13 biennia that incorporate Governor Gregoire's *Book 2.1* proposal, which were provided to us by the Office of Financial Management (OFM 2010).

The left column of the table shows the 2009–11 situation under the governor's *Book 2.1* proposal. The GF-S began the current biennium with a balance of \$189 million. The February forecast pegs GF-S revenue for the biennium at \$28.7 billion; the state constitution requires that \$252 million of this be transferred to the rainy day fund. The 2009–11 budget enacted last spring transferred \$963 million to the GF-S from other state accounts. Of this amount, \$45 million came from the rainy day fund. The governor's supplemental proposal transfers to the GF-S another \$229 million from the rainy day fund as well as \$395 million from other state accounts. This brings total transfers for the biennium to \$1.6 billion. *Book 2.1* revenue proposals add \$759 million (shown on two lines, "Dot Foods clarification" and "new reve-

nue proposals”). The governor’s job package reduces revenue by \$15 million. Revenue and transfers to the GF-S sum to \$30.7 billion and total resources, including the beginning balance, are \$31.0 billion.

Four-Year Outlook for the GF–S

Assuming the Governor’s Book 2 Supplemental Budget 2/16/10

Dollars in Millions

	2009-11	2011-13
RESOURCES		
Beginning balance	189	511
February forecast	28,725	32,224
Enacted fund transfers	963	
Mandated transfer to Rainy Day Fund	(252)	(310)
<i>Governor’s Proposed Supplemental:</i>		
Fund transfers to GF-S	395	
Use of Rainy Day Fund	229	
DOT Foods clarification	154	191
New revenue proposals	605	1,482
Jobs package	(15)	(60)
Total Resources	30,993	34,038
EXPENDITURES		
Baseline estimated expenditures	30,918	33,931
Replace Federal recovery funding/other		974
Pension costs above the base		702
Catch-up for Initiative 728 (HB 2356)		667
Catch-up for Initiative 732 (HB 2363)		172
<i>Governor’s Proposed Supplemental:</i>		
Mandatory changes (Maintenance Level)	852	1,036
Federal stimulus funds	(435)	
Budget reductions and other changes	(853)	(1,288)
Total Expenditures	30,482	36,194
RESERVES		
Ending GF-S balance	511	(2,156)
Rainy day fund balance	0	310
Total reserves	511	(1,846)

Source: OFM

The enacted budget appropriates \$30.9 billion (GF-S) for the biennium. OFM has identified an additional \$852 million in spending needed to maintain existing programs. Of this, \$760 million was known at the time Governor Gregoire presented her Book 1 budget in early December. The additional \$92 million was announced at the time of the February caseload forecasts. Funding these maintenance level changes would raise spending for the biennium to nearly \$31.8 billion. Governor Gregoire believes that the Federal government will provide an additional \$435 million in Medicaid matching funds to cover a portion of these expenses and she proposes (net) program reductions of \$853 million to hold GF-S spending to \$30.5 billion.

Under the governor’s proposal, the projected GF-S ending balance is \$511 million and the rainy day fund’s ending balance is zero.

While the governor’s proposed supplemental budget puts the 2009–11 budget technically into balance, expenditures exceed revenues by \$1 billion dollars, with the difference covered by transfers to the GF-S from other state accounts. In addition, about \$1.4 billion in federal stimulus funds are covering ongoing program costs that would normally be funded from the GF-S. This imbalance between revenues and expenditures sets the stage for a gap to reappear in the 2011–13 biennium.

2011–13 OUTLOOK

The right column in the table shows the outlook for the 2011–13 biennium. The expected beginning balance is \$511 million. The recent forecast council meeting provided the first official forecast

of 2011–13 revenues, \$32.2 billion. The governor’s supplemental revenue proposals add \$1.67 billion, her jobs package subtracts \$60 million, and the required transfer to the rainy day fund subtracts \$310 million. Total GF-S resources are \$34.0 billion.

The estimated cost of continuing in 2011–13 the programs funded in the enacted 2009–11 GF-S budget is \$33.9 billion. This estimate assumes that teachers and others covered by Initiative 732 will receive pay increases at the projected rate of CPI inflation (1.3 percent for FY 2012 and 2.0 percent for FY 2013) and that other employees will receive pay increases at the projected rate of increase of the implicit price deflator (1.8 percent and 1.9 percent). Per capita costs of employee health care and medical assistance are expected to grow by 6 percent per year. Per capita costs of other health-related programs are expected to grow by 3.6 percent per year. Per capita costs for most other programs grow at the rate of increase in the im-

plicit price deflator.

The OFM analysis identifies \$2.5 billion in additional costs. Maintaining in 2011–13 GF-S programs that the enacted budget funds in FY 2011 with federal stimulus monies would add nearly \$1 billion to 2011–13 GF-S spending. Additional pension costs add \$702 million, while catching up with Initiatives 728 and 732 would add \$839 million.

