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Policy Brief

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HOUSE BILL 3176:

"AN ACT RELATING TO INCREASING STATE REVENUES TO PRESERVE FUNDING FOR EDUCATION, PUBLIC SAFETY, HEALTH CARE, AND SAFETY NET SERVICES FOR ELDERLY, DISABLED, AND VULNERABLE PEOPLE BY PREVENTING ABUSIVE TAX AVOIDANCE TRANSACTIONS, NARROWING OR ELIMINATING CERTAIN TAX PREFERENCES, AND PROVIDING EQUITABLE TAX TREATMENT"

BRIEFLY

With the release of the February revenue forecast, the serious work on the budget begins for the legislature. With the senate's vote on Wednesday to suspend Initiative 960, it is clear that legislative leaders intend to raise taxes as part of their solution to the state's $2.7 billion budget gap. A large number of options will be on their table. Some of these are in HB 3176, a bill sponsored by house finance committee chair Ross Hunter. There is a lot not to like in HB 3176. But ultimately their choice to raise taxes means that legislators will be forced choosing from among a large number of bad options.

Over the next month, as it strives to close the now $2.7 billion gap in the 2009–11 budget, the legislature will consider a number of specific tax increases. The senate has already passed a bill (SB 6130) to suspend Initiative 960 with its supermajority requirement for tax increases. In this brief we will examine HB 3176, an omnibus tax bill that would make a number of tax changes. The Office of Financial Management has not yet published a fiscal note on HB 3176. House finance committee chair Ross Hunter has speculated that the bill would add $363 million dollars to general fund revenues in the current biennium.

HB 3176 is 89 pages long and is divided into 15 parts. Part 1 makes fundamental changes to the way B&O tax applies to interstate transactions in the service and royalty categories. Part II gives the Department of Revenue sweeping powers with respect to "abusive" tax avoidance transactions. Parts III–XII and XIV repeal or narrow 11 specific tax exemptions or preferences. Part XIII increases the liability of chief executives and chief financial officers for tax debts of the entities they head, while the concluding Part XV contains miscellaneous/housekeeping provisions.

B&O TAX ON SERVICES AND ROYALTIES.

HB 3176 makes two fundamental changes to B&O taxation of services and royalties. First, it broadens the nexus rule used to determine whether a business has sufficient connection to the state to be subject to its taxing power. Second, it changes the apportionment formulas used to determine the shares of multistate businesses' revenues that are subject to Washington's B&O.

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, represented by receipts of one-half million dollars from customers in the state. The relevant language is:

> A person engaging in 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;
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> (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:

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(i) More than fifty thousand dollars of property in this state;

(ii) More than fifty thousand dollars of payroll in this state;

(iii) More than five hundred 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.

Notwithstanding anything to the contrary in this section, a person is not subject to taxes imposed under this chapter on any activity not included in the definition of apportionable activities in RCW 82.04.460 [i.e. royalties and most services], unless the person has a physical presence in this state, which need only be demonstrably more than a slightest presence. For purposes of this subsection, a person is physically present in this state if the person has property or employees in this state or the person, either directly or through an agent or other representative, engages in activities in this state that are significantly associated with the person's ability to establish or maintain a market for its products in this state.

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. HB 3176 shifts 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.

Discussion. In January the Department of Revenue (DOR) estimated that these changes to the nexus and apportionment rules would raise an additional $73 billion in the second year of the current biennium and $375 million in the 2011¬13 biennium. We were told that 88 percent of this gain in revenue would come from financial institutions, with about one-half of that related to credit cards.

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. Does the HB 3176 pass constitutional muster?

DOR staff say that there are other states that use equivalent nexus standards for their corporate income taxes and that these standards have been upheld in federal district and appeals courts. 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 classifies the B&O as a sales tax.

Bill supporters assert 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 pay when they sell into Washington.

ABUSIVE TAX TRANSACTIONS.

Part II of HB 3176 grants broad general powers to DOR with respect to "abusive tax avoidance transactions."

> 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 providing 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; and
> >
> > (e) 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.

Tax treatment of transactions, plans and arrangements initiated before July 1, 2010 are grandfathered in instances where:

> The taxpayer had reported its tax liability in conformance with either specific written instructions provided by the department to the taxpayer, a determination published under the authority of RCW 82.32.410, or other document published by the department…
>
> "Specific written instructions" means tax reporting instructions provided to a taxpayer and which specifically identifies the taxpayer to whom the instructions apply. Specific written instructions may be provided as part of an audit, tax assessment, determination, closing agreement, or in response to a binding ruling request.

The bill imposes a penalty of 35 percent of the avoided tax on abusive tax avoidance transactions.

The bill directs DOR to prepare a study of the state's policy with respect to the taxation of intercompany transactions. Specifically the department is to compare Washington's taxation of intercompany transactions with that of other states.

Beyond these general provisions, the bill clarifies some ambiguous language in existing law and 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.

Discussion. Much of the language in Part II of HB 3176 has been taken from HB 2960, a bill requested by DOR. There are some significant differences between the bills, however. HB 2960 placed the burden on the taxpayer to prove an arrangement has economic substance; HB 3176 puts the burden on DOR to prove the arrangement lacks substance. HB 2960 did not grandfather transactions that had previously been blessed by DOR and did not direct DOR to prepare a study of intercompany transactions. HB 2960 contained 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.