The net reduction in spending in the governor’s Book 2.1 supplemental budget would carry forward to save \$1,288 million in 2011–13. Summing it all up, the projected GF-S balance at the end of 2011–13 is *negative* \$2.16 billion.

THE REVENUE PACKAGE

Governor Gregoire’s revenue package has 14 elements that all together would yield \$759.1 million for the GF-S over the remainder of this biennium. Six of these were included in HB 3176, which we examined in an earlier policy brief (WRC 2010b). Another five are sin taxes. (The sins are consumption of petroleum products, bottled water, soda pop, tobacco, and candy and gum.) Listed in order of the revenue yielded, the 14 elements in Gregoire’s package are:

Direct Sellers B&O exemption. State law provides an exemption from the B&O tax for businesses selling consumer products in Washington exclusively through direct seller’s representatives. The companies must have no presence in the state other than the representatives, who are not employees of the companies and pay B&O on the commissions they receive.

The department of revenue (DOR) has interpreted this exemption narrowly as applying to companies whose representatives mostly sell consumer products door-to-door—Avon and Mary Kay Cosmetics, for example. The Washington State Supreme Court, however, recently ruled, in the Dot Foods case, that the exemption applies more broadly.

The governor’s proposal is contained in DOR request bills HB 2971 and SB 6711 and has two parts. The first part is a retroactive clarification that the existing exemption does not apply to firms like Dot Foods. This clarification is expected to increase general fund revenue by \$153.6 million in the current biennium and \$190.8 million in 2011–13. The second part fully repeals the exemption effective July 1, 2010. The repeal yields an additional \$3.7 million in the current biennium and \$8.6 million in 2011–13. (On the balance sheet, the repeal money is included on the new revenue proposals line.)

Hazardous Substances Tax. The current hazardous substance tax was enacted via Initiative 97, which was approved by voters in November 1989. The initiative is also known as the model toxics control act, and the tax is often called the MTCA (pronounced “motka”) tax. The MTCA tax rate is presently 0.7 percent, with 47.1 percent of revenues dedicated to the state toxics control account and 52.9 percent to the local toxics control account.

The governor, following the lead of legislation already introduced in the House (HB 3181), proposes to raise the rate on the MTCA tax from 0.7 percent to 2.0 percent. In the long run (FY 2014 and beyond) the revenue from the additional 1.3 percent will be divided among five separate accounts (the storm water, oil spill prevention, Puget Sound recovery, state clean water and motor vehicle accounts) and dedicated to mitigation of environmental contamination. Over the first three years, however, nearly half of the proceeds will be diverted to the general fund (see table on page

4). The general fund would gain \$148 million during the current biennium and \$206 million for 2011–13.

DOR reports that about 550 firms pay the MTCA tax, however the majority of the tax is paid by the state’s five petroleum refineries. The tax would apply to petroleum products produced in the state, whether sold in-state or

out of state, and to products imported to the state. Washington’s refineries exported 36.6 percent of their products in 2007 (WRC 2009a).

Margins in refining are very low. In 2008 (the most recent year for which the U.S. Department of Energy has data) average revenue for refineries nationwide was \$2.600 per gallon, while total refined product costs were \$2.565 per gallon (EIA 2009). The refined product margin

was thus only 3.5 cents, 1.36 percent of revenue. Although 2 percent may not seem to be a very high tax rate, in a business with margins as thin as refining, 2 percent is huge tax. Since product shipped into the state from out-of- state competitors is also subject to the tax, the refiners may be able to pass the MTCA tax on to in-state customers in the form of higher prices. At the 2008 average wholesale price of gasoline in Washington (\$2.63), 1.3 percent added to the MTCA tax, if passed through, would add 3.4 cents to the price of gasoline.

Refiners have much less ability to pass the tax on to the out-of-state customers who take more than one-third their output. Nationally there is excess capacity in refining at the present time, and it has been suggested that 5 to 8 percent of U.S. refining capacity needs to be retired to bring supply into balance with demand (Mouawad 2009). Increasing the MTCA tax increases the chance that some of that capacity retirement will take place at Washington refineries.

Bottled Water. It was once the case that bottled water was considered to be a virtuous alternative to drinking soda pop. No longer. The governor proposes the state impose a 1 cent per ounce tax on bottled water. This is expected to yield \$135 million over the remainder of the biennium and \$311 million in 2011–13.

Carbonated Beverage Tax. Since 1989, soda pop has been taxed through a tax on the syrup 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. (Governor Gregoire wants to eliminate this credit. See below.) Governor Gregoire proposes that the state impose an additional tax on carbonated beverages at the rate of 5 cents per 12 ounces. As justification for this tax, she points to “growing public health issues” associated with the consumption of soda pop, “including childhood obesity and diabetes.” It is estimated that the tax would raise \$94 million over the remainder of the current biennium and \$202 million in 2011–13.

Cigarette Tax. Governor Gregoire proposes to raise the state cigarette and tobacco product taxes. The cigarette tax would increase by one dollar, from \$2.025 to \$3.025 per pack. As justification for this increase, the governor notes that “tobacco, in all forms, continues to be a major health hazard. Increasing the price of cigarettes and tobacco products reduces con-

Distribution of Proceeds from Proposed 1.3 Percent MTCA Tax

	FY 2011	FY 2012	FY 2013	FY 2014 and Later
Storm Water Account	20%	45%	45%	70%
Oil Spill Prevention Account	2%	1%	1%	1%
Puget Sound Recovery Account	2.1%	2.4%	4.5%	9.5%
State Clean Water Account	2.1%	2.4%	4.4%	9.5%
Motor Vehicle Account	5%	5%	10%	10%
General Fund–State	69%	44%	35%	0%

sumption, especially among young people.” It is estimated that the increase would raise \$89 million in the current biennium and \$201 million in 2011–13

B&O tax on services and royalties. Governor Gregoire’s proposal to change the B&O taxation of interstate service and royalty transactions is contained in DOR request bills HB 3157 and SB 6818. This proposal was also included in HB 3176, the omnibus tax bill whose primary sponsor is House finance committee chair Ross Hunter (WRC 2010b).

The governor proposes two fundamental changes to B&O taxation of services and royalties. The first of these changes would broaden the nexus rule used to determine whether a business has sufficient connection to the state to be subject to its taxing power. Currently the state asserts nexus for the B&O tax exists if the business has a physical presence in the state. HB 3176 broadens the standard to include not just firms with a physical presence but also those with a substantial economic presence in the state, signified by annual receipts exceeding one-half million dollars from customers in the 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. The governor proposes shifting to a single factor apportionment formula based on sales. The share of revenue that would be subject to the B&O would equal the share of revenue from customers in the state.

The governor asserts that the new apportionment method would improve the competitiveness of state service and royalty businesses vis-à-vis out-of-state rivals by reducing the taxes the Washington businesses pay when they sell into other states while increasing the taxes paid by of out-of-state businesses when they sell into Washington.

The fiscal note for HB 3157 estimates that these changes would increase general fund revenues by \$73.1 million in the current biennium and \$374.6 million in the 2011–13 biennium. A DOR representative has told us that 88 percent of the net gain in revenue would come from financial institutions, with about one-half of that related to credit cards.

Sales tax on Candy and Gum. Candy and chewing gum currently fall under the sales tax exemption for food purchased for human consumption. Governor Gregoire proposes extending the sales tax to these goods, saying that this would “encourage healthier food choices.” This proposal would raise \$28 million this biennium and \$63 million in 2011–13.

Abusive tax transactions. Governor Gregoire’s proposal with respect to “abusive tax transactions” is contained in two DOR request bills, HB 2970 and its companion SB 6714. HB 2970 and SB 6714 grant sweeping powers to DOR to disregard transactions determined to be abusive:

The department must disregard, for tax purposes, abusive tax avoidance transactions. In disregarding an abusive tax avoidance transaction, the department may:

- (a) Recharacterize the nature of income, such as recharacterizing dividends received from a related entity as income received for pro-

viding services to that entity;

(b) Disregard the form of a corporate or other entity, even when legal formalities have been observed, when the form of entity is used as part of an abusive tax avoidance transaction;

(c) Treat the tax effects of the transaction, plan, or arrangement according to its underlying substance rather than its form;

(d) Treat a series of formally separate steps as a single transaction;

(e) Impute income to a taxpayer that provides services to a related person and the consideration received for providing such services does not reflect fair market value; and

(f) Take any other reasonable steps necessary to deny the tax benefit that would otherwise arise as a result of the abusive tax avoidance transaction.

Abusive tax avoidance transactions are defined:

For purposes of this section, "abusive tax avoidance transaction" means the avoidance of any tax collected by the department under the provisions of this chapter by means of a transaction, plan, or arrangement that lacks economic substance.

While economic substance is defined:

A transaction, plan, or arrangement will be considered as having economic substance only if:

(i) The transaction, plan, or arrangement changes in a meaningful way, apart from its tax effects, the taxpayer's economic position;

(ii) The taxpayer has a substantial nontax purpose for entering into the transaction, plan, or arrangement; and

(iii) The transaction, plan, or arrangement is an objectively reasonable means of accomplishing the substantial nontax purpose.

The burden is on the taxpayer to prove that the transaction, plan or arrangement has economic substance.