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.

The same criticism would apply to Part II of HB 3176.

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. HB 3176 Part III caps the annual deduction for each taxpayer at $35 million.

Discussion. This cap is in part a response to the HomeStreet Bank case, in which the Washington Supreme Court ruled (correctly we believe) that amounts retained as servicing fees by lenders after the loan is sold on the secondary market are interest payments that qualify for the mortgage interest deduction. It is likely that whatever additional taxes financial businesses pay as a result of the cap will be passed on to borrowers in the form of higher interest rates.

NON RESIDENT SALES TAX EXEMPTION.

Currently purchases of tangible personal property for use outside of Washington by individuals who live in a U.S. state or possession, or a Canadian province that has a sales tax rate less than 3 percent are exempt from the sales tax. The primary beneficiaries of this exemption are residents of Oregon, Alaska, Montana and Alberta. Part IV of HB 3176 would eliminate this exemption.

Discussion. According to DOR's study *Tax Exemptions 2008*, avoided state sales taxes on nonresidents' purchases will total $78.3 million in FY 2010. (The value of the exempt purchases exceeds $1.2 billion.) The study notes, however, that the state's revenue gain would be less than this because purchases by nonresidents would decline.

Eliminating this exemption would hurt Washington retailers, particularly those located near the Oregon border.

DIRECT SELLER B&O EXEMPTION.

State law 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. The representatives pay B&O on the commissions they receive.

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, 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.

Part V of HB 3176 retroactively conforms the direct seller exemption to DOR's narrow interpretation and totally eliminates the exemption beginning April 1, 2010.

B&O PREFERENCES FOR CERTAIN 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.

Part VI of HB 3176 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.

B&O EXEMPTION FOR BULLION

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. Part VII of HB 3176 eliminates bullion's B&O exemption. Bullion would remain exempt from the sales and use taxes.

Discussion. Bullion is purchased as an investment, with the expectation that it will be resold in the future for a profit, not for consumption, thus it is appropriately exempt from the sales and use tax. The current B&O treatment of bullion is analogous to the treatment of other investments such as stocks and bonds. Bullion and coin dealers fear that the added expense will drive customers to out of state dealers or to alternative vehicles for investing in precious metals, such as gold exchange traded funds or exchange traded notes.

SALES AND USE EXEMPTION FOR LIVESTOCK NUTRIENT EQUIPMENT AND FACILITIES

Livestock nutrient equipment and facilities are currently exempt from the sales and use taxes. Part VIII of HB 3176 eliminates this exemption.

CORPORATE DIRECTOR'S FEES

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. Part IX of HB 3176 specifies that beginning July 1, 2010 compensation received as a corporate director will be subject to the B&O at the 1.5 percent service rate.

Discussion. The bill explicitly 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.

AIRCRAFT EXCISE TAX

Aircraft registered in the state are currently subject to an annual excise tax ranging from $20 to $125 depending on type. Interstate commercial aircraft are exempted from the tax, it tax applies mainly to private owners of small planes. Part X of HB 3176 increases the tax to 0.5 percent of fair market value. This is the same as the excise tax rate for watercraft.

Discussion. Because interstate commercial aircraft are exempted from the tax, it applies primarily to small private planes.

PUBLIC UTILITY TAX EXEMPTION FOR INTERSTATE COMMERCE.

The state levies the public utility tax on rail and motor transportation at the rate of 1.926 percent. Currently, however, the state exempts interstate trips from this tax. Part XI of HB 3176 eliminates this exemption, beginning July 1, 2010, and establishes a system of apportionment under which the portion of the trip within Washington State will be subject to the tax.

Discussion. At the time the public utility tax was enacted, the U.S. Supreme Court interpreted the commerce clause of the U.S. Constitution to prohibit state taxation on interstate transportation. Subsequently the Court's interpretation has changed so that states are allowed to tax the in-state portion of interstate trips as long as the tax does not discriminate against interstate commerce.

Foreclosure sales

Currently, conveyance of real estate pursuant to a foreclosure is exempt from real estate excise tax. Part XII of HB 3176 limits the exemption to instances where the property is conveyed to the mortgagee.

Discussion. Whatever the long-run merits of this exemption, the middle of a real estate based financial crisis is not a good time to hike taxes on foreclosed properties.

Tax debts

Part XIII of HB 3176 makes the chief executive and chief financial officer of a limited liability business entity personally liable for any taxes unpaid when the entity is terminated, dissolved or abandoned, or is insolvent.

Discussion. 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" and regardless of whether the failure to pay the taxes was the result of an intentional, conscious, and voluntary course of action. Such broad liability is likely to retard business development in the state by discouraging individuals from becoming chief executives or chief financial officers.

B&O credit for new employment for International Service Activities

Businesses engaged in certain international service activities are allowed a $3,000 B&O tax credit for each new job created. Part XIV of HB 3176 repeals this credit.

Discussion. Eligible activities include computer, legal, accounting, engineering, architectural, advertising and financial services. DOR reports that, from 1998 to 2007 fewer than three firms had applied for this credit.

References

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