After reviewing HB 2960, lawyers at the firm Sutherland, Asbill and Brennan concluded:

This legislation would create uncertainty for companies doing business in the state. There are provisions of HB 2970 directing the department to adopt rules explaining its interpretation of an "abusive tax avoidance transaction," but the uncertainty that is sure to exist in the interim is likely to hinder major corporate investment in the state (Salt 2010).

HB 2960 contains a provision exposing tax practitioners to increased risk of liability in instances where their clients are found to have engaged in an abusive tax avoidance transaction.

Beyond these general provisions, the bill closes a loophole which allowed transfers of personal property to avoid sales or use tax when that property was transferred through a "step" transaction. "An example of a step transaction involves a business creating a subsidiary entity, transferring tangible assets to the subsidiary, transferring ownership of the subsidiary to another business (the acquiring business), followed by a merger of the acquired subsidiary into the acquiring business" (DOR 2010).

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.

The fiscal note for HB 2970 estimates that the bill will increase general fund revenues by \$11.6 million in this biennium and \$54.4 million in the 2011–13 biennium.

First mortgage interest deduction. Under current law, 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 the HomeStreet Bank case, Washington Supreme Court recently ruled that the portions of interest retained as servicing fees by lenders after the loan is sold on the secondary market qualify for the mortgage interest deduction. Governor Gregoire proposes to narrow the definition of interest that qualifies for deduction to exclude these servicing fees, as well as certain other fees. DOR request legislation HB 2971 and SB 6711 contain this proposal.

DOR estimates that this change will increase general fund revenues by \$8.6 million in this biennium and \$21.8 million in the 2011–13 biennium.

Syrup Tax B&O credit. In 2007 the legislature established a credit against B&O tax for syrup tax paid. The credit phased in over four years (25 percent per year) and became fully effective in FY2010. From the point of view of taxpayers, the credit effectively eliminates the syrup tax. The legislature chose to establish the credit rather than repeal the tax, so that the general fund rather than the violence reduction and drug enforcement account (to which the syrup tax was then dedicated) would bear the revenue loss. The violence reduction and drug enforcement account was folded into the general fund on July 1, 2009. Governor Gregoire now proposes to eliminate the credit. It is estimated that elimination of the credit will increase general fund revenues by \$8 million in the current biennium and \$17 million in 2011–13.

B&O preferences for processors of meats, fruits and vegetables. 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.

Governor Gregoire proposes to narrow 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. She also proposes to limit the fruit and vegetable preference to products that are at least 50 percent fruit or vegetable by weight or volume. These proposals (which are contained in HB 2971 and SB 6711) are expected to increase general fund revenue by \$4.1 million in the current biennium and \$8.8 million in 2011–13.

Corporate directors' fees. Governor Gregoire proposes to extend the B&O tax to compensation received by 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. State statutes do not currently specify whether corporate directors qualify for the employee exemption or are independent contractors. DOR request legislation HB 2972 and SB 6713 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, leaving that matter to the courts.

This proposal is expected to increase general fund revenues by \$2.1 million in the current biennium and \$4.6 in 2011–13.

B&O tax on bullion sales. Sales of precious metals and of coins made from precious metals are exempt from the sales, use and B&O taxes. Dealers do pay B&O at the service rate on any commissions earned on sales. Governor Gregoire proposes to eliminate bullion's B&O exemption. Bullion would remain exempt from the sales and use taxes. (The DOR request bills HB 2972 and SB 6713 would eliminate sales and use exemptions as well as the B&O exemption.) It is expected that this proposal will increase general fund revenues by \$210,000 in the current biennium and \$480,000 in 2011–13.

Sales and Use tax exemption for livestock nutrient equipment and facilities. Livestock nutrient equipment and facilities are currently exempt from the sales and use taxes. Governor Gregoire proposes to suspend this exemption for beef cattle feeding operations for three years, from July 1, 2010 to June 30, 2013. This proposal is contained in HB 2972 and SB 6713. It is expected that this proposal will increase general fund revenues by \$130,000 in the current biennium and \$260,000 in 2011–13.

OBSERVATION

Less than three weeks remain in the session.

Yesterday (February 22) the Senate voted for the third (and final ?) time to suspend Initiative 960's two-thirds majority requirement for tax increases for the balance of the 2009–11 biennium. It is clear that legislative leaders intend to raise taxes as part of their solution to the state's budget gap. A large number of options are on their table. Some of these are in governor's proposal; others are in HB 3176, a bill sponsored by House finance com-

mittee chair Ross Hunter; Still others are in the Senate ways and means committee chair's supplemental proposal, which was released this (February 23) morning and raises \$950 million in new revenue this biennium. Additional options will surely emerge when House leadership releases its revenue proposal. Ultimately the choice to raise taxes means that legislators will be forced to choose from among a large number of bad options.

